

## NOTICE TO MEMBERS

N°: 066-24

May 24, 2024

### REQUEST FOR COMMENTS

#### **AMENDMENTS TO THE DEFAULT MANUAL OF THE CANADIAN DERIVATIVES CLEARING CORPORATION REGARDING THE CORPORATION'S DEFAULT RISK CAPITAL AMOUNT AVAILABLE DURING A DEFAULT MANAGEMENT PROCESS**

On October 26, 2023, the Board of Directors of the Canadian Derivatives Clearing Corporation (“**CDCC**”) approved an increase in CDCC’s amount of Default Risk Capital available during a default management process and an amendment to CDCC’s Default Manual to that effect.

Please find enclosed an analysis document as well as the proposed amendment.

#### **Process for Changes to the Rules**

CDCC is recognized as a clearing house under section 12 of the *Derivatives Act* (Québec) by the Autorité des marchés financiers (“**AMF**”) and as a recognized clearing agency under section 21.2 of the *Securities Act* (Ontario) by the Ontario Securities Commission (“**OSC**”).

The Board of Directors of CDCC has the power to approve the adoption or amendment of the Rules and the Operations Manual of CDCC. Amendments are submitted to the AMF in accordance with the self-certification process and to the OSC in accordance with the process provided in the Recognition Order.

Comments on the proposed amendments must be submitted before June 28, 2024. Please submit your comments to:

**Martin Jannelle**

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A copy of these comments shall also be forwarded to the AMF and to the OSC to:

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Corporate Secretary and  
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For any question or clarification, Clearing Members may contact Martin Jannelle, Director, Business Advisory & Regulatory Affairs (Post-Trade), at 514-787-6578 or by email at [martin.jannelle@tmx.com](mailto:martin.jannelle@tmx.com).

George Kormas  
President



## AMENDMENTS TO THE DEFAULT MANUAL OF THE CANADIAN DERIVATIVES CLEARING CORPORATION REGARDING THE CORPORATION'S DEFAULT RISK CAPITAL AMOUNT AVAILABLE DURING A DEFAULT MANAGEMENT PROCESS

### I. DESCRIPTION

In the central counterparty business, skin-in-the-game (“SITG”) refers to the amount of a clearinghouse’s own assets that are available specifically to address a loss arising from a clearing member default and the order in which clearinghouse resources would be used relative to all other available resources<sup>1</sup>. Generally, members of clearinghouses mutualize clearing member default risk. Hence, they have long argued that clearinghouses should commit their own resources to a default fund so that shareholders of the clearinghouses would share with clearing members the risk of a clearing member default. In fact, clearing members often state that by committing the clearinghouse’s own capital to the default fund, SITG encourages clearinghouses to minimize such default risk and better align shareholder interests with those of clearing members<sup>2</sup>.

It is often argued by Clearing Members that SITG should be commensurate to the Clearing Fund calculated by the Clearing House. However, ample documentation supports the view that SITG is not meant to be a material source of loss absorption capacity<sup>3</sup>. It is meant to incentivize proper risk management and consequently should be sized consistent with the size of the business. Therefore scaling the SITG to clearing member default resources would be inappropriate<sup>4</sup>.

Given the comments voiced by certain Canadian Derivatives Clearing Corporation (“CDCC”) Clearing Members, and the value of these relationships, CDCC has decided to review its current position regarding the level of the SITG. CDCC is open to increasing its SITG as further described in

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<sup>1</sup>Berndsen, R. *A CCP's skin-in-the-game: Is there a trade-off?*

<https://focus.world-exchanges.org/articles/ccp-skin-game>

Edmonds, C., Panse, A. *The Importance of 'Skin-in-the-Game' in Managing CCP Risk,*

<https://focus.world-exchanges.org/articles/ccp-risk-ice>

Huang W., and Takáts. E. *BIS Working Papers No 866 Model risk at central counterparties: Is skin-in-the-game a game changer?* file:///C:/Users/Public/Desktop/Downloads/SSRN-id3613194.pdf

Carter, L. and Garner M., *Skin in the Game – Central Counterparty Risk Controls and Incentives*, pp. 81 & 82.

<https://www.rba.gov.au/publications/bulletin/2015/jun/pdf/bu-0615-9.pdf>

<sup>2</sup>European Association of CCP Clearing Houses Paper. *Carrots and sticks: How the skin in the game incentivises CCPs to perform robust risk management*, p 1.

[https://eachccp.eu/wp-content/uploads/2021/01/EACH-Paper-Carrots-and-sticks\\_How-the-skin-in-the-game-incentivises-CCPs-to-perform-robust-risk-management-January-2021.pdf](https://eachccp.eu/wp-content/uploads/2021/01/EACH-Paper-Carrots-and-sticks_How-the-skin-in-the-game-incentivises-CCPs-to-perform-robust-risk-management-January-2021.pdf)

<sup>3</sup>Financial Stability Board. *Financial resources to support CCP resolution and the treatment of CCP equity in resolution*, p. 18. <https://www.fsb.org/wp-content/uploads/P151118-2.pdf>

<sup>4</sup> Berndsen, R. *Ibid.*

this notice, in the interests of promoting a strategic partnership with, and enhance the confidence of, Clearing Members.

Unless otherwise defined herein, any defined term used in this analysis will have the meaning described in the Rules.

## II. PROPOSED AMENDMENTS

The current CDCC SITG is described as a 5+5 approach, where there is \$5M currently at risk in the default waterfall with an additional \$5M in pre-funded resources in place to automatically replenish the first layer if used.

First, CDCC has determined that an increase from \$5M (plus an additional \$5M) to \$15M would be acceptable to CDCC and its Clearing Members and would represent a meaningful increase at this time given the size of the current business.

Second, CDCC is of the view that the amount of SITG should not be indicated in its Rules and Manuals but instead, be specified in CDCC Quantitative Disclosure documents posted on CDCC's website every quarter.

Subsection 1.6 ii. of the Default Manual is therefore amended to remove the reference to the specific amount of the Default Capital Risk in the first paragraph of the subsection. The changes will be as follows:

*“ii. Resources of the Corporation (Default Risk Capital - DRC)*

• *CDCC has capital reserves set aside specifically for the purpose of absorbing any loss outstanding after the exhaustion of the suspended Clearing Member's resources. This capital is determined by CDCC from time to time and ~~which is currently \$5 million~~; is referred to herein as “Default Risk Capital” or “DRC”.*

*If, after applying these resources of the suspended Clearing Member and of CDCC, a shortfall still remains, CDCC will, as indicated below, use the required Clearing Fund deposits (referred therein as “Clearing Fund Requirement”) of the other Clearing Members to cover the loss.”*

## III. ANALYSIS

### a. Background

In Canada, SITG was introduced as a regulatory requirement in 2012 by the Bank of Canada (through the Bank of Canada's risk-management standards for designated systemically important financial market infrastructure). In addition, National Instrument NI 24-102 requires, since 2016, that a “*recognized clearing agency that operates as a central counterparty must dedicate and use a reasonable portion of its own capital to cover losses resulting from one or more participant defaults*”<sup>5</sup>. However, the Canadian regulation does not prescribe any specific amount. In contrast,

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<sup>5</sup> Regulation 24-102 respecting Clearing Agency Requirements, s. 4.5

the European Union imposes a requirement that derivatives clearinghouses have a minimum amount of SITG of 25% of regulatory capital<sup>6</sup>.

CDCC's SITG is used as the second tranche of its Default Loss Waterfall provisions, as shown in Figure 1 below:

Current CDCC Default Loss Waterfall	
1.	Suspended Clearing Member Resource
a.	Suspended Clearing Member's Margin Deposit
b.	Suspended Clearing Member's Clearing Fund deposits.
2.	Resources of the Corporation (Default Risk Capital - DRC aka "SITG")
3.	Surviving Clearing Members Clearing Fund Requirements
4.	2nd Surviving Clearing Members' Clearing Fund Requirements
5.	Surviving Clearing Members' Supplemental Liquidity Contributions

**Figure 1: CDCC Default Loss Waterfall**

### **b. Objectives**

Given the importance of CDCC's relationship with its Clearing Members, CDCC is open to increasing its SITG in the interests of promoting strategic partnerships to develop the business further. An increment of \$5M in SITG would be a meaningful increase at this time given the size of the current business. In confirming this amount, CDCC has considered the following factors:

- CDCC's current revenue-generating capacity of the business; and
- Fee elasticity that would be required to fund any SITG increases.

The increase of the SITG to \$15M would represent a ratio of approximately 30% in SITG/revenue and would therefore bring CDCC in line with its peers, like Eurex and ICE. The amount would even be larger than CME's commitment. CDCC remains open to further reviews of SITG in the future as the business develops and expands.

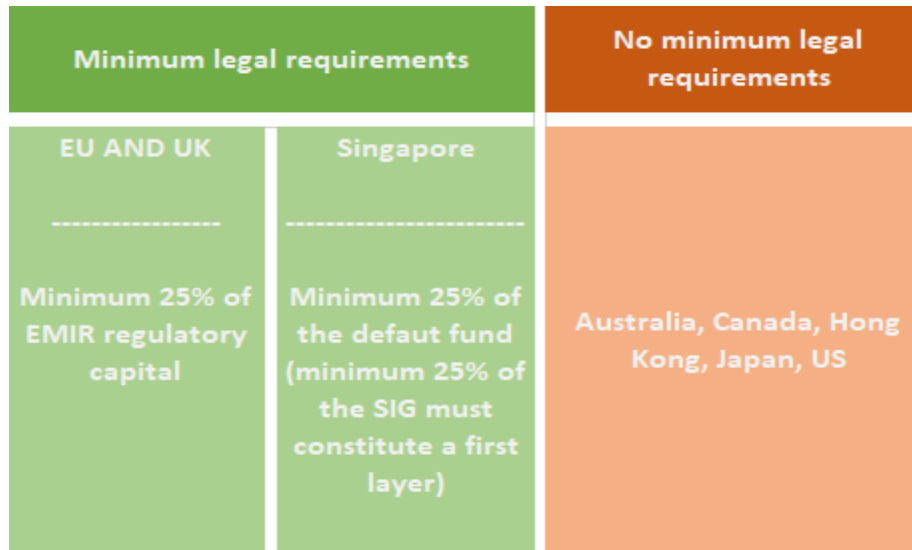
### **c. Comparative Analysis**

From an international perspective, the current legal and regulatory requirements based on jurisdictions of central counterparties are summarized in Figure 2, below<sup>7</sup>:

