CME Group

04/29/2022

VIA ELECTRONIC SUBMISSION

Re: Report on *Central Counterparty Financial Resources for Recovery and Resolution*

To Whom It May Concern:

CME Group Inc. ("CME Group")[1] appreciates the opportunity to comment on the Financial Stability Board ("FSB"), Committee on Payments and Market Infrastructures ("CPMI"), and International Organization of Securities Commissions ("IOSCO"), together the "standard setting bodies" or "SSBs", report on *Central Counterparty Financial Resources for Recovery and Resolution* (the "Report").[2]

Chicago Mercantile Exchange Inc. ("CME") is a wholly-owned subsidiary of CME Group. CME is registered with the Commodity Futures Trading Commission as a derivatives clearing organization ("DCO"). "CME Clearing", a division of CME, offers clearing and settlement services for listed futures and options on futures contracts, as well as over-the-counter derivatives transactions, including interest rate swaps products. On July 18, 2012, the Financial Stability Oversight Council designated CME as a systemically important financial market utility ("SIFMU") under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. As a SIFMU, CME is also a systemically important DCO ("SIDCO").

I. Introduction

CME Group appreciates the SSBs ongoing focus on supporting the stability of the broader financial system. This includes the strong framework that has been adopted by local policy-makers through their implementations of the *Principles for financial market infrastructures* ("PFMIs"),[3] which promotes central counterparties' ("CCPs") resiliency and recovery. The PFMIs rightfully allow local jurisdictions to appropriately tailor legislative and regulatory requirements to their local legal and regulatory frameworks and the CCPs they oversee. This has proven a successful approach, as evidenced by the successful performance of CCPs illustrated in the Report. This was despite the fact that the scenarios analyzed were not only extreme, but in many cases, implausible. Given this and considering the work already undertaken by the SSBs and the strong frameworks that are in place in local jurisdictions for CCPs' resources and tools for resilience, recovery and resolution, we do not believe that further work on CCPs' financial resources is necessary.

Additionally, it is important to recognize that CCPs' resources and tools for addressing stress events should not be observed in a vacuum from their other risk management practices. A

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[1] As a leading and diverse derivatives marketplace, CME Group enables clients to trade in futures, cash and over-the-counter markets, optimize portfolios, and analyze data – empowering market participants worldwide to efficiently manage risk and capture opportunities. CME Group's exchanges offer the widest range of global benchmark products across all major asset classes based on interest rates, equity indexes, foreign exchange, energy, agricultural products, and metals. CME Group offers futures trading through the CME Globex platform, fixed income trading via BrokerTec, foreign exchange trading on the EBS platform. In addition, it operates one of the world's leading central counterparty clearing providers, CME Clearing.

[2] Financial Stability Board, Committee on Payments and Market Infrastructures, and Board of the International Organization of Securities Commissions, *Central Counterparty Financial Resources for Recovery and Resolution* [hereafter, "*Report*"] (Mar. 2022).

[3] Committee on Payment and Settlement Systems (later renamed the Committee on Payments and Market Infrastructures) and Board of the International Organization of Securities Commissions*, Principles for financial market infrastructures* (Apr. 2012).

CCP's core function is to manage the risks taken by its market participants by acting as a market risk-neutral, creditworthy counterparty to every buyer and seller of the contracts it clears. A CCP mitigates counterparty risk by netting down exposures on a multi-lateral basis and by employing risk mitigation and management practices, such as risk-based membership requirements, collection of initial margin and default fund resources, and conducting at least daily settlement cycles, among others. Not only does a CCP employ tools that are designed to mitigate the likelihood of and manage a clearing member default, but it also employs a number of practices to mitigate and manage non-default related risks, such as counterparty and liquidity risk management practices, cyber protections, operational resiliency practices, and well-defined settlement procedures, among others. CCPs also have legal protections in their rulebooks to address these risks. It is important to recognize that these risk management practices and legal protections significantly reduce the likelihood of a recovery event occurring, as demonstrated by the resiliency of CCPs in navigating the recent unprecedented COVID-related volatility. However, where default events cannot be avoided, CCPs, including CME Clearing, have historically demonstrated their ability to successfully manage sizeable and complex default events in periods of stress without the mutualization of losses, including during the financial crisis and COVID-related volatility.

As described further below and addressed in CME Clearing's past letter to the FSB,[4] CCPs' risk management practices, including their resources and recovery tools, have been carefully designed to support incentives for market participants to effectively manage their risks in both business-as-usual and stressed market conditions. CCPs also typically contribute their own resources to the default waterfall to demonstrate their confidence in their risk management practices. The carefully calibrated incentives of the central clearing model are critical to the future success and resiliency of the model and must be maintained so that central clearing can continue to provide stability to financial markets, particularly during times of stress.

II. Scenario Analysis

The participating CCPs performed remarkably well against the evaluated stress scenarios, demonstrating the sufficiency of the existing resources and tools in place, despite the extreme and implausible nature of the scenarios chosen, as described below. While CME Group appreciates that CCPs must be sufficiently prepared to address both default losses and non-default losses ("NDLs"), implausible events should not be the basis upon which CCPs' resources are evaluated and sized. This approach would be inconsistent with the PFMIs. More specifically, the PFMIs state that CCPs "should identify scenarios that may potentially prevent it from being able to provide its critical operations and services as a going concern and assess the effectiveness of a full range of options for recovery or orderly wind-down."[5] They also establish that CCPs should have resources and tools for addressing uncovered credit losses and liquidity shortfalls.[6] Considering the standards already in place and the performance of CCPs in this scenario analysis, we do not believe that further work on CCPs' financial resources is necessary.

Default Losses

CME Group appreciates that the Report correctly recognizes that the analyzed default loss scenario was "intended to be significantly more severe than the 'extreme but plausible' standard set out in the PFMI."[7] This is very straightforward, given that the scenario: i) applied a 1.4X multiplier to stress shocks used in the participating CCPs' historical stress scenarios, which,

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[4] CME Group, Letter to the FSB on the Consultative document on Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution [hereafter, *CME Group Response*] (July 2020), *available at* https://www.fsb.org/wp-content/uploads/CME-Group-3.pdf.
[5] *PFMI* at Principle 3, Key Consideration 4.
[6] *PFMI* at Principle 7, Key Consideration 10 and Principle 4, Key Consideration 7.
[7] *Report* at pg. 5.

consistent with the PFMIs, already capture extreme but plausible market conditions; and ii) assumed the default of the four largest clearing member groups at each of the participating CCPs, which is well beyond the standard under the PFMIs that CCPs maintain resources to address the default of the two largest clearing member groups.[8] We believe that the implausibility of the scenario should be more clearly recognized in the Report, as should the conclusion that the limitations of the scenario analysis do not undermine the results of the analysis itself. In particular, the Report states that there were limitations relating to the scenario analysis of default losses, but fails to recognize that these are compensated for by the implausibility of the scenario:[9]

- **Forward-Looking Hypothetical Stress Test Scenario**;
  While the scenario analysis used the participating CCPs' historical stress scenarios as the basis for the analysis, the required assumptions (i.e., the 1.4X multiplier and default of four largest clearing member groups) also create a hypothetical basis for the scenario that is far more extreme than historical scenarios observed. Regardless of how one looks at it, the scenario still captured extreme and implausible market conditions, as explained above. Furthermore, as noted in the Report, this approach to selecting the default loss scenario helpfully provided for greater comparability of severity across CCPs.

- **Variation in Concentration of Participants Across CCPs**; and
  Regardless of the fact that the concentration of participants at CCPs may vary, the scenario analysis captured a sizeable exposure to each of the participating CCPs, since it assumed the failure of the four largest clearing member groups.

- **System-Wide Effects**.
  It is important to note that while system-wide effects were not directly evaluated as part of the Report, given the participating CCPs' successful performance against the implausible scenario evaluated, it's highly likely that CCPs would be able to navigate a more plausible scenario where system-wide effects are directly considered. Further, the Report found that recovery cash calls and variation margin gains haircutting ("VMGH") would have a limited impact on clearing members and have a low performance risk, thus suggesting that the system-wide effects of these tools would be negligible.[10] In particular, the quantitative analysis in the Report found that recovery cash calls and VMGH had little impact on bank clearing members' liquidity and capital, even where the maximum amount of cash calls that clearing members would have been exposed to during March 2020 were applied and VMGH was applied to 100% of gains.[11] The Report also notes that "VMGH has the potential to address losses comprehensively."[12]

Given the above and the extreme and implausible nature of the default loss scenario analysis, we disagree with the Reports conclusion that the results should be evaluated cautiously.[13] It's promising that seven of the 15 CCP service lines fully addressed the potential default losses with only their pre-funded financial resources and of the eight CCP service lines that used tools beyond the mutualized default fund, six were able to address the losses using recovery cash calls, as set out in their rulebooks. Additionally, the Report notes that for the one CCP that had to employ the use of both assessments and VMGH, at the individual bank clearing member

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[8] *PFMI* at Principle 4, Key Consideration 4.
[9] *Report* at pgs. 6-7.
[10] *Report* at pgs. 18-19.
[11] *Report* at pgs. 16-17.
[12] *Report* at pg. 10
[13] *Report* at pg. 20.

level, the analysis "identified only limited impacts on their liquidity and solvency from the use"[14] of such tools. These findings demonstrate that even when subjected to extreme and implausible scenarios, CCPs' financial resources were sufficient to manage the losses in all cases and as such, support CME Group's belief that further work on CCPs' resources for default losses is unnecessary.

