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Re: Discussion Paper on Central Counterparty Practices to Address Non-default Losses (the "Discussion Paper") by the Committee on Payments and Market Infrastructures ("CPMI") and the Board of the International Organization of Securities Commissions ("IOSCO")

Dear Secretariats:

The Asset Management Group of the Securities Industry and Financial Markets Association ("**SIFMA AMG**" or "**AMG**")[1] appreciates the important work of CPMI and IOSCO (collectively, the "**Supervisory Authorities**") in assessing issues related to how central counterparties ("**CCPs**") address non-default losses ("**NDLs**"), including scenarios that could lead to NDLs, how NDLs can be quantified, and assessing the sufficiency of resources and tools to manage NDL risk. SIFMA AMG appreciates the Supervisory Authorities' attention to CCP risk given global clearing mandates which can expose our members to the risk of a CCP failure and the possibility of incurring losses arising from such a failure. We applaud the Supervisory Authorities for their efforts to enhance the resiliency of CCPs for participants such as our members and their investors.

Overwhelmingly, SIFMA AMG members have embraced the transition of the over-the-counter market to clearing. Our members have been consistent, engaged supporters of the global mandates for the central clearing of standardized derivatives, and have worked closely with global regulators, with clearing members, and with CCPs to enhance the regulatory framework for central clearing so that it is a resilient structure to facilitate healthy, growing cleared markets. SIFMA AMG has long advocated for a globally harmonious, risk-appropriate, and efficient ruleset targeting improvements with respect to CCP transparency, governance, capital, and margin.

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1 SIFMA AMG brings the asset management community together to provide views on policy matters and to create industry best practices. SIFMA AMG's members represent U.S. and multinational asset management firms whose combined global assets under management exceed $45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.

Our members applaud the CPMI-IOSCO's focus on:

(1) examining NDL scenarios, quantifying NDL risk, and assessing resource adequacy for NDLs;
(2) achieving operational effectiveness in addressing NDLs;
(3) testing plans to address NDLs; and
(4) providing effective governance and transparency with respect to NDL risk, both ongoing and during a loss event, including engaging with authorities, clearing members, and clearing participants.

The issue of CCP NDL risk involves opportunities to enhance CCP practices in terms of transparency, governance, and capital. And given clearing mandates, we do not believe it appropriate to rely on CCP best practices, but instead call on the Supervisory Authorities to establish clear standards to appropriately mitigate risks while allowing individual CCPs to exceed such standards in a manner tailored to individual needs. Best practices are insufficient as they may be relaxed in the event of business exigencies. Moreover, setting standards creates a level playing field of risk mitigation and minimizes the potential for competition arising from different levels of risk management.

SIFMA AMG members serve as fiduciaries for their investors and, as such, have due diligence responsibilities with respect to the risks presented by their trading counterparties. We welcome the heightened focus on CCP risks, including NDL risk, called for in the Discussion Paper as in the event NDL risk is not fully understood and addressed, we are concerned about the potential that SIFMA AMG Members may be required to contribute in the event of a loss. SIFMA AMG commits to engage closely with the Supervisory Authorities as this effort progresses.

In this letter, we will express general observations about CCP NDL risk; including its connection to CCP transparency, governance, and capital reserves; and our thoughts as to the questions raised in the Discussion Paper.

I. General Observations:

SIFMA AMG members primarily engage in futures, options, and other derivatives with a CCP through the services of a clearing member. The mandated transition to the clearing of certain derivatives, together with the voluntary clearing of other products, has produced efficiencies for our members and for the market generally. And it is for this reason that SIFMA AMG members have remained fully committed to secure enhancements to the ruleset associated with clearing to reduce certain risks presented by clearing and to better ensure the resiliency of cleared markets for the future.

With respect to CCP NDLs, we maintain it is inappropriate for clearing participants to bear a CCP's NDLs. Clearing members and their customers are not involved in the decisions or management oversight that could lead to a CCP's NDLs, including operational failures, fraud, theft, cyber-threats, and attacks that could lead to monetary loss or market value loss of margin investments. We applaud the Supervisory Authorities in their efforts to assess existing risks and practices and to consider potential regulatory gaps and more appropriately address CCP capital in a manner commensurate with the risk managed by the CCPs. While the PFMI's are intended to require CCPs to be accountable for their risk management decisions, we remain concerned that beyond requiring limited capital coverage for NDLs, CCPs may inappropriately seek to allocate losses and costs in excess of the required coverage to clearing participants.

With respect to transparency and governance, SIFMA AMG believes clearing participants should play a well-defined role in identifying and assessing CCP NDL risk and mitigation approaches, including with respect to CCP IT controls and cyber risk practices. We encourage the Supervisory Authorities to develop strong NDL mitigants (policies, procedures, and back-testing), as well as the requirement for adequate CCP resources to cover the NDL without recourse to clearing participants.

SIFMA AMG asserts that CCPs should maintain appropriately sized capital requirements to cover NDLs for which they are responsible, and neither a CCP's default fund nor clearing participants should be used to cover NDLs. The incentive effect of a comprehensive capital regime – including addressing NDL risk - is enhanced when it is not left to a more voluntary approach – no matter how strong current practices are. We agree with applicable law in some jurisdictions which prohibits the use of mutualized financial resources intended for default-related purposes to be used to cover NDLs. The CCP should be responsible for NDLs including the market value investment losses related to the investments a CCP directs, for clearing participants' funds. And it is important to note that as CCPs' distinct operations likely present different NDL profiles, such differences should be considered in determining the approach to address NDL risk.

II. Executive Summary:

A. **CCPs Own NDL Risk:** The Supervisory Authorities must act to confirm that NDL risk, including operational failures, fraud, theft, cyber-threats, and attacks that could lead to monetary loss or market value loss of margin investments, are solely the responsibility of the CCPs and should not be mutualized to clearing participants.

B. **Standards.** Recommended best practices have proven insufficient to adequately mitigate CCP risks, including NDL risk. The Supervisory Authorities must work to develop global standards to create a robust, consistent, and ever improving CCP risk management approach.

C. **Third Parties:** Supervisory Authorities should address the risk presented by third parties relevant to CCP NDL risk including, but not limited to, custodians and settlement banks.

D. **Engage Experts to Develop Standards:** Supervisory Authorities should leverage experts from clearing participants in their work to develop standards, including standards to identify applicable scenarios, assess the risk within and across such scenarios, develop policies and procedures to mitigate scenario risk, require back-testing to assess the efficacy of such policies and procedures, and identify capital reserves tailored to meet NDL risk should risk mitigants fail.

- **E. Transparency**: Due diligence concerns must trump confidentiality issues as CCP risk data and performance must be disclosed to clearing participants who can sign non-disclosure agreements to mitigate confidentiality concerns.

- **F. Governance**: Experts from clearing participants must be included in CCP risk committees to oversee CCP risk mitigation policies and procedures and advise CCPs upon the occurrence of a non-default event.

- **G. Capital**: CCP capital reserves to address NDL risk cannot be set to meet static, arbitrary levels, but instead must be informed by risk scenarios and performance and calibrated by the size of the actual risk presented by each CCP's unique business model against market conditions. Committed liquidity facilities and third-party insurers should be required to address the risk that CCP reserves for NDLs are insufficient.

III. Responses to Questions

A. Overarching Questions.

1. Are there areas in the context of CCP NDLs where further guidance under the PFMI might be helpful? If so, what are the potential areas where further guidance might be most helpful?

The PFMI's should require an assessment of CCP NDL risk, including operational failures, fraud, theft, cyber-threats, and attacks that could lead to monetary loss or market value loss of margin investments. The required assessment should be comprehensive and conservative with the aim to develop practices to manage the risk and reserve capital to fund such losses should they occur - without recourse to default resources or to clearing participants. Stress testing should be performed to demonstrate that mitigation strategies worked and that there were adequate CCP resources dedicated to meet all losses.

The assessment, development of mitigant tools, stress testing, and capital adequacy should receive input and oversight of a risk committee including clearing participants with transparency provided to risk committee members.

2. Are there any additional points of consideration or practices, in addition to those mentioned in this discussion paper or in the PFMI and existing guidance, that would help CCPs effectively and comprehensively address losses from non-default events? Are there areas that require additional clarity from authorities? If so, what are they?

We want to emphasize that points of consideration or the development of best practices are insufficient given the importance of CCPs and clearing to capital markets. While nuanced approaches to risk management may be appropriate given different CCP business models and a degree of flexibility may be needed to address market conditions, standards must be mandated with respect to the assessment of risk, development and application of tools, review and stress testing of performance, and capital adequacy to avoid recourse to default resources or to clearing participants.

3. **Are there particular challenges that CCPs face in planning for an orderly wind-down in a NDL scenario? Are there means to motivate further progress in orderly wind-down planning?**

Across the areas of NDL risk including operational failures, fraud, theft, cyber-threats, and attacks that could lead to monetary loss or market value loss of margin investments, it is unclear to us what unique challenges are presented to CCPs that are not present for other market participants. Especially as clearing participants have limited transparency into or oversight of CCP operational decision making and risk management, it is completely inappropriate to consider clearing participant assets as a resource for CCP NDLs.

4. **Would a similar review of practices in the context of NDLs for FMIs other than CCPs be helpful? Would further guidance under the PFMI be helpful in this context?**

As custodian and settlement bank risk represents a possibly meaningful component of CCP NDL risk, further PFMI guidance with respect to the oversight and accountability for those types of entities is completely appropriate.

B. Identifying NDL scenarios, quantifying NDLs and assessing the sufficiency of resources (Section 2)

5. **How can a CCP identify potential NDL scenarios comprehensively as well as with an appropriate degree of granularity?**

In our view, there are several best-in-class CCPs that have in place policies and procedures to assess NDL scenarios, strong controls to mitigate NDL risk, effective back-testing to test such controls in such scenarios, and sizeable capital reserves relative to such NDL risk.

As noted previously, while nuanced differences in approach reflecting different CCP business models may be appropriate, materially different levels of NDL risk mitigation could serve to limit effectiveness and could be deployed for competitive advantage. We recommend that the Supervisory Authorities compile a record of such best in class scenarios, policies and procedures, controls, and capital approaches to develop robust standards as a tool to inform the development of robust standards for application globally. While individual CCPs may present different types and levels of risk, each should be subject to effective minimum standards that they can build on as needed.

6. **Given that a CCP's efforts to prevent losses from non-default events may fail, what are effective approaches to prepare for and address resulting losses, in particular from low-probability, high impact events?**

Our members appreciate that the Supervisory Authorities are thinking beyond NDL risk management policies and procedures to the need for CCP capital reserves for use should such policies and procedures fail. And we believe the resources needed should not be limited to more of a static number and should instead be informed by the actual risk. We also acknowledge that the clearing community (including both clearing members and participants) has a wealth of dedicated experts that should be deployed as a part of both regulatory standard setting and CCP ongoing transparency and governance.

Experts in operational risk, CCP business risk, investment and counterparty risk, custody risk, legal risk, cyber risk, etc., should be convened to review the best-in-class approaches compiled as noted in our answer to the previous question. In addition to applying such experts to assist in developing global standards, the added transparency can serve as a potential governor to better assess what level of risk participants are prepared to take with respect to their CCPs. While the qualitative and quantitative PFMIs have assisted in participant due diligence, there are still gaps in terms of the timeliness, consistency, and quality of the information provided.

Participant experts assisting in the assessment and standard setting of NDL risk regulations and serving on CCP risk management governance committees will inevitably lead to more robust practices while at the same time better allowing participants to calibrate business levels commensurate with the level of risk being managed.

7. **Are approaches such as sensitivity analysis, scenario simulations, drills, or stress-testing analysis useful for quantifying resource needs and assessing adequate NDL coverage? If so, what are potential obstacles hampering progress in this area and what could be possible avenues for reducing those obstacles?**

In the experience of SIFMA AMG members, CCPs have been reluctant to embrace aspects of our preferred approach to transparency, governance, and capital, citing business sensitivities and competitive pressures. And while we acknowledge the presence of such sensitivities, we remain concerned that multi-year efforts to voluntarily collaborate to improve practices have proven unsatisfactory. Given the existing levels of clearing – both voluntary and mandated – as well as the anticipated growth in clearing - both voluntary and mandated – the need for mandated standards is clear.

And, as noted above, the clearing community has a wealth of experts among both clearing members and clearing participants who should be leveraged in both standard setting and ongoing CCP transparency and governance to enhance the resiliency of our market critical clearing ecosystem.

8. **Are there particular types of NDL scenario that CCPs could consider to help assess potential resource needs and coverage for NDLs? (e.g., stressed business and operational risk scenarios extrapolated from past events, NDL scenarios exacerbated by wider macroeconomic stress, or other hypothetical NDL scenarios)?**

SIFMA AMG members have concerns with CCP NDL risk involving operational failures, fraud, theft, cyber-threats, and attacks that could lead to monetary loss or market value loss of margin investments. To add more detail to this list, we recommend the Supervisory Authorities focus on the following areas of risk for global base-line standard setting:

- Investment losses unrelated to member defaults (including failures of repo counterparties and defaults or downgrades in credit ratings of sovereigns) – the scenarios should consider the investment strategy of the CCP and the potential sizes of exposures using their own historical data.
- Losses arising from failures of securities custodians or settlement banks unrelated to member defaults – historical data should be used as a guide for potential exposures, and scenarios should consider both wider market stress and an unexpected failure due to an idiosyncratic event.
- Losses caused by fraud, theft, or other bad acts of employees and/or third parties – CCPs should consider access rights and permissions given to employees and third parties whilst estimating the magnitude of potential harms.
- Losses resulting from cyber-attacks – CCP's should consider vulnerabilities, and the time required to execute remediation plans and potential for stolen assets in estimating loss magnitudes and should also include any mitigants such as insurance policies.
- Losses from operational or systems failure – again, CCP's should consider vulnerabilities, failover options (including backup sites in alternative geographic locations), IT release testing procedures, etc in assessing potential harm and should use data from prior all operational/system related failures in making this assessment.
- Losses from legal claims against actions by CCP management in the course of managing the CCP.

Obviously, this is a significant undertaking, and our members stand ready to contribute to the analysis and standard setting and to play an ongoing role serving on substantive CCP risk management committees.

9. **How and to what extent can the potential simultaneous occurrence of default and non-default related events be taken into account?**

The simultaneous occurrence of both default and non-default losses is a very real possibility – especially given the multiple roles clearing members and even clearing participants may play across the clearing ecosystem. The effective scenario analysis identified above must include the impact of the potential default of a clearing member or clearing participant that may also play another role for the CCP (e.g., repo counterparty, investment agent, settlement bank etc.). For example, it would be prudent to assess the failure of a clearing member who may also serve as the CCP's custodian and/or settlement bank.

And, as noted previously, while the default of one or more clearing members may also involve non-default losses should the clearing member also serve the CCP in another capacity, default losses must be treated differently from NDLs, with NDL losses never applied against the default fund or otherwise mutualized across clearing participants.

10. **What factors, in addition to those suggested in the PFMI, might a CCP helpfully consider when calculating the amount of liquid net assets funded by equity that is sufficient to implement its recovery and orderly wind-down plans? How can a CCP effectively incorporate its general business risk profile and the length of time required to achieve recovery or orderly wind-down into this analysis?**

As noted previously, our members are not comfortable with existing guidance where too much discretion is afforded to the CCPs. This includes the approach of the existing PFMIs whereby CCPs assess the necessary liquidity needs based, among other things, on their own NDL planning and scenario analysis. While many best-in-class CCPs voluntarily set aside relatively larger amounts to cover NDLs, the practice is not consistent, and the voluntary nature of the practice lends itself to abuse given business exigencies.

SIFMA AMG members recommend the Supervisory Authorities establish standards based on best-in-class scenario analysis informed using experts from across the clearing ecosystem. Across the areas of NDL risk including operational failures, fraud, theft, cyber-threats, and attacks that could lead to monetary loss or market value loss of margin investments, a quantitative analysis of on-going business levels can inform the appropriate reserves for NDL losses tailored to each CCP's unique business approach and the risk thereof.

The capital needs of banks have received significant attention during the past ten years, and it is now time for CCP capital requirements – for each of default and NDL risk – to receive a similar level of focus and standard setting.

11. **Given the limited availability of historical data on severe NDL events, what do you consider the most important sources of information in developing plans to address NDLs, particularly for potential recovery situations (e.g., internal expertise, key stakeholders such as clearing participants and service providers, external market experts, relevant authorities, frameworks, and practices in place for other types of financial institution)?**

As previously discussed, through the leveraging of best-in-class scenario analysis, as well as input from experts across the clearing ecosystem, appropriate base-line standards can be set addressing the common risks outlined above, which can then be added to as required given the risk profile of individual CCPs. To supplement internal CCP expertise, risk management committees must include experts from across clearing members and clearing participants as a check on the potential conflict involving CCP self-assessments.

12. Do you have any suggestions for how the clearing industry could leverage loss data from other industries or collaborate to share anonymised loss data?

Through the involvement of experts from clearing participants, the sharing of industry loss data will naturally be achieved – both in setting standards and in ongoing risk management through inclusive CCP risk committees. To not involve experts from a diverse range of participants can only serve to compromise the success of these efforts.

13. What key measures can help to ensure that capital replenishment could be achieved in a timely and effective manner? Does the clear definition and testing of processes to obtain backup funding from affiliates or external sources underpin the credibility of that funding? How do you assess the current availability of committed or legally binding funding arrangements?

SIFMA AMG members firmly believe that as a part of the standards to be set, CCPs should be required to have formal plans to obtain capital replenishment whether from affiliates or external sources. And we note that the viability of such formal plans can only be increased if the NDL risk management process is transparent, involves robust governance including experts from clearing participants, and establishes realistic funding needs from the outset instead of setting funding levels at comparatively arbitrary regulatory minimums. In addition, the Supervisory Authorities should carefully consider the merit of requiring the use of pre-positioned resolution resources ("TLAC type" resources) for NDL.

14. What role should insurance play for NDL, considering potential uncertainties about coverage, pay-out delays and performance risk? Are there certain types of NDL risk for which insurance may be a more appropriate loss-absorbing resource than for other types of NDL risk?

The use of external insurance is highly recommended, especially as it leverages resources outside of the clearing ecosystem and is thereby likely to be insulated from losses affecting the CCP. An added benefit is the due diligence to be performed (and robust risk management practices to be required) by the insurance provider. Insurance providers will also inevitably apply external data sources to assess low-probability NDL risks.

15. What practices might improve CCPs' planning for an orderly wind-down necessitated by NDLs?

Plans for an orderly wind-down are naturally enhanced when the CCP is required to meet consistent standards including transparency, governance, and capital requirements. NDL scenario construction, assessment, risk mitigation policy development, back-testing, and capital reserves – all informed by a diverse governance team involving clearing participants – can best avoid the need for wind-down while charting an orderly course should wind-down be required. Individualized approaches, with the CCPs having greater discretion in application, present a greater risk for unanticipated consequences at wind-down.

C. Achieving operational effectiveness (Section 3)

16. Are there any additional notable practices that could promote the operational effectiveness of plans to address NDLs?

As noted previously, SIFMA AMG firmly believes it is time for the Supervisory Authorities to implement consistent standards to address CCP risk, including NDL risk. And such standards must be developed with input from experts including clearing participants. And on-going, CCPs must be required to have robust governance practices to oversee risk management including the participation of experts from clearing participants.

17. What approaches might be helpful to ensure that relevant third parties (such as service and liquidity providers) fully understand and are prepared for their potential role in addressing NDLs?

Service and liquidity providers must be included both in scenario analysis and NDL risk management planning. As noted previously, we recommend the Supervisory Authorities extend their focus to custodians and settlement banks. Liquidity planning must require pre-approved funding sources such as affiliates, third parties, and insurance providers.

18. What are the essential elements of appropriate due diligence vis-à-vis relevant third parties on which CCPs would expect to rely in an NDL event?

We agree whole-heartedly that applicable standards must require CCPs to perform comprehensive due diligence on their clearing members and relevant third parties. This should extend to third parties that would have a role in either causing or mitigating NDL events.

19. What are the key factors and constraints that impact the choice and order of different tools for the various types of NDL scenario?

Standards for tool usage to address NDL risk must be informed by experts from the clearing ecosystem, and on an on-going basis can be guided by a CCPs own robust risk committee governance approach involving experts from clearing participants.

20. What technological tools should be developed to promote the operational effectiveness of plans to address NDLs?

In our experience, scenario construction, analysis, and back-testing are of critical importance. Especially with respect to cyber-attacks, a robust IT infrastructure, well-guarded and with clear dependable redundancies, is fundamental. Again, experts at clearing participants are best situated to inform standard setting and contribute to oversight through the risk committees.

D. Reviewing and testing plans for NDLs (Section 4)

21. Are there additional notable practices for reviewing and testing plans to address NDLs?

SIFMA AMG members firmly believe that there needs to be standards requiring enhanced transparency and governance inclusive of clearing participants. This cannot be left to recommended best practices as we have long found disclosures to be out of date, inconsistent, and unreliable. The participation of experts from clearing participants in the development of the standards and then on CCP risk committees will help to ensure both accountability and better outcomes.

22. What challenges are there to achieving the goal of increasing the involvement of additional stakeholders in different stages of review and testing of plans to address NDLs?

We have long heard that confidentiality concerns merit limiting the scope of involvement by clearing members and clearing participants in CCP risk issues. We believe it is time to address such a concern to find ways to minimize the exploitation of confidential information while at the same time leveraging external expertise and sharing information involving risk issues in a more timely, consistent, and accurate manner. We believe clearing participants and third parties have no issue with signing non-disclosure arrangements to manage confidentiality issues. It is critical clearing participants have a full understanding of the risks presented by clearing so that they can manage their own exposures. Especially as there are often limited CCPs offering access to certain markets, and the clearing of certain products may be mandated, there must be standards for enhanced transparency and inclusive governance going forward.

23. Are multi-CCP crisis management drills an effective tool for testing preparedness to address NDLs? Are there any barriers to effectively conducting this type of exercise? What role should authorities play in supporting these exercises?

Multi-CCP fire drills are an excellent way to evaluate the effectiveness of policies and procedures as well as capital adequacy. To be most effective, such drills should involve CCPs, third party service providers, clearing members, and clearing participants and should be overseen with the direct involvement of the relevant authorities.

As noted previously, and especially for NDLs, stress testing of policies and procedures and capital should be performed by each CCP as many types of non-default risk may more likely be specific to a certain CCP. While custodian or settlement system fails may affect multiple CCPs simultaneously, risks involving fraud and cyber-attacks may affect only one CCP.

E. Providing effective governance, transparency and engagement with participants and authorities (Section 5)

24. Are there additional notable practices for providing effective governance, transparency and engagement with participants and authorities in the context of NDLs?

The most effective approach will be to engage clearing participants in the process of setting standards and then including them in CCP risk committees to oversee compliance and address developments going forward.

25. What are the most important elements of appropriate processes and governance arrangements for rule-based loss allocation to support clearing members in anticipating and preparing for potential exposures?

In general, NDL risk should be borne by CCPs and not applied against the default fund or mutualized among clearing participants. To mitigate the risk of NDLs, clearing participants should be involved with authorities in the development of standards and then should be engaged in an ongoing basis on CCP risk committees. The crafting of NDL scenarios, the assessment of risk within such scenarios, the development of policies and procedures to address such risk, stress -testing such policies and procedures, and reserving adequate capital (including third-party committed funding sources) must be mandated and not left to individual CCP best practices.

SIFMA AMG appreciates the important work of CPMI and IOSCO in assessing issues related to how CCPs address NDLs which can expose our members to the risk of a CCP failure and the possibility of incurring losses arising from such a failure. We applaud the Supervisory Authorities for their efforts to enhance the resiliency of CCPs for participants such as our members and their investors.

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We look forward to participating in future discussions on the topic of CCP NDLs as well as enhancements to CCP transparency, governance, capital, and margin and we look forward to discussing these comments. Should you have any questions, please contact William Thum at 202-962-7381 or bthum@sifma.org.

Respectfully submitted,

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