IOSCO's and BIS' Report on client clearing: access and portability. International Bulletin of November 2022.

On 8 September 2022, the International Organization of Securities Commissions (IOSCO) and the Bank for International Settlements' Committee on Payments and Market Infrastructures (CPMI) published a report (the "Report") on access to central clearing that aims to increase the common understanding of certain new access models ("direct" and "sponsored" access models) and effective porting practices as well as to identify potential issues for possible follow-up work from the industry.
The Report provides additional information and analysis to the CPMI-IOSCO discussion paper published on 29 November 2021 ("November Paper"). The November Paper on client clearing, access and portability was published for public consultation, including an industry workshop and written responses. Overall, the paper was well-received and respondents to the November Paper provided support for the work.

The Report considers the potential benefits and challenges, particularly around risk management, of the new access models developed by central counterparties (CCP), considering industry feedback. CPMI and IOSCO have encouraged industry efforts to engage in further work to:

• Enhance transparency and disclosure regarding direct and sponsored access model participation; and
• Develop further effective practices to facilitate porting, thereby ensuring clients' continued access to clearing in the event of an intermediary default.

The Report is divided into the following sections:

Section 1 explains the objectives of the work.
Section 2 discusses the different access models and features.
Section 3 outlines porting practices, focusing on alternative or backup CCSP arrangements and game plans.
Section 4 identifies potential challenges, as well as the potential benefits that could be achieved through actions industry stakeholders could take, as well as some potential future work for CPMI-IOSCO.

The client clearing process facilitates access to central counterparties, particularly for firms (known as '"clients") that are not direct participants in a central counterparty and must rely on intermediaries to indirectly clear their trades. Since some entities cannot, or choose not to, directly participate in a central counterparty, improving access to client clearing is critical to the success of the G20 objective to have all standardized over-the-counter (OTC) derivatives contracts cleared through CCPs.

Objective
The Report is in response to the CPMI-IOSCO Steering Group´s mandate of whether and to what extent concentration in client clearing creates issues of concern specifically in relation to client access. Under the Principles for Financial Market Infrastructures (PFMI)[1] Key Consideration 1 notes that "CCPs should allow for fair and open access to its services, including by direct and, where relevant, indirect participants and other Financial Market Infrastructures (FMIs), based on reasonable risk-related participation requirements." In particular, and the focus of the Report, the CPMI-IOSCO Steering Group mandated the Policy Steering Group (PSG) to: (i) develop knowledge and understanding regarding new access models through which entities that historically have participated indirectly as "clients" can directly access CCP services; (ii) develop knowledge and understanding of current porting processes at CCPs; (iii) examine and analyze possible solutions to facilitate access and portability arrangements; (iv) consider in particular the potential benefits, risks and challenges that these new possible solutions may bring with respect to access (Principle 18 of the PFMI), tiering (Principle 19) and portability (Principle 14 of the PFMI); and (v) set out the next steps. The Report elaborates on information collected through (i) an industry workshop in July 2019; (ii) a survey addressed to CCPs, client clearing service providers (CCSPs)

and clients in late 2019; (iii) targeted interviews in the Fall of 2020; and (iv) industry feedback on the November Paper.

Section 2: Direct and Sponsored access models

The Report describes "direct" and "sponsored" access models that allow entities that have historically participated indirectly as clients to directly access CCP services. The new models introduce new challenges, incentives, and risk distribution among different kind of participants. They also introduce new risks, including sponsor default, with the availability and use of these types of models varying significantly in different segments of cleared markets.

Feedback received from the November Paper showed that industry stakeholders consider several factors in determining whether to use and offer new access models. The outcome of the analysis varies for different products and markets, by participant size, and in consideration of applicable regulatory framework, including capital charges and sectoral-specific rules. Based upon survey results and industry outreach, the new models seem to be primarily driven by client demand and have gained the most traction in the repo markets.

The new access models provide additional mechanisms for clients to access clearing without a CCSP's full-fledge intermediation. In a direct model, a client becomes a clearing member without the need for any assistance or sponsorship by a CCSP. In a sponsored access model (sometimes called hybrid model), the client gains direct access to the CCP by performing one or more clearing member functions, but still needs that assistance of another clearing member.

Potential defaults

The Report states that all direct and sponsored access models appear to share one key feature: they shift the responsibility for contributing to the CCP's default or clearing fund. In sponsored access models, this obligation is fulfilled by a "sponsor", which pays the default fund contribution to cover the portion of the stressed exposure over the initial margin created by the transactions of the sponsored participant to the CCP. While the sponsored member still provides initial margin during business-as-usual (BAU), if the sponsored member defaults, the sponsor is expected to bear losses on the paid default contribution, and then bear all residual losses. In such cases, CPMI-IOSCO's understanding is that, as a consequence the sponsor has greater control over the sponsored member's positions, as compared with a sponsored model without a guarantee. This adds an additional layer of complexity to the sponsor's operational and risk management.

By contrast, in "direct" access models, the CCP waives the default fund contribution requirement. Some CCPs collect a multiplied margin requirement that is equivalent to either full collateralization, or to a figure that amounts to both initial margin and the default fund contributions of traditional direct clearing members. At other CCPs, neither the new, direct members nor any of the CCSPs contribute funds to offset the default fund contribution. In this arrangement it is the perceived low credit risk of the new, direct participants (ie. public pension funds) that serves as the basis for the waiver.

Diversity of the Risk Profile

The Report acknowledges that new types of direct and sponsored access models could address the concentration issues that arise with respect to client clearing and may also encourage more direct participation in the CCP. However, the extent to which this could reduce the overall risks within the clearing system is not clear. "Principle 2 of PFMI states that an FMI should have governance arrangements that are clear and transparent, promote the safety and efficiency of the FMI, and support the stability of the broader financial system, other relevant public interest considerations, and objectives of relevant stakeholders." Overall, a balance must be struck, especially regarding smaller and potentially less profitable clients. The roles and responsibilities of sponsors and sponsored members should be transparently and clearly delineated.

Respondents reflected that, in general, the expectation is that a CCP's overall risk frameworks will remain unchanged. However, the CCP should implement additional measures that are appropriate to manage any new, uncovered risks. From a procedural and regulatory perspective, CCPs need to adjust their rules, policies, and procedures accordingly as they expand clearing membership to new categories of direct participants.

The Report also acknowledges that as diversity and complexity of direct and sponsored access models grow, so do the operational challenges. This requires careful management. Key consideration 4 of Principle 13 of the PFMI states that a CCP "should involve its participants and other stakeholders in the testing and review of the [CCP]'s default procedures." Periodic testing and review is needed for CCPs and participants to understand procedures and to identify any lack of clarity in the rules and procedures.

Uptake of Models

CCPs continue to develop and enhance direct and sponsored access models. The Report states that three major CCPs are creating a more secure sponsored guarantee model in which the sponsor provides an unlimited guarantee in the event of its sponsored member's default, in exchange for the sponsor's control of the sponsored member's positions. This additional safeguard would allow the onboarding of sponsored members with lower credit standing.

CCPs also have identified several regulatory adjustments that could facilitate the uptake of new access models. These include the clarification of sectoral-specific regulation for insurance and funds, extension of the clearing obligation to pension funds, and clarifications regarding the application of Basel III requirements.

Further, CCSPs favor a fundamentally different approach to improving access and reducing CCSP concentration risk that does not involve facilitating new access models. These market participants seek to encourage new CCSP entrants and promote greater levels of activity among existing players, by introducing measures to increase the attractiveness of offering traditional client clearing services.

Section 3: Porting

Currently, if a central counterparty member defaults, its clients' accounts need to be transferred to another CCP member or liquidated in a short time frame. Since forced liquidation is undesirable, the Report proposes possible effective practices concerning three key elements of a successful central counterparty porting framework: communication, coordination, and harmonization. The Report also outlines issues for CCPs to consider when developing a porting protocol and identifies a series of suggested next steps for the industry regarding porting practices.

Successful Porting Practices

Industry outreach noted two factors that appear to support successful porting in the event of a default:

*Alternative or backup CCSPs for clients of defaulted CCSPs-many CCPs encourage clients to identify a backup or multiple backup CCSPs. Clients that have only one active CCSP relationship may not be able to offset the costs of maintaining another active CCSP or alternative or backup arrangements to an extent that justifies the benefits.

*Game Plan-A CCP may also maintain its own analysis to identify the CCSPs most likely to accept certain clients of a potential defaulting CCSP.

In certain cases, forced liquidation of a defaulting CCSP's client positions is the only viable option, such as when a CCP cannot obtain the required client consent. Porting is also unnecessary for very short-dated positions, where the applicable client positions will settle before porting can be completed.

Some CCPs employ mechanisms that permit clients to make direct payments and/or maintain excess collateral, which may facilitate porting by easing clients' ability to ensure their accounts are fully margined. The potential success of direct payment mechanisms is likely to increase when established during BAU, prior to the CCSP default. Furthermore, a CCP may be able to extend the time to port a client account when it can rely on excess collateral attributable to individual clients, subject to jurisdictional restraints. Excess collateral provides a buffer that may be applied to a client's collateral requirements, even where those might change during the course of default management, thereby increasing the likelihood that the account will be fully margined or nearly so.

Industry outreach responses provided a range of factors that impede porting in the event of a CCSP default. While a CCP's preparations during BAU may allow it to overcome some porting challenges, product constraints, balance sheet availability, and the low profitability of providing clearing services to certain clients will hinder many CCSPs from receiving ported clients. In addition, surveyed CCPS identified regulatory impediments, insolvency frameworks, and collateral transfer, as other potential factors that may promote or hinder porting.

Several principles strengthen successful porting including transparency, efficiency, effectiveness, and testing.

Section 4: Next Steps

The Report identifies several potential issues that could benefit from further industry engagement, either jointly or individually. Access to client clearing continues to be an issue of priority for CPMI-IOSCO. The strong response received in the public consultation of the November Paper demonstrates the industry commitment to developing the issues identified.

CPMI-IOSCO encourages an increase of transparency and disclosure which are critical to the participation of CCSPs, clients, sponsored members, and direct members in the CCP. As access models continue to evolve, discussion and education regarding the roles, responsibilities, and risks associated with the new models is essential to ensure that all participants, direct and indirect, traditional, or not, are prepared to monitor and manage the risks associated with participation in the CCP. In addition, CPMI-IOSCO welcomes and encourages industry efforts to enhance portability, so that client clearing access can continue to be provided following a default and forced liquidations are avoided. These solutions include:

• analyzing regulatory frameworks and CCP rules to identify industry solutions to mitigate potential impediments to portability;
• increasing CCSP and client education regarding roles, responsibilities, and risks associated with porting;
• improving disclosures regarding portability risks associated with different account structures;
• taking BAU steps to improve default communications and coordination; and
• developing rigorous porting exercises.

1 The Principles for Financial Market Infrastructures (PFMI) are the international standards for financial market infrastructures, ie. payment systems, central securities depositories, securities settlement systems, central counterparties and trade repositories. Issued by the CPMI and the International Organization of Securities Commissions (IOSCO), the PFMI are part of a set of 12 key standards that the international community considers essential to strengthening and preserving financial stability.

Useful link:
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