Non-Default Losses

The Report characterizes the NDL scenarios utilized in this analysis as "two hypothetical common scenarios which were considered sufficiently severe."[15] This is a mischaracterization, as these scenarios are uncommon and extreme and implausible. However, CME Group appreciates that the Report recognizes that the NDL scenarios "are hypothetical rather than grounded in actual experiences" and "did not take into account ways in which the CCP's operational arrangements or cyber security measures might reduce the risk or extent of loss."[16] For these reasons and others described below, the implausibility of the NDL scenarios should be more clearly recognized in the Report.

The primary assumption of the first NDL scenario required a participating CCP to assume that it lost access to accounts at an institution (other than a central bank) holding assets on its behalf that would have caused the largest liquidity risk to the CCP and if that institution had any affiliates that were clearing members, it was required to assume they also defaulted. Further, a participating CCP was asked to assume two additional complicating assumptions: i) the default of the two clearing member groups that would create the largest aggregate payment obligations to the CCP; and ii) the loss of access and subsequent defaults under i) happening in the middle of the CCP's settlement cycle. This set of assumptions creates a scenario that considers a combination of events that are highly implausible to happen independently, particularly given the regulatory regime for financial institutions (as described below), and virtually impossible to occur simultaneously. In particular, the first NDL scenario is extreme and implausible for the following reasons:

- **Regulatory Regime for Financial Institutions**: The scenario implausibly assumes the failure of the regulatory regime in other parts of the financial system to function as intended, since continuity of access to assets and protection of depositors is designed to be safeguarded under the regulatory regime for custodians and banks (e.g., bank living wills). In particular, the regime for major U.S. banks provides a runway period and is designed to ensure ongoing collateral access and services.[17] This affirms the fact that the primary assumption and second complicating assumption of the first NDL scenario are highly implausible. Further, it should be noted, that loss of access to a custodian and settlement services would not be idiosyncratic to CCPs and thus, would likely necessitate broad scale regulatory intervention to prevent potential contagion issues across financial markets.

  Notwithstanding this, CCPs cannot and should not be obligated to guarantee the performance of third-party custodians and banks, including by holding resources to address their failure. No entity that utilizes third-party custodial and banking services provides such a guarantee. Arbitrarily placing (or even assuming to place) this guarantee obligation on CCPs risks undermining financial stability by distracting from a CCP's primary function of guaranteeing the financial performance of the contracts it clears. This is even more troubling considering the significant policymaking efforts that support the

[14] *Report* at pg. 3.
[15] *Report* at pg. 11.
[16] *Report* at pg. 12.
[17] *See* 12 CFR 243.2 and 243.3(a)(1)(ii), 12 CFR 381.2 and 381.3(a)(1)(ii), and 84 FR 1438 (noting, the resolution planning for "critical operations" and those material entities that are significant to those operations).

current bank capital and resolution regimes for major U.S. and global systemically important banks, since the first NDL scenario suggests that CCPs may need to act as a backstop against the failure of these highly regulated third-parties providing custodial and settlement services.[18]

- **Timeframe for Settlements**: Finally, the second complicating assumption of the first NDL scenario implausibly assumes that the loss of access to assets (i.e., under the primary assumption) happens during the middle of a settlement cycle while settlement variation funds are moving between banks, which typically occurs in a very narrow time window for CCPs (e.g., 30-minutes or less). Such a sudden failure would be unprecedented and a clear failure of the regulatory regime for settlement banks.

