



8011-01
SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-82853; File No. SR-ICC-2018-001)

March 12, 2018

Self-Regulatory Organizations; ICE Clear Credit LLC; Order Approving Proposed Rule Change Relating to the ICC Rules, ICC Risk Management Model Description Document, ICC Risk Management Framework, ICC Stress Testing Framework, and ICC Liquidity Risk Management Framework

I. Introduction

On January 16, 2018, ICE Clear Credit LLC (“ICC”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² a proposed rule change (SR-ICC-2018-001) to revise: (i) ICC’s Clearing Rules to support the clearing of a new transaction type; and (ii) the ICC Risk Management Model Description Document, the ICC Risk Management Framework, the ICC Stress Testing Framework, and the ICC Liquidity Risk Management Framework to incorporate certain modifications to its risk management methodology.³ The proposed rule change was published for comment in the Federal Register on January 26, 2018.⁴ The Commission did not receive comments on the proposed rule change. For the reasons discussed below, the Commission is approving the proposed rule change.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Capitalized terms used in this order, but not defined herein, have the same meaning as in the ICC Clearing Rules.

⁴ Securities Exchange Act Release No. 34-82542 (January 19, 2018), 83 FR 3821 (January 26, 2018) (SR-ICC-2018-001) (“Notice”).

II. Description of the Proposed Rule Change

ICC proposed revisions to its Rules, Risk Management Model Description Document, Risk Management Framework, Stress Testing Framework, and Liquidity Risk Management Framework in order to provide for the clearing of a new transaction type, the Standard European Senior Non-Preferred Financial Corporate, and to provide for revised risk management practices.

A. Changes to ICC Rules

ICC proposed amending Rule 26H-102, which sets forth the List of Eligible Standard European Financial Corporate (“STEFC”) Reference Entities, to include the Standard European Senior Non-Preferred Financial Corporate transaction type as an Eligible STEFC Reference Entity to be cleared by ICC.⁵

ICC also proposed amending Rule 26H-102 to state that for a STEFC Reference Entity where the transaction type is the Standard European Senior Non-Preferred Financial Corporate, the STEFC Contracts Reference Obligation shall be determined in accordance with the Additional Provisions for Senior Non-Preferred Reference Obligations as published by the International Swaps and Derivatives Association. In addition, ICC proposed to incorporate certain conforming changes to Rule 26H-303 and Rule 26H-315 to add references to the new transaction type.⁶

B. Changes to ICC Risk Management Methodology

As currently constructed, ICC’s risk management methodology takes into consideration the potential losses associated with idiosyncratic credit events, which ICC

⁵ Notice, 82 FR at 3821.

⁶ Id.

refers to as “Loss-Given Default” or “LGD.” ICC deems each Single Name (“SN”) reference entity a Risk Factor, and each combination of definition, doc-clause, tier, and currency for a given SN Risk Factor as a SN Risk Sub-Factor. ICC currently measures losses associated with credit events through a stress-based approach incorporating three recovery rate scenarios: a minimum recovery rate, an expected recovery rate, and maximum recovery rate. ICC combines exposures for Outright and index-derived Risk Sub-Factors at each recovery rate scenario.⁷

ICC currently uses the results from the recovery rate scenarios as an input into the Profit/Loss-Given-Default (“P/LGD”) calculations at both the Risk Sub-Factor and Risk Factor levels. For each Risk Sub-Factor, ICC calculates the P/LGD as the worst credit event outcome, and for each Risk Factor, ICC calculates the P/LGD as the sum of the worst credit outcomes per Risk Sub-Factor. These final P/LGD results are used as part of the determination of risk requirements.⁸

ICC proposed changes to its LGD framework at the Risk Factor level with respect to the LGD calculation. Specifically, ICC proposed a change to its approach by incorporating more consistency in the calculation of the P/LGD by using the same recovery rate scenarios applied to the different Risk Sub-Factors which are part of the considered Risk Factor. For each Risk Factor, ICC would continue to calculate an “extreme outcome” as the sum of the worst Risk Sub-Factor P/LGDs across all scenarios and would also, for each Risk Factor, calculate an “expected outcome” as the worst sum of all the Risk Sub-Factors P/LGDs across all of the same scenarios. Under the proposed

⁷ Id.

⁸ Id.

changes, ICC would then combine the results of the “extreme outcome” calculation and the “expected outcome” calculation to compute the total LGD for each Risk Factor.⁹ ICC proposed to apply a weight of 25% to the extreme outcome component in order to implement certain requirements of relevant regulatory technical standards arising under the European Market Infrastructure Regulation.¹⁰

ICC also proposed to expand its LGD analysis to incorporate a new “Risk Factor Group” level. Under the proposed changes, a set of related Risk Factors would form a Risk Factor Group based on either (1) having a common majority parental sovereign ownership (e.g. quasi-sovereigns and sovereigns), or (2) being a majority owned subsidiary of a common parent entity according to the Bloomberg Related Securities Analysis. ICC noted that a Risk Factor Group could consist of only one Risk Factor.¹¹

Under the proposed revisions, ICC would calculate the total quantity LGD on a Risk Factor Group level, and account for the exposure due to credit events associated with the reference entities within a given Risk Factor Group. Where a Risk Factor Group contains only one Risk Factor, ICC would compute the LGD as the risk exposure due to a credit event for a given underlying reference entity. Moreover, under the proposed approach, ICC would sum the P/LGDs for each Risk Factor in a given Risk Factor

⁹ Id. at 3821-22.

¹⁰ See Commission Delegated Regulation (EU) No 153/2013 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on requirements for central counterparties. As a third-country central counterparty recognized by the European Securities and Markets Authority, ICC is subject to the requirements of the European Market Infrastructure Regulation and associated regulatory technical standards.

¹¹ Notice, 82 FR at 3822.

Group, with limited offsets in the event the Risk Factors exhibit positive P/LGD. Using the results of the above calculation, ICC would obtain the Risk Factor Group level LGD. The proposed approach would also include a calculation which allows for the Risk Factor Group level LGD to be attributed to each Risk Factor within the considered Risk Factor Group.¹²

In addition to these changes, ICC also proposed changes to various components of its Risk Management Model Description Document. Specifically, the “Loss Given Default Risk Analysis” section of its Risk Management Model Description Document would be changed to incorporate the Risk Factor and Risk Factor Group LGD calculation changes described above. ICC also proposed certain conforming changes to other sections of the Risk Management Description Document to incorporate these methodology changes and reflect the Risk Factor Group analysis.¹³

ICC also proposed further changes with respect to the ‘Idiosyncratic Jump-to-Default Requirements’ section of the Risk Management Model Description document. As currently constructed, the portfolio jump-to-default approach collateralizes the worst uncollateralized LGD (“ULGD”) exposure among all Risk Factors. Under the proposed changes, the portfolio Jump-to-Default (“JTD”) approach will collateralize, through the portfolio JTD initial margin requirement that accounts for the Risk Factor Group-specific LGD collateralization, the worst ULGD exposure among all Risk Factor Groups. The

¹² Id.

¹³ Id.

ULGD exposure for a given Risk Factor Group would be calculated as a sum of the associated Risk Factor ULGDs.¹⁴

ICC also proposed certain minor edits to the “Portfolio Level Wrong-Way Risk and Contagion Risk Analysis” section to update language and calculation descriptions to accommodