IIAC ACCVM
INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

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Via email: george.kormas@tmx.com

Dear George:

Re: Treatment of Non-Default Losses at CDS and CDCC

Thank you and your team for meeting with members of the IIAC on November 9, 2020 to discuss the process and ultimate determination of the parties that bear responsibility for Non-Default Losses (NDL) incurred at the Canadian Derivatives Clearing Corp. (CDCC) and/or Canadian Depository for Securities (CDS). While the type and size of NDL are difficult to predict, the potential loss incurred could be sufficiently large to jeopardize the viability of CDS/CDCC possibly forcing it into resolution.

In the meeting, IIAC members were advised that the current rules, which pre-date the Maple Transaction, provide the CDS/CDCC Board with discretion to require CDS/CDCC to absorb NDL or pass some or all of the NDL to Participants. Participants refer to direct members of the CDCC and/or CDS. Such decisions would be taken on a case-by-case basis, based on the circumstances and options available to CDS/CDCC at that point.

CDS/CDCC's reference to the Board deciding whether it would cover a loss or allocate the loss to the Participants needs further clarification. The discussion at our meeting appeared to imply that it is more accurate to characterize a NDL as a cost to the Participants UNLESS the Board decides otherwise. This is an important distinction.

Our concern, therefore, is that the financial risk of NDL may potentially be placed largely on the shoulders of Participants. This outcome is contrary to the more widely accepted principle of "whoever manages the risk, pays."[1] Moreover, allocating NDL to Participants could be procyclical and could put financial stress on Participants enough that it contributes to systemic risk.

It is critical to consider that the Participant rules as they relate to NDL were drafted when Participants owned these Financial Market Infrastructures (FMIs). Under that structure, payment of a loss by the FMI, or allocation to the Participants ultimately resulted in the same effect – the Participants paid either directly or by virtue of the devaluation of their FMI ownership. The change in the ownership structure from a member-owned entity to a for-profit arm of a publicly traded issuer, necessitate a shift of risk to owners with control over decision making and away from Participants without such control. It is inappropriate for CDS/CDCC to retain governance provisions designed for an industry utility when it has transitioned to a commercial for-profit structure.

The mutualization of default losses among Participants to prevent a FMI's insolvency cannot serve as the model for addressing NDL in FMI recovery or resolution. As such, proper steps must be taken by the FMI to monitor and mitigate NDL. Should a loss be incurred, Participants must have a clear understanding, based on pre-established agreement between the FMI and its Participants of how the loss will be extinguished, taking into account each type of NDL. This clear understanding must be documented in the FMI's respective rulebooks so that Participants have transparency into how each type of NDL is allocated and can incorporate any obligations into their liquidity and risk plans.

To properly incentivize CDS and CDCC to exercise prudent risk management, they and their parent company and shareholders, should assume most NDL, and in particular all NDL attributed to perils that are exclusively within their control.

Steps for Mitigating and Managing NDL

Our members' expectation is that CDS and CDCC have controls in place to mitigate NDL, and that management has undertaken significant scenario analysis to ensure, to the degree possible, that such losses would be able to be absorbed by CDS/CDCC. To assure Participants that CDS and CDCC will remain well protected in event of a NDL, it would be helpful to disclose regularly to Participants and regulators the following:

- What NDL scenarios you have planned for
- How are these NDL scenarios classified (Participant vs CDS/CDCC vs shared responsibility)
- How you have modeled the risk of loss associated for each NDL
- The size of potential losses as determined by your modelling
- What resources, including insurance coverage, are available at CDS/CDCC to cover these risks
- How the loss will be extinguished.

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[1] https://www.isda.org/a/dM9TE/FIA-ISDA-CCP-Non-Default-Losses-final.pdf

Furthermore, FMIs are required to hold capital against losses associated with operational risks to be able to continue operating as a going concern. Vulnerability assessments, peer benchmarking, enhanced software testing, and comprehensive monitoring are some additional best practices that can contribute to mitigating NDL at CDS and CDCC.

While the allocation of losses resulting from NDL are important financial considerations, the primary focus should remain the avoidance and mitigation of these risks.

When should CDS and CDCC bear all the loss?

