Consultation paper on 'Prudential norms for exposure of Clearing Corporations'

Objective

I. To mitigate the concentration risk or exposure of Clearing Corporations (CCs) to various entities through stipulation of prudential norms.

Background

II. CCs are Market Infrastructure Institutions (MIIs) which essentially assume the counterparty or credit risk by interposing themselves between the parties to every trade and thus act as legal counterparties. In the ordinary course of business, CCs owing to their association with banks have exposure to such entities under various heads e.g. deposits placed with banks in respect of Core Settlement Guarantee Fund (Core SGF) as well as own funds of CCs; instruments issued by banks such as Fixed Deposits (FDs) or Bank Guarantees (BGs) or Equity or Debt securities, etc. placed as collateral with CCs by Clearing Members (CMs). A bank also acts as a clearing bank/ CM/ custodian/ liquidity provider, etc. Further, CCs are also exposed to other (non-bank) entities through equity or debt securities placed as collaterals by CMs to CCs. Thus, CCs are exposed to concentration risk that may arise from the aggregate of exposures of CCs and their subsidiaries (which may not be financially independent) to various bank and non-bank entities.

III. Given the role of a CC being a central counterparty, it is essential that any type of exposure of CC is appropriately monitored and managed. In the international context, the Committee on Payment and Market Infrastructures ("CPMI") and the Technical Committee of the International Organization of Securities Commissions ("IOSCO") have published the Principles for Financial Market Infrastructures ("PFMI"). The PFMI set out the international standards for Financial Market Infrastructures ("FMIs"), which among other entities, include central counter parties (CCPs). The PFMI provide a set of key standards for strengthening and preserving financial stability in the markets. Relevant extracts from the PFMI are stated below:

<u>Money Settlements</u>

"…If an FMI settles in commercial bank money, it should monitor, manage, and limit its credit and liquidity risks arising from the commercial settlement banks. In particular, an FMI should establish and monitor adherence to strict criteria for its settlement banks that take account of, among other things, their regulation and supervision, creditworthiness, capitalization, access to liquidity, and operational reliability. An FMI should also monitor and manage the concentration of credit and liquidity exposures to its commercial settlement banks…".

<u>Custody & Investment Risks</u>

"…An FMI should evaluate and understand its exposures to its custodian banks, taking into account the full scope of its relationships with each custodian bank".

Explanatory Note 3.16.1

"…Assets that are used by an FMI to support its operating funds or capital funds or that have been provided by participants to secure their obligations to the FMI should be held at supervised or regulated entities that have strong processes, systems, and credit profiles…".

Explanatory Note 3.16.3

"…An FMI should evaluate and understand its exposures to its custodian banks, taking into account the full scope of its relationships with each custodian bank. For example, a financial institution may serve as a custodian bank to an FMI as well as a settlement bank and liquidity provider to the FMI. The custodian bank also might be a participant in the FMI and offer clearing services to other participants. An FMI should carefully consider all of its relationships with a particular custodian bank to ensure that its overall risk exposure to an individual custodian remains within acceptable concentration limits…".

Existing guidelines

i. While framing the 'Investment policy', the clearing corporations shall consider the following principles:

(a) The investment policy of the Clearing Corporation shall be built on the premise of highest degree of safety and least market risk.

(b) The investments shall be broadly in Fixed Deposits/ Central Government Securities and Liquid schemes of Debt Mutual Funds.

ii. CCs shall align the investment policy in line with the principles laid above subject to the following-

(a) Fixed Deposit with Banks [only those banks which have a net worth of more than INR 500 crore and are rated A1 (or A1+) or equivalent.

(b) Central Government Securities;

(c) Liquid schemes of debt mutual funds; and

(d) Overnight Fund

Combined investments made by Clearing Corporations in Liquid Funds and Overnight Funds shall not exceed a limit of ten per cent of the total investible resources held by the clearing corporation, at any point in time.

iii. The total exposure of the clearing corporation to the debt or equity securities of any company shall not exceed 15% of the total liquid assets (as defined in SEBI circular No.IES/DC/CIR-4/99 dated July 28, 1999) of the clearing corporation / house.

iv. The bonds shall be treated as part of the non-cash component of the liquid assets of the clearing member and shall not exceed 10% of the total liquid assets of the clearing member.

