

# FEDERAL RESERVE BANK OF CHICAGO

**MICHAEL H. MOSKOW**

President and Chief Executive Officer

June 8, 2004

Secretariat to the CPSS-IOSCO Task Force on Securities Settlement Systems Bank for  
International Settlements CH-4002 Basel, Switzerland  
Email: [cpss@bis.org](mailto:cpss@bis.org)

Re: Recommendations for Central Counterparties, Committee on Payment and  
Settlement Systems and Technical Committee of the International Organization of  
Securities Commissions

Dear Mr. Nakajima:

The Federal Reserve Bank of Chicago (the "Chicago Reserve Bank") welcomes the opportunity to provide comments on the Consultative Report of the Task Force on Securities Settlement Systems, entitled Recommendations for Central Counterparties (the "Consultative Report"). The Consultative Report sets out comprehensive standards for the design, operation and oversight of securities settlement systems that utilize a central counterparty ("CCP") in the clearing and settlement of financial transactions. Consistent with widespread international usage, the Consultative Report uses the term "security" to include derivatives contracts. Therefore, we read the term "securities settlement system," as used in the Consultative Report, to mean ". . . the full set of institutional arrangements for confirmation, clearance and settlement of securities [and derivatives] trades and safekeeping of securities." (Consultative Report, Annex 1, Glossary).

The Chicago Reserve Bank has a special interest in the formulation of standards for the design, operation and oversight of systemically important payment systems and securities settlement systems. As you may be aware, Chicago is home to a number of important exchanges, CCPs and commercial banks that provide settlement services to market participants. The CCPs based in Chicago play a key role in the clearing and settlement of derivatives transactions and are critically reliant upon the safe and effective operation of the payment system, routinely processing well over a billion dollars in settlements daily. Moreover, these CCPs have substantial and complex clearing linkages to other domestic and international CCPs.

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As these components of the securities settlement system have grown significantly, together with their potential impact on the financial system, the Chicago Reserve Bank has sought to understand the systemic implications of CCPs for the payment system, the wide range of institutions involved in the settlement of financial transactions and financial stability in

general. For that reason, the Chicago Reserve Bank has closely followed and generally supported previous financial stability initiatives of the Committee on Payment and Settlement Systems of the central banks of the Group of Ten countries ("CPSS") and the Technical Committee of the International Organization of Securities Commissions ("IOSCO").

The enclosed paper, which was prepared by Chicago Reserve Bank staff, provides comments on the scope and application of the recommendations. On balance, the Chicago Reserve Bank believes that they are sufficiently comprehensive and flexible to be useful for their intended purpose. However, we also believe that certain revisions concerning the scope and application of the recommendations would be helpful. To assist the Task Force in its work, we have provided the details of those suggested revisions in the enclosed paper.

I hope you will find the Chicago Reserve Bank's comments on the Consultative Report useful. I want to thank you for inviting comments and I would welcome any further discussion or clarification of our comments that you may find helpful. If my staff or I may be of further assistance, please do not hesitate to contact one of us.

Sincerely,



Enclosure

## FEDERAL RESERVE BANK OF CHICAGO

Comments<sup>1</sup> on the Consultative Report of the Task Force on Securities Settlement Systems, *Recommendations for Central Counterparties*, Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions

June 8, 2004

### I. Introduction

The Federal Reserve Bank of Chicago (the “Chicago Reserve Bank”) supports the efforts of the Committee on Payment and Settlement Systems of the central banks of the Group of Ten countries (“CPSS”) and the Technical Committee of the International Organization of Securities Commissions (“IOSCO”) to formulate flexible, risk-focused recommendations for securities settlement systems that utilize a central counterparty (“CCP”) in the clearing and settlement of systemically important financial transactions.<sup>2</sup>

Clearing and settlement systems are critical to the stability of the financial system, a system that is increasingly interconnected and global in scope. As the Task Force on Securities Settlement Systems (the “Task Force”) notes in its Consultative Report, entitled *Recommendations for Central Counterparties* (also referred to as the “Consultative Report”), CCPs have “. . . long been used by derivatives exchanges and a few securities exchanges and trading systems” as a key component of their clearing and settlement arrangements. (Consultative Report at §1.1). More recently, as the Consultative Report also notes, CCPs have been “. . . introduced by many more securities exchanges and have begun to provide their services to over-the-counter markets, including markets for securities repurchase agreements and derivatives.” (Id.). Accordingly, the Chicago Reserve Bank believes that it is especially appropriate to establish broadly applicable, internationally-agreed-upon standards for the design, operation and risk management of CCPs and similar credit risk enhancement arrangements that support securities settlement systems.

The Chicago Reserve Bank appreciates this opportunity to provide the Task Force with comments on both the scope and application of the recommendations. On balance, the Chicago Reserve Bank believes that they are sufficiently comprehensive and flexible to be useful for their intended purpose. However, we also believe that certain revisions

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<sup>1</sup> This commentary was prepared by the following Federal Reserve Bank of Chicago staff: Richard Lamm, John McPartland, Tara Rice and Robert Steigerwald.

<sup>2</sup> The Chicago Reserve Bank notes that the *Recommendations for Central Counterparties* represents an extension of the *Recommendations for Securities Settlement System* (“SSS Recommendations”), jointly adopted in November 2001 by CPSS and IOSCO. The Bank also notes that substantially similar standards have been adopted for systemically important payment systems. See, *Core Principles for Systemically Important Payment Systems*, Committee on Payment and Settlement Systems of the central banks of the Group of Ten countries (January 2001).

affecting the scope and application of the recommendations would be helpful. The Chicago Reserve Bank's comments concerning those matters follow:

## II. Comments

### A. Scope of Application: Guarantees, Other Credit Enhancement Structures and Clearing Intermediaries

The Consultative Report defines a CCP as “. . . [a]n entity that interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer.” (Consultative Report, Annex 1: Glossary). That definition accurately describes the formal characteristics of a central counterparty clearing arrangement: namely, that a CCP becomes a substituted principal to contract obligations originating with other members of a financial market. Because it is interposed as both the buyer to the seller and the seller to the buyer, the CCP's market risk exposure is symmetric and offsetting – such risk effectively remains with the original counterparties to the trade. Credit risk (including replacement cost risk<sup>3</sup>), on the other hand, is centralized in the CCP itself – making it unnecessary for the original counterparties to initially evaluate or continuously monitor each other's creditworthiness. In fact, participants in a market that utilizes a CCP to provide credit enhancement may be entirely unknown to each other.

By centralizing credit risk management functions in a financial market, a CCP has the “. . . potential to reduce significantly risks by market participants . . . [and] enhance the liquidity of the market that it serves. . . .” (Consultative Report at §1.2). In particular, the utilization of a CCP may facilitate multilateral netting of obligations and payments, centralize collateral management and credit risk monitoring and permit market participants to trade anonymously, because they do not bear counterparty credit risk other than to the CCP. As the Consultative Report observes, these functions also “. . . concentrate risks and responsibility for risk management in the CCP . . . [making it critical to evaluate] the effectiveness of a CCP's risk controls and the adequacy of its financial resources. . . .” (Id.).

However, the use of a CCP is simply one of many possible alternative structures that may be used to meet the credit risk management objectives of a financial market.<sup>4</sup>

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<sup>3</sup> The replacement cost risk that a CCP bears as a result of being interposed as a “synthetic” market participant is, of course, inversely related to the market risk that original counterparties to the trade retain. That is, the CCP is exposed to the risk of loss, in the event of the default of one of its counterparties, of the “in the money amount” (the amount owed by the defaulting counterparty to the CCP); that amount is identical to the defaulting counterparty's “out of the money amount” (the amount it owes to the CCP), as both are defined by the same underlying variation in market prices.

<sup>4</sup> See, e.g., B. Hills, et al., *Central counterparty clearing houses and financial stability*, Bank of England, Financial Stability Review at 122, 124 (June 1999): “Of course, a central counterparty is not the only means of controlling counterparty credit risk.” See also SSS Recommendations at §1.10: “Because of the diversity of institutional arrangements internationally, the recommendations must focus on the functions to be performed, not on the institutions that may perform them.”

For example, as the Consultative Report points out, the performance of trade obligations can be assured through the use of a guarantee fund without counterparty substitution. Such a fund “. . . would be used to compensate non-defaulting participants from losses they may suffer in the event that one or more participants default on their obligations as counterparties.” (Consultative Report at §2.3). Because the use of a guarantee fund as a credit enhancement structure for a financial market may pose the same risks as those associated with the use of a CCP,<sup>5</sup> the Chicago Reserve Bank fully supports the Task Force’s decision to extend the application of relevant parts of the recommendations to guarantee arrangements.<sup>6</sup>

Credit enhancement structures for financial markets may emerge in the future that do not utilize either a traditional CCP or a guarantee fund, or that are hybrid structures having some, but not all of the characteristics of a CCP or guarantee fund. In fact, it appears that such structures are currently being developed for so-called “business-to-business” (or “b2b”) and over-the-counter markets.<sup>7</sup> This is hardly surprising, since most of the economic functions performed by a typical CCP – such as facilitating multilateral netting, centralized collateral management and credit risk monitoring, etc. – can, depending upon applicable law, be accomplished without interposing a CCP as a “synthetic” market participant. Because such structures may pose the same risks as those that utilize a CCP or guarantee arrangement, the Chicago Reserve Bank believes that relevant parts of the recommendations should apply to economically equivalent credit enhancement arrangements, if such arrangements are systemically important.

The Chicago Reserve Bank recognizes, however, that imposing the full panoply of requirements set forth in the recommendations to alternative credit enhancement structures may have unintended costs, including the possibility of impeding innovation and competition, that are not justified by the benefits of such regulation. To avoid either

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<sup>5</sup> See Consultative Report at § 2.3: “Although such [guarantee] arrangements do not involve a CCP, they do create a concentration of responsibility for risk management. A risk management failure by the operator of such a guarantee fund would have effects similar to those of a risk management failure by a CCP – the liquidity of the market for which it guarantees trades would be disrupted, and possibly the payment and settlement systems used to settle trades in those markets.” See also, B. Hills, et al., *Central counterparty clearing houses and financial stability*, Bank of England, Financial Stability Review at 122, 129 (June 1999)(discussing problems experienced in 1987 in connection with the Hong Kong Futures Guarantee Corporation).

<sup>6</sup> See discussion at Part II.A.1 *infra*.

<sup>7</sup> For example, the Virtual Markets Assurance Corporation (“VMAC”) describes itself as a provider of “. . . [a] suite of broadly applicable hedges which allow qualified participants to mitigate the credit and liquidity risks associated with the forward contracting of OTC instruments. The . . . VMAC hedging program allows participants to settle all mark-to-market amounts with a single hedge counterparty, resulting in a reduction of up to 90% in the amount of capital required to support mark-to-market obligations.” See [www.vmac.com](http://www.vmac.com). Although VMAC uses “a single hedge counterparty” in connection with its service, our understanding is that this arrangement falls short of being a true CCP. Since VMAC provides clearing services to some, but not necessarily all, of the participants in a market, it does not appear that either VMAC or any other entity becomes the buyer to every seller and the seller to every buyer in the markets for which VMAC provides credit enhancement services.

over-inclusive or under-inclusive regulation of potentially beneficial financial arrangements, we believe that the recommendations should be applied to credit enhancement structures, if systemically important, that facilitate:

- multilateral netting of obligations and/or payments; or
- centralized collateral management and/or credit risk monitoring.

Structures that do not constitute part of a clearing and settlement system, as defined by each relevant national authority, and are characteristic of common services provided by commercial banks would be excluded from the scope of application of the recommendations, as would purely bilateral arrangements.

The following are specific comments concerning the application of the recommendations to guarantees and other credit enhancement structures that do not utilize a CCP, as well as clearing participants that act as trade intermediaries:

*1. Guarantees and Other Credit Enhancement Structures<sup>8</sup>*

As noted above, the Chicago Reserve Bank fully supports the Task Force's decision to extend the application of relevant parts of the recommendations to guarantees. In particular, we believe that guarantees should be subject to each of the following recommendations:

- Recommendation 1: Legal Risk
- Recommendation 4: Financial Resources
- Recommendation 5: Default Procedures
- Recommendation 6: Custody and Investment Risks
- Recommendation 9: Physical Deliveries
- Recommendation 12: Governance
- Recommendation 13: Transparency
- Recommendation 14: Regulation and Oversight

Furthermore, the Chicago Reserve Bank believes that relevant parts of the recommendations should apply to certain alternative credit enhancement structures that do not utilize either a traditional CCP or a guarantee fund, or that represent hybrid structures having some, but not all of the characteristics of a CCP or guarantee fund. In particular, we believe that such arrangements should be subject to each of the following recommendations:

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<sup>8</sup> The Chicago Reserve Bank believes that the recommendations relating to legal certainty, adequacy of financial and operational resources, default procedures, and custodial and investment risks, physical deliveries, governance and transparency should apply to guarantee arrangements. Specifically, the Chicago Reserve Bank believes that the following subsections of the Consultative Report are relevant to guarantee arrangements: 2.3, 3.4, 3.5, 3.6, 4.1.1, 4.1.3 to 4.1.10, 4.2.1 to 4.2.5, 4.3.1 to 4.3.9, 4.4.1 to 4.4.12, 4.5.1 to 4.5.9, 4.6.1 to 4.6.4, 4.7.4, 4.7.6, 4.7.8, 4.9.1 to 4.9.5, 4.12.1, 4.12.2 to 4.12.6, 4.13.1 to 4.13.3 and 4.14.1 to 4.14.4. This additional level of detail is being provided since it does not seem appropriate for all subsections to be applied to guarantee arrangements.

- Recommendation 1: Legal Risk
- Recommendation 4: Financial Resources
- Recommendation 5: Default Procedures
- Recommendation 6: Custody and Investment Risks
- Recommendation 7: Operational Risk
- Recommendation 8: Money Settlements
- Recommendation 9: Physical Deliveries
- Recommendation 12: Governance
- Recommendation 13: Transparency
- Recommendation 14: Regulation and Oversight

## 2. *Clearing Participants as Trade Intermediaries*

The Task Force specifically requested public comment concerning the application of the recommendations to clearing participants that serve as intermediaries through which other market participants access CCPs. As CPSS and IOSCO explained in adopting the SSS Recommendations, one rationale for extending minimum design, operational and risk management standards to market participants who utilize the services of a CCP is that “. . . the distinctions between the functions of CSDs [Central Securities Depositories] and custodians have become blurred in some markets where custodians settle trades between clients on their own books.” (SSS Recommendations at §1.10). In markets where custodians perform such functions “. . . some of the [SSS Recommendations] addressed to CSDs may need to be applied to such custodians.” (Id.). Recognizing the diversity of institutional arrangements for clearing and settlement of financial transactions internationally, CPSS and IOSCO also concluded that many of the SSS Recommendations “. . . are also relevant to the broker-dealers, banks, investment managers and investors who use the services provided by [custodians and CSDs].” (Id.).

CPSS and IOSCO also recognized that the application of the SSS Recommendations to such market users and participants poses thorny issues of regulatory jurisdiction and requires careful balancing of the costs and benefits of regulation. Therefore, they concluded that “. . . [s]ecurities regulators, central banks and, in some cases, banking supervisors will need to work together to determine the appropriate scope of application of the [SSS Recommendations] and to develop an action plan for implementation.” (Id.). The Chicago Reserve Bank believes that the same public policy considerations are relevant to the application of the recommendations discussed in the Consultative Report to clearing participants that serve as intermediaries through which other market participants access a CCP.

Nevertheless, clearing participants that act as intermediaries for other market participants serve a critical role as “gatekeepers” to the clearing and settlement infrastructure for financial markets. As noted above, a CCP becomes a substituted principal to contract obligations originating with other members of a financial market – making it unnecessary for the original counterparties to initially evaluate or continuously monitor each other’s creditworthiness. Market participants that use the services of a clearing intermediary are not, however, protected against the credit risk associated with

their own intermediaries. That is, the interposition of a CCP assures that the original buyer in a financial transaction is protected against the default of the original seller (and vice versa); nothing in a CCP arrangement, however, protects either the buyer or the seller against the default of its own clearing intermediary. This distinction, which often is not well understood,<sup>9</sup> is of special importance because clearing intermediaries in some markets play a critical role in the handling of their customers' collateral and other property.