NDL can stem from a wide range of events such as operational failures (including cyber incidents, poor business decisions), credit or market deterioration of investments, fraud, theft or malicious acts of employees, and failure of a custodian or settlement bank. These risks would not necessarily lead to a loss, given the risk mitigation practices at CDS and CDCC. However, our view is that where decisions or actions that contributed to the NDL were solely under the control and management of CDS/CDCC then CDS/CDCC, their parent company and shareholders should bear the loss. We acknowledge that there may be scenarios where both the FMI and a Participant(s) made choices that contributed to an NDL. In such circumstances it is not unreasonable for Participants to share in the loss. Allocating losses in this way is equitable to the FMI and its Participants and incentivizes all parties to minimize the risk of NDL.

To determine how to allocate losses in accordance with each party's contribution to the loss, each type of non-default loss requires its own evaluation.

At a macro level, members suggested that CDS should be open to considering other funding mechanisms to cover NDL such as the use of shareholder equity or parental guarantees.

Operational/Business Risks

We generally view operational risks, including general business risk (business disruption and system failures, damage to physical assets, execution, delivery & process management), legal & regulatory risks, information security risks including cyber risks and risk from fraud, solely as the responsibility of the FMI and managed through its respective enterprise risk management framework. As such, CDS/CDCC should bear all the financial consequence of any losses from these risks.

The scenario analysis for CDS shared with the IIAC and its members indicates that it is most probable that the Operating Risk Capital (ORC) of CDS and CDCC will be sufficient to cover the potential losses from operational and business risk. For situations where ORC or other dedicated funding (for example, insurance) is insufficient to cover the loss, their parent company (TMX Group), should bear the remaining losses.

Custodial Risk

It is our understanding that, where possible, CDS and CDCC use the central bank as its custodian or holder of cash. Where it is not possible to hold cash at the central bank, commercial financial institutions are selected by CDS/CDCC to be custodians and hold the cash deposits or secured alternatives. For securities collateral, both FMIs utilize CDS as the custody agent.

For custodial risk, common industry practice is for the FMI to disclaim liability for its use of third-party custodians and banks in respect of Participant and client collateral. However, given that CDS serves as custodian to both FMIs and given that CDS is also part of the TMX group, this portion of custodial risk should be assumed solely by CDS and CDCC as part of their enterprise risk framework.

Investment Risk

Market risk losses may occur based on the poor performance of the FMI's invested assets, including Participant cash collateral. CDS/CDCC invests these assets according to their investment policies which we understand follows the PFMI Principle 16: An FMI can mitigate investment risk by choosing instruments with minimal credit, market and liquidity risks.

Our understanding based on our recent meeting is that any earnings (interest or income) associated with participant related collateral investment will be delivered to Participants net of any applicable administration cost. In turn, losses incurred by CDS/CDCC related to Participant related collateral investment (including any negative interest) will be ultimately borne by Participants prorated by business activity/service. Most concerning is that the scenario analysis provided by the CDS/CDCC team indicates that Participants may potentially be exposed to very large losses.

In our view, CDS and CDCC should assume all losses associated with investment risk given they are in full control of the investment decisions. In instances where Participants are part of the investment decisions, then consideration should be given to having Participants pay a portion of any resulting loss

Settlement Bank Risk

There may be specific scenarios related settlement bank risk in which CDS or CDCC may disclaim full responsibility for potential losses, however, we continue to expect a standard of care at CDS/CDCC for managing such risks. Any NDL borne by Participants should be considered separately for each type of NDL.

Conclusion

CDS, CDCC and their respective Participants should assume financial responsibility for non-default losses **in accordance with each party's control of the risk**. Where only CDS/CDCC manage the risk and/or made decisions that contributed to the loss, CDS/CDCC should bear the entire loss. Where both the FMI and a Participant(s) made decisions that contributed to an NDL, they should share in the loss. We believe allocating losses in this manner is fair and provides all parties with an incentive to minimize the risk of non-default loss. So that Participants may undertake appropriate risk management within their respective firms, the rulebooks must explicitly articulate the responsibilities of the relevant parties for NDL.

Given the number of scenarios and outcomes associated with NDLs, and the significant impact that it can have on Participants, it is critical that Participants be included in the process that examines each scenario and develops the process for determination of the allocation of loss.   We would be pleased to offer our dealer subcommittee to assist in this process.

We look forward to the next steps.

Sincerely,

Susan Copland

Jack Rando

Cc.

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