Need for review

IV. Considering the critical role played by a CC in the securities market ecosystem and the fact that the CC is exposed to concentration risk that may arise from the aggregate of exposures of CC and its subsidiaries to various entities, it is important to protect the CC from the risks associated with such entities to which the CC is exposed to and ensure that such exposures of CC are adequately diversified.

Data on bank and non-bank total exposure of CCs as on May 31, 2023

Sl. No.	CCs	Total Bank Exposure of CCs										
		Bank 1		Bank 2		Bank 3		Bank 4		Bank 5		Total Bank exposure
		Cash, FD,BG	Equity, Debt	Cash, FD,BG	Equity, Debt	Cash, FD, BG	Equity, Debt	Cash, FD, BG	Equity, Debt	Cash, FD, BG	Equity, Debt	
1	CC1	11.44%	0.63%	6.63%	0.51%	5.55%	0.31%	3.42%	0.00%	2.26%	0.28%	50.31%
2	CC2	9.38	0.40	6.58	0.72	4.57	0.00	4.01	0.30	3.93	0.11	48.57%
3	CC3	21.3%	0.17%	16.8%	0.06%	13.2%	0.04%	9.6%	0.23%	7.3%	0.01%	76.38%
4	CC4	27.65%	0.05%	12.64%	0.00%	8.55%	0.17%	7.70%	0.06%	7.28%	0.02%	91.08%

Sl. No.	CCs	Total Non- Bank Exposure of CCs				
		Equity	Debt	G-Secs	Mutual Funds	Other Collaterals	Total non- Bank exposure
1	CC1	24.31%	0.34%	14.76%	10.29%	NA	49.69%
2	CC2	42.33%	0.23%	6.56%	2.31%	NA	51.43%
3	CC3	8.09%	-	8.02%	4.94%	2.57%	23.62%
4	CC4	3.16%	0.00%	0.00%	5.49%	0.27%	8.92%

Proposals for Public Comments

V. The detailed proposal in this regard is outlined as under:

1. Exposure of CCs - For the purpose of monitoring of exposure, CCs shall, *inter-alia,* consider the following types of exposures:
    - i. CCs' own funds invested or deployed with banks;
    - ii. Core Settlement Guarantee Fund (SGF) corpus invested or deployed with banks;
    - iii. CCs' balances with the bank in its capacity as a clearing bank;
    - iv. FDs and BGs lien marked to CCs;
    - v. Equity shares pledged or re-pledged with CCs;

vi. Debt instruments pledged or re-pledged with CCs.
vii. Mutual fund units pledged or re-pledged with CCs;
viii. CCs' similar exposure through their subsidiaries (which are not financially independent).

2. <u>Criteria for selection of Banks</u>

2.1 CCs shall devise well-defined criteria for selection of banks, which shall be based on parameters such as financials (including net-worth), capital adequacy, credit worthiness considering long term credit rating, etc. of the bank as part of their internal policy.

2.2 CCs shall closely and continuously monitor such parameters and other material events or news surrounding such banks in order to take appropriate steps for mitigating the risks that may arise on account of any significant event.

2.3 CCs shall have exposure (through Cash, FDs and BGs) to such banks which fulfil the following criteria:

(i) Minimum net worth of INR 5,000 Cr.;
(ii) Unsupported long-term issuer rating of AA and above or unsupported credit rating of a long-term instrument of AA and above. In case of foreign banks, an equivalent credit rating on the global credit rating scale (equivalent to AA and above rating by domestic Credit Rating Agencies (CRAs)) may be considered by the CCs for assessment of the credit worthiness of the bank; and
(iii) Meet the capital adequacy requirements prescribed by Reserve Bank of India (RBI) from time to time.

2.4 In case of exposure to banks whose rating has been downgraded from the rating criteria specified in the paragraph above, the CCs shall rebalance the exposure as soon as possible but no later than three months from such downgrade.

3. <u>Bank Exposure (through Cash, FDs and BGs) Limit</u>

3.1. The exposure of CCs and subsidiaries towards banks must be liquid and adequately diversified, and daily exposure to a single bank shall not exceed the limits given below:

3.1.1. 15% of the average daily exposure of the previous three months (considering all exposures of CCs) in case of AAA rating as mentioned at paragraph 2.3(ii) above and

3.1.2. 10% of the average daily exposure of the previous three months (considering all exposures of CCs) in case of AA and above but below AAA rating as mentioned at paragraph 2.3(ii) above.

3.1.3. The above limits shall be applicable separately for the following heads:

i. CCs' own funds.
ii. Core SGF corpus.
iii. CCs' exposure through their members or warehouse service providers or other entities (through Cash, FDs and BGs).

As per the existing regulatory requirements, CCs' own funds and core SGF corpus can only be deployed in FDs, T-bills, G-secs and money market or liquid mutual funds.

3.2. The daily exposure to a single bank should not exceed 15% (or 10% as the case may be) of the average daily exposure of the previous three months, separately under the respective heads mentioned at paragraph 3.1.3 above. However, the daily exposure can be extended by 5% in order to allow the CCs to have operational flexibility. In those cases, the CCs shall record the reasons for such increase in exposure and ensure to bring down the daily exposure to a single bank to 15% (or 10% as the case may be) on monthly average basis on priority.

4. Exposure of CCs to equity and debt instruments (both bank and non-bank entities) through Clearing Members

4.1. CCs shall devise well-defined criteria for exposure to equity and debt instruments through Clearing Members in order to ensure adequate diversification, liquidity, etc.

4.2. The total issuer wise exposure of the CC to equity and debt instruments of a company received through Clearing Member (CM) put together shall not exceed 15% of total liquid assets of the CC in both cash and F&O segment (including commodity derivatives segment); and shall be treated as part of non-cash component of the total liquid assets of the CC.

4.3. CCs shall ensure that the corporate bonds provided by a CM shall not exceed;

4.3.1. 10% of the total liquid assets of the CM placed with CC, in case the unsupported long-term issuer rating or unsupported credit rating of a long-term instrument of that issuer is AAA.

4.3.2. 8% of the total liquid assets of the CM placed with CC, in case the unsupported long-term issuer rating or unsupported credit rating of a long-term instrument of that issuer is AA and above but below AAA.

In case of exposure to entities whose instruments' rating has been downgraded from the rating criteria specified in the paragraph above, the CCs shall rebalance the exposure as soon as possible but no later than three months from such downgrade.

Further, no such collateral provided by CMs to CCs shall be acquired through bespoke transactions, i.e., the CMs shall not be the sole subscribers of such corporate bond issuances.

4.4. Exposure for this purpose means the mark to market value of the securities less the applicable haircuts.

5. The overall daily exposure of a CC (including exposure through its subsidiaries) to a single bank (including cash, FD, BG, equity and debt) shall not exceed 20% of the total exposure. An illustration on the exposure limits of CCs is provided below:

Exposure Limits

Suppose the average daily total exposure for the three months i.e. from April 2023 to June 2023 of a CC is INR 1,500 Cr. under the following heads:

Sl. No.	**Exposure Heads**	**Exposure**
i	CCs' own funds	INR 250 Cr.
ii	Core SGF corpus	INR 350 Cr.
iii	Exposure (through cash, FDs and BGs) of CCs through CMs or warehouse service providers or other entities (a+b)	
	a) FDs and BGs issued by the bank and lien marked to CCs	INR 400 Cr.
	b) CCs' balances with the bank in its capacity as a clearing bank	INR 100 Cr.
iv	Exposure of CCs to equity and debt instruments through CMs (c+d)	
	c) Total Equity Securities	INR 300 Cr.
	d) Total Debt Securities	INR 100 Cr.
v	**Total Exposure**	INR 1500 Cr.