Accordingly, the Chicago Reserve Bank believes that it may be beneficial for the Task Force to articulate a clear understanding of the special role that clearing participants perform in the clearing and settlement infrastructure for financial markets that use a CCP. In particular, the Chicago Reserve Bank believes that national authorities should take account of: (a) the important role clearing intermediaries play in the markets for which such authorities have responsibility; and (b) the availability in their home jurisdictions of measures, such as segregation requirements (which we discuss in Part II.D below), to address customer protection concerns related to that role. These issues should be important factors for national authorities to consider as they decide whether to extend relevant parts of the recommendations to clearing intermediaries.<sup>10</sup>

Having discussed the scope of application of the recommendations to guarantees and other credit enhancement structures that do not utilize a CCP, as well as clearing participants that act as trade intermediaries, we now turn to specific comments concerning the recommendations for the management of legal risk, management of collateral and other financial resources, default procedures and transparency.

### B. Management of Legal Risk

Recommendation 1 provides that: "A CCP should have a well founded, transparent and enforceable legal framework for each aspect of its activities in all relevant jurisdictions." The Chicago Reserve Bank supports this recommendation. As the Consultative Report notes, ". . . cross-border participation and product offerings of CCPs have grown, along with links between CCPs [located in different jurisdictions]." (Consultative Report at § 3.31). Accordingly, the Consultative Report properly

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<sup>9</sup> In 1985, for example, Volume Investors Corporation, a clearing member of a U.S. clearinghouse, defaulted after a sharp movement in commodity prices caused it to become insolvent. The failure resulted in losses to customers that cleared through Volume Investors, notwithstanding the clearinghouse guarantee. See, Commodity Futures Trading Commission, Volume Investors Corporation, Report of the Division of Trading and Markets (July 1985).

<sup>10</sup> Specifically, the Chicago Reserve Bank believes that the following subsections of the Consultative Report are relevant to trade intermediaries: 2.4, 3.2 to 3.14, 3.16 to 3.24, 3.26 to 3.31, 4.1.1 to 4.1.8, 4.2.2, 4.2.4, 4.3.1 to 4.3.5, 4.3.7 to 4.3.9, 4.4.1 to 4.4.5, 4.4.7 to 4.4.9, 4.4.11, 4.5.1 to 4.5.5, 4.5.7, 4.5.8, 4.6.1 to 4.6.4, 4.7.1 to 4.7.8, 4.8.4, 4.8.5 and 4.12.5, where the terms "trade intermediary" or "clearing participant" would be substituted for "CCP". This additional level of detail is being provided since it does not seem appropriate for all subsections to be applied to trade intermediaries.



emphasizes that CCPs must institute an effective process for resolving material conflicts of law (or private international law) issues that arise in the cross-border context.

We read the commentary accompanying Recommendation 1 to require an ongoing, *ex ante* review and assessment of the legal foundation for a CCP's activities. That reading is consistent with the standards for other critical components of the financial system (e.g., the Core Principles for Systemically Important Payment Systems) and with explicit statements in the Consultative Report itself. For example, the Consultative Report notes that "CCPs manage legal risk through a well founded framework that supports each aspect of a CCP's operations and through careful review of relevant law and design of contracts and rules, both at creation and on an ongoing basis." (Consultative Report at §3.30). In addition, the Consultative Report notes that CCPs must obtain advice from legal counsel attesting to the "high degree of assurance that there is a clear and effective legal basis" for the CCP's activities in each relevant jurisdiction. (See, e.g., Consultative Report at Explanatory Note 2 to Recommendation 1).

Of course, as the Consultative Report also notes ". . . statutes and rules are often untested in court." (Id.). Furthermore, statutes, rules and other legally binding requirements sometimes change. Therefore, the Chicago Reserve Bank believes that it may be useful for the Consultative Report to emphasize that compliance with Recommendation 1 requires a CCP to institute and maintain an effective and ongoing process for reviewing and assessing the legal foundation for its activities.

### C. Management of Collateral and Other Financial Resources

Recommendation 3 provides that: "A CCP should calculate its credit exposures to participants on a daily basis and hold collateral that in normal market conditions covers its potential losses from closing out positions held by a defaulting participant." Recommendation 4 provides that: "A CCP should maintain sufficient financial resources to withstand a default by the participant to which it has the largest exposure in extreme but plausible market conditions that produces losses not fully covered by collateral requirements." The Chicago Reserve Bank supports these complimentary, mutually reinforcing recommendations.