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<sup>6</sup> Article 9(14)&(15) of Regulation (EU) 2021/23 of the European Parliament and of the Council of 16 December 2020 on a framework for the recovery and resolution of central counterparties: *Following a default or a non-default event, a CCP shall use an additional amount of its pre-funded dedicated own resources, prior to the use of the arrangements and measures referred to in point 15 of Section A of the Annex to this Regulation. That amount shall not be lower than 10% nor higher than 25% of the risk-based capital requirements calculated in accordance with Article 16(2) of Regulation (EU) No 648/2012.*

<sup>7</sup> **Financial Stability Board.** *Financial resources to support CCP resolution and the treatment of CCP equity in resolution*, p. 14. <https://www.fsb.org/wp-content/uploads/P151118-2.pdf>



**Figure 2: Legal and regulatory requirements for establishing SITG level**

From the CDCC peers’ perspective, and based on publicly available information including the documentation regarding quantitative disclosures, CDCC has identified the following figures:

GLOBAL BENCHMARKING: SITG TO REVENUE					
	Regulatory Capital (MM)	SITG Regulatory Standard	(A)Actual SITG (MM)	(B)Annual* Revenue (MM)	Ratio (A)/(B) (%)
CDCC (CAD)	29	N/A	5	143 (1)	3.50%
CME	2,000	N/A	100 Base + 150 Swap	4,000 (1)	2.50%
LCH Ltd	117	25%	89	2,987	3.00%
NASDAQ Clearing (3)	19	25%	37	207 (1)	17.90%
LCH SA	41	25%	42	204	20%
ICE Clear US	398	N/A	90	836	10.80%
Eurex	110	25%	196	2,348	8.30%
ASX	145	N/A	238	409 (2)	58%
ICE Europe	174	25%	247	1,494	16%

**\*Please note that in some cases, revenues are annualized using quarterly results. All amounts are in USD unless otherwise indicated. As indicated in the table, please refer to the following notes:**

- 1) **Clearing and trading combined;**
- 2) **Markets, Securities and Payment included;**
- 3) **Includes estimated trading revenues to ensure comparisons.**

The main conclusion from the above benchmarking is that there is apparent variability of SITG at global central counterparties. However, a key differentiator seems to be the “mandate for central clearing” (for certain OTC derivatives). For example, CME, ASX, Eurex and LCH have all increased their SITG due to interest rate swap activity. Correcting for this fact, the risk factors of the existing businesses drive the level of SITG.

Based on the foregoing, and after review, CDCC concludes that it is not offside global regulatory

standards. However, as previously indicated, given the importance of CDCC's relationship with its Clearing Members, CDCC is open to increasing its SITG in the interests of promoting a strategic partnership to develop the business further.

Finally, CDCC's benchmarking also reveals that the SITG amounts of other central counterparties are not formally indicated in the Rules and Manual, hence providing the flexibility to adjust the SITG amount if needed.

#### **d. Analysis of Impacts**

##### **i. Impacts on Market**

The purpose of SITG is to ensure that a central counterparty is incentivized to perform robust risk management and that an alignment between the central counterparty's and clearing members' interests is in place. With their own funds at risk after the contributions of the defaulting clearing member are exhausted, central counterparties are very strongly incentivized to exercise prudent risk management to limit the impact on their own funds, thereby limiting the impact on non-defaulted members' funds<sup>8</sup>.

##### **ii. Impacts on Technology**

The Proposed Amendments will have no impact on the technological systems of CDCC, the Bourse, the Clearing Members or any third parties.

##### **iii. Impacts on Trading Functions**

The Proposed Amendments will have no impact on the trading functions of the Bourse.

##### **iv. Public Interest**

CDCC considers the Proposed Amendments to be in the interest of the public. In fact, CDCC is of the view that an appropriate SITG ensures aligned incentives between CDCC and its Clearing Members. Together with existing default management policies, it ensures all participants act in the market's best interest during stress periods.

#### **IV. PROCESS**

The Proposed Amendments, including this analysis, have been approved by CDCC's board of directors and submitted to the Autorité des marchés financiers, in accordance with the regulatory self-certification process, and to the Ontario Securities Commission in accordance with the rules stated in Appendix "A" of Schedule "A" CDCC Recognition Order dated June 15, 2023. The Proposed Amendments and analysis will also be submitted to the Bank of Canada in accordance with the Oversight Agreement. Subject to public comments and following regulatory approval, the Rules Change is expected to take effect during Q1 2024.

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<sup>8</sup> **Financial Stability Board.** *Financial resources to support CCP resolution and the treatment of CCP equity in resolution*, p. 14. <https://www.fsb.org/wp-content/uploads/P151118-2.pdf>