The second NDL scenario required a participating CCP to assume that a quantum of cash equal to the highest daily value of the sum of all cash transferred to any single institution on a single day was subject to cyber theft. This scenario is inherently implausible because it assumes that a CCP would ignore the occurrence of multiple thefts of transferred funds throughout the day. To put this into context, it is common practice for many CCPs, including CME Clearing, to make numerous cash transfers during the day, so if a CCP were to observe an issue with an institution relating to a single transfer, it would cease engaging with that institution until any issues were resolved. The plausibility of this scenario is further called into question due to the risk management practices in place at CCPs, such as CME Clearing, that make this scenario occurring implausible. For example, at CME Clearing these include:

- **Account Set-Up & Use Controls:** CME Clearing's agreements with settlement banks are with respect to specific accounts and payments can only flow to these pre-established and pre-approved accounts of clearing members at the relevant settlement banks. Multiple teams, including teams outside of CME Clearing, authorize and approve accounts and the same team cannot set-up and approve accounts.

- **Automation Controls:** SWIFT wires are automated and the ability to reroute wires would require manual intervention, triggering additional manual approval by other individuals. Moreover, a single actor cannot create or modify and then approve the SWIFT message, so a single actor would not be able to modify the bank on a SWIFT message.

- **Daily Settlement Operations Controls:** Each day multiple wires are executed across multiple banks throughout the day. Every wire is matched against an expected pay or collect message and any unauthorized wire would generate an unmatched exception that would result in management review.

Given the extreme and implausible nature of the NDL scenario analysis, it's promising to see the participating CCPs largely successful navigation of the scenarios. For the first NDL scenario, all CCPs were able to address the liquidity needs without the complicating assumptions and with the first complicating assumption (i.e., the two clearing members generating the largest payment obligation also default). Further, for the second complicating assumption (i.e., the funds deposited to a settlement bank become inaccessible mid-settlement cycle), all but one CCP had sufficient liquidity resources and arrangements to manage the liquidity needs. For the second NDL scenario, two CCPs' prefunded and recovery resources were sufficient to cover the theft and resolution was triggered for the other five participating CCPs. Considering the implausibility of the NDL scenarios, particularly with the complicating assumptions added, this

[18] For further information on these concerns, please see Section II.A of the *CME Group Response, available at* https://www.fsb.org/wp-content/uploads/CME-Group-3.pdf

should not be a basis for concern or further work. This is particularly true, since these extreme and implausible NDL scenarios did not consider the participating CCPs' operational arrangements and cyber security measures in place to mitigate the likelihood of these events occurring.[19]

III. Risk Management Incentives

As previously noted, the primary role of a CCP is to manage risk by becoming a market risk-neutral, creditworthy counterparty to every buyer and seller of the contracts it clears. The franchise value of a CCP is dependent on the integrity of its markets, predicated on its success as a risk manager. As such, protecting the franchise value of the CCP is an important incentive for CCPs in setting margin requirements and evaluating and maintaining the risk coverage of the rest of the financial safeguards waterfall, as well as effectively managing non-default related risks.

CCPs have carefully designed their financial resources and tools, including those that make up the default waterfall, to support incentives for market participants to effectively manage their risks, as has been demonstrated historically. The Report helpfully notes that the usefulness of a CCP's risk management tools goes beyond just addressing losses and states, "a CCP's ability to use recovery tools is likely to incentivize more active participation in the CCP's default management process, including through bidding in auctions."[20] These incentive effects are also further noted in CPMI-IOSCO's report on *Recovery of financial market infrastructures,* which states that a CCP's "recovery tools should create appropriate incentives for an FMI's owners, participants and, where relevant, other stakeholders to (i) control the amount of risk that they bring to or incur in the system; (ii) monitor the FMI's risk-taking and risk management activities; and (iii) assist in the FMI's default management process."[21] CCPs' resources and risk management tools are carefully designed to accomplish these goals. Thus, it's of the utmost importance that the carefully calibrated incentives of the central clearing model are preserved and that any future work of the SSBs does not result in inappropriate changes to participants' incentives.

[19] *Report* at pg. 12.
[20] *Report* at pg. 18.
[21] Committee on Payments and Market Infrastructures and Board of the International Organization of Securities Commissions, *Recovery of financial market infrastructures*, at pg. 14 (July 2017), *available at* https://www.bis.org/cpmi/publ/d162.pdf.

IV. Conclusion

CME Group appreciates the ongoing policy focus on supporting financial stability. At this juncture, we encourage the FSB, CPMI, and IOSCO to again consider if further work is actually necessary on CCPs' financial resources, in light of their successful performance against the scenarios analyzed. We do not believe such work is needed at this time. However, to the extent that such work is pursued, it should ensure that CCPs' resources are not altered in a manner that would undermine the incentives-based success of the central clearing model.

We would be happy to further discuss our comments with the standard-setting bodies. If any comments or questions regarding this submission arise.

Sincerely,

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