We are aware that clearing participants are increasingly active in more than one market, often on a global scale, and that CCPs are increasingly providing credit enhancement services to multiple markets. Recommendations 3 and 4 do not explicitly prescribe a method for calculating the collateral and other financial resource requirements for a CCP in situations where a clearing participant is active in more than one market cleared by the CCP. However, we think it would be prudent to take account of a CCP's exposure to such clearing participants on the assumption that a default in one market would result in a default in all other markets cleared by the CCP. The default of such a participant, if triggered by bankruptcy or another form of credit impairment, is likely to affect adversely its ability to perform all obligations to a CCP (and, indeed, to all CCPs and other counterparties), regardless of the market that is the source of those obligations.

To manage its risks accordingly, a CCP may choose to provide credit enhancement services to multiple markets through separately incorporated, and separately

collateralized, entities. On the other hand, it may prove costly and burdensome to provide economically equivalent services to multiple markets through separate legal entities. In any event, the Chicago Reserve Bank believes that a CCP that provides clearing services to multiple markets should, at a minimum, disclose to its participants the extent to which collateral and other financial resources are leveraged across those markets.<sup>11</sup>

Specific comments concerning collateral eligibility and measures to assure that collateral and other financial resources are used only for their intended purposes follow:

### *1. Eligible Forms and Management of Collateral*

The Chicago Reserve Bank agrees that the collateral upon which a CCP depends for risk management purposes must be of “...high quality and appropriately valued.”(Consultative Report at §4.3.9). Moreover, assets should not be eligible as collateral unless they exhibit “...high liquidity, low market risk and minimal credit risk.” (Id.). A CCP can manage the market risk associated with securities and other assets that are traded in liquid markets by setting appropriate haircuts and concentration limits for such assets.<sup>12</sup> As the Consultative Report explains:

Haircuts should be applied so that the value of collateral adequately reflects the potential for its value to decline over the interval between its last revaluation and the time by which it can reasonably be assumed to be liquidated in the event of a participant’s default; these haircut procedures should be reviewed regularly. Because of potential concerns about the ability to liquidate collateral quickly and without significant price effects, a CCP may impose a cap on the total amount of assets . . . accepted as collateral to minimize concentration risk. (Consultative Report at §4.3.9).

The Chicago Reserve Bank supports the use of appropriate caps “. . . on the total amount of assets (for example, securities issued by individual obligors and bank guarantees) accepted as collateral to minimise concentration risk.” (Consultative Report at §4.3.9). However, such concentration limits may not be sufficient to mitigate the risks associated with letters of credit, bank guarantees and similar assets. For such forms of collateral, it may not be sufficient to diversify the sources of funding among different

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<sup>11</sup> See discussion at Part II.E.2, *infra*.

<sup>12</sup> Haircuts may also be structured to provide incentives for clearing participants to deposit a form of collateral the CCP prefers to handle (for example, collateral denominated in the currency of the jurisdiction in which the CCP operates or which it finds simplest to administer) and disincentives for clearing participants to deposit other forms of collateral (such as securities issued by certain entities).

banks if those banks are likely to face liquidity constraints collectively if they are called upon to make payments to the clearing house in the event of a participant default.<sup>13</sup>

The Chicago Reserve Bank also agrees that it is useful for CCPs to give “careful consideration” to the remaining maturity of securities held either as collateral or for contingency purposes for purposes of setting appropriate “haircuts”.<sup>14</sup> Securities having longer remaining maturities typically have greater price volatility than securities with shorter maturities, all other things being equal. Additionally, insofar as haircuts are set to cover market risk and not credit risk, uncertainty and model error may be positively related to maturity. Limiting remaining maturity of securities held as collateral, therefore, has the effect of limiting exposure to model risk. To account for such risk, we suggest that proportionally higher haircuts (relative to historic volatility) should be considered for longer maturity securities.