The scenarios of maximum permissible limits of exposure to a single entity under the various heads for the month of July 2023 are given as under:

Sl. No.	Exposure Heads	Maximum permissible limits to single Bank/ Entity	Value (in INR Cr.)	Relevant information
1	CCs' own funds invested in banks	15% of CCs' own funds	37.5	Average daily exposure to a single bank shall not exceed 15% of total exposure. However, the daily exposure can be extended to 20% (INR 50 Cr.) in order to allow the CCs to have operational flexibility. In those cases, the CCs shall ensure to bring down the average daily exposure to the bank to 15% on a priority basis.
2	Core SGF corpus invested in banks	15% of Core SGF of CCs	52.5	Average daily exposure to a single bank shall not exceed 15% of total exposure. However, the daily exposure can be extended to 20% (INR 70 Cr.) in order to allow the CCs to have operational flexibility. In those cases, the CCs shall ensure to bring down the average daily exposure to the bank to 15% on a priority basis.
3	CCs' exposure (through cash, FDs and BGs) (a+b)	15% of (iii) (a+b)	75	Average daily exposure to a single bank shall not exceed 15% of total exposure. However, the daily exposure can be extended to 20% (INR 100 Cr.) in order to allow the CCs to have operational flexibility. In those cases, the CCs shall ensure to bring down the average daily exposure to the bank to 15% on a priority basis.

4	Exposure to Equity and Debt securities	15% of total liquid assets of CMs with CCs [(iii)+(iv)]	135	The total liquid assets of CC shall have the same meaning as specified in SEBI circular No.IES/DC/CIR-4/99 dated July 28, 1999.
5	Overall exposure to a single Bank	20% of total exposure	300	The overall daily exposure to a single bank including all the heads from point 1 to point 4 shall be less than or equal to 20% of the total exposure.

For the purpose of simplicity, it is assumed that the exposure of CCs is to entities whose long-term issuer credit rating is AAA.

6. <u>Acceptance of FDs, BGs, equity securities or debt instruments, issued by CM, Trading Member (TM) or its group or associates, as collateral</u>

6.1. CCs shall not accept FDs, BGs, equity or debt securities as collateral from CMs, which are issued by themselves or their TMs; or group or associate companies of such CMs/TMs.

<u>Explanation</u> – for this purpose, 'associate' shall have the same meaning as defined under Regulation 2(1)(b) of Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018.

7. CCs shall incorporate periodic targets in their internal policy so as to achieve the above mentioned exposure limits in a timely manner. Further, CCs shall have a mechanism in place for monitoring the real time exposure towards banks through CMs/TMs and keep a cushion of limits so that the exposures can be maintained within the limit without any operational difficulties.

8. In order to ensure smooth implementation, the above measures are proposed to be implemented in a phased manner as indicated below:

Sl. No.	Exposure Type	Proposed Timeline
1	CCs' own funds and Core SGF funds invested or deployed with banks	3 months
2	Following exposure of CCs' to banks through their members or warehouse service providers or other entities: i. FDs and BGs lien marked to CCs ii. CCs' balances with the bank in their capacity as a clearing bank.	1 year
3	Phasing out of collaterals with CCs, which are issued by themselves or their TMs; or group or associate companies of such CMs/TMs; in the form of FDS, BGs, equity or debt securities.	6 months
4	Overall exposure limit of 20% to a single bank.	1 year

Public Comments on this Consultation Paper

Considering the implications of the proposals on the market participants, public comments are invited on the same. The comments/ suggestions may be provided as per the format given below:

Kindly mention the subject of the communication as, Consultation paper on ***'Prudential Norms for exposure of Clearing Corporations'***

Name of the person/entity proposing comments
Name of organizations (If applicable)
Contact Details
Category: whether market intermediary/ participant (mention type/ category) or public (investor, academician etc.)

S. No.	Relevant sub-paragraphs of proposals mentioned at paragraph V	Concern/issues	Rationale
1			
2			

VI. Comments as per aforesaid format may be sent to the e-mail ID dhanushs@sebi.gov.in, latest by August 10, 2023.

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