## *2. Earmarking and Trust Arrangements*

The Consultative Report states that “[i]t . . . is important that financial resources that are intended to be used in the event of participants’ defaults are not used by the CCP for any other purposes.” (Consultative Report at §4.4.10). The Chicago Reserve Bank fully agrees. However, we believe that the Task Force should revise the discussion to clarify that “earmarking” (or similar measures incorporated in the rules and procedures of the CCP) is a necessary condition to establishing compliance with Recommendation 4. In particular, the Consultative Report should be revised to clarify that trust arrangements may or may not play a useful role in identifying and properly controlling default financial resources, depending upon the circumstances and applicable law. As it currently reads, the Consultative Report may be misread to mean that a trust alone may be sufficient – a conclusion that is dependent upon the circumstances and applicable law.<sup>15</sup>

### D. Default Procedures

In addition to Recommendations 3 and 4, which relate to the collateral and other financial resources a CCP may hold to mitigate the risk of a potential default by a clearing participant, Recommendation 5 provides: “A CCP’s default procedures should

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<sup>13</sup> The impairment of liquidity is likely to be even more severe where letters of credit or bank guarantees are held by a CCP as part of its other financial resources. If a CCP were to be forced to resort to letters of credit or bank guarantees in the event of a default, it is likely that it would be drawing down funds nearly simultaneously from more than one bank.

<sup>14</sup> See Consultative Report at §4.4, explanatory note 1: “Careful consideration should be given to the maturity of the assets accepted [as support for the non-collateral financial resources of a CCP].”

<sup>15</sup> Section 4.4.10 of the Consultative Report states: “It is also important that financial resources that are intended to be used in the event of participants’ defaults are not used by the CCP for any other purposes. Two elements are essential to achieve this insulation. First, the financial resources should be placed in trust or earmarked. Second, the rules of the CCP should clearly state that the financial resources earmarked to support participants’ defaults are not permitted to be used for any other purposes, and the rules should expressly set out the situations in which the resources can be used.”

be clear and transparent, and they should ensure that the CCP can take timely action to contain losses and liquidity pressures and to continue meeting its obligations.” The Chicago Reserve Bank supports this recommendation.

As has been previously discussed,<sup>16</sup> clearing participants in some markets play a critical role in the handling of their customers’ collateral and other property. The interposition of a CCP between a buyer and seller in such a market does nothing to protect either the buyer or the seller from the risk of the default of its own clearing intermediary. Moreover, the default of a clearing participant that acts as an intermediary for other market participants may result from losses attributable to trading conducted on behalf of either the intermediary itself (so-called “proprietary” trading) or other customers. This may create some confusion about the ability of a CCP to use collateral in the event of a clearing participant default – a situation that is all the more problematic where collateral is held on an “omnibus” basis for both proprietary and customer accounts.

Recognizing that there may be valid public policy reasons for differences in the mechanisms for holding and accounting for collateral in different jurisdictions, the Chicago Reserve Bank believes that the Consultative Report should explicitly state that customers must not be disadvantaged in the event, or to the extent, that a default is attributable to losses in the proprietary account. The Consultative Report currently states:

A [CCP] participant’s default may be caused by losses in its proprietary account or by a customer default which exceeds the participant’s financial resources. Where a customer’s collateral is held on an omnibus basis at a CCP, it may be used to cover losses arising from any customer within the account, but should not be used to cover losses in the proprietary account, unless other protections are available. (Consultative Report at §4.5, Explanatory Note 5).

The Chicago Reserve Bank believes that the most effective way of implementing this prohibition against the misuse of customer collateral is to require separate custody of and accounting for “customer” and “proprietary” funds and positions. To be sure, segregation requirements alone cannot insulate market participants against fraud and other misuse of customer funds. However, such measures are beneficial to the extent that they simplify the task of identifying whether a CCP holds collateral of a particular type or amount for either customers – albeit on an aggregate (or “commingled”) basis for all customers alike – or the clearing participant. This can facilitate the orderly liquidation of a clearing participant and the transfer of customer positions, supported by customer collateral, to a solvent clearing participant, thus limiting the systemic implications of a default.

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<sup>16</sup> See discussion at Part I.A.2, *supra*.

## E. Transparency

Recommendation 13 provides that: “A CCP should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using its services.” The Chicago Reserve Bank supports this recommendation. In particular, we have the following comments concerning transparency in connection with the use of default insurance as part of the default financial resources of a CCP and multiple leverage of collateral and other financial resources.

### *1. Default Insurance*

We are aware of the recent trend for CCPs to rely in part upon external financial resources, such as default insurance provided by third-party insurance carriers, in the event of a participant default. Default insurance can be a useful means of diversifying the sources of financial support for a CCP, if there are not unnecessary legal conditions or practical impediments to prompt drawdowns in the event of a participant default.

Nevertheless, the Chicago Reserve Bank believes that market participants may not be able to adequately evaluate the extent to which such insurance provides a reliable and ongoing means of financial support in the event of a participant default. Therefore, we believe that CCPs that publicly identify default insurance as a component of their financial resources should disclose to their participants all material terms of those policies (e.g., factors affecting the availability of drawdowns, as well as renewal, replenishment and cancellation terms).

### *2. Multiple Leverage of Collateral and Other Financial Resources*

As discussed above, the Chicago Reserve Bank believes that it would be prudent for a CCP that provides clearing services to more than one market to take account of its risk exposure on the assumption that a default by a clearing participant in one market would result in a default by that participant in all other markets cleared by the CCP.<sup>17</sup> At a minimum, we believe that a CCP that provides services to multiple markets should disclose to its participants the extent to which collateral and other financial resources are leveraged across those markets.

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<sup>17</sup> See discussion at Part II.C, *supra*.

### III. Summary and Conclusion

The Chicago Reserve Bank supports the efforts of CPSS and IOSCO to formulate flexible, risk-focused recommendations for securities settlement systems that utilize a central counterparty. On balance, the Chicago Reserve Bank believes that the recommendations are sufficiently comprehensive and flexible to be useful for their intended purpose. However, we question whether the scope of application of the recommendations is broad enough to cover economically equivalent credit enhancement structures that are systemically important, yet narrow enough to avoid unintended consequences.

Accordingly, the Chicago Reserve Bank supports the extension of the recommendations (or a relevant part thereof) to (1) guarantees and (2) alternative credit enhancement structures, if systemically important, that facilitate (a) multilateral netting of obligations and/or payments or (b) centralized collateral management and/or credit risk monitoring. However, structures that do not constitute part of a clearing and settlement system, as defined by each relevant national authority, and are characteristic of common services provided by commercial banks would be excluded from the application of the recommendations, as would purely bilateral arrangements.

The Chicago Reserve Bank also believes that national authorities should take account of (a) the important role clearing intermediaries play in the markets for which such authorities have responsibility and (b) the availability in their home jurisdictions of measures, such as segregation requirements, to address customer protection concerns related to that role. The Chicago Reserve Bank believes these issues should be important factors for national authorities to consider as they decide whether to extend relevant parts of the recommendations to clearing intermediaries.

We also suggest some specific revisions in relation to the following recommendations:

- Recommendation 1 (Management of Legal Risk)

The Consultative Report should emphasize that a CCP must institute and maintain an effective and ongoing process for reviewing and assessing the legal foundation for its activities.

- Recommendations 3 and 4 (Collateral and Other Financial Resources)

The Consultative Report should address the risk exposure that a CCP incurs when it provides credit enhancement services to multiple markets and leverages its collateral and other financial resources across those markets. In addition, the Consultative Report should clarify the discussion of collateral eligibility, management of collateral and measures to assure that collateral and other financial resources are used only for their intended purposes.

- Recommendation 5 (Default Procedures)

The Consultative Report should discuss the benefits of segregation requirements, which can simplify the task of identifying whether a CCP holds collateral of a particular type or amount for either customers of a clearing participant or the clearing participant itself.

- Recommendation 13 (Transparency)

The Consultative Report should address the disclosure obligations of a CCP that either (i) publicly identifies default insurance as a component of its financial resources or (ii) provides credit enhancement services to multiple markets and leverages its collateral and other financial resources across those markets.

As we noted above, clearing and settlement systems are critical to the stability of the financial system. The Task Force's efforts to address the key public policy issues that arise from the design, operation and oversight of such systems are, therefore, particularly timely. We hope that the Chicago Reserve Bank's comments will be useful to the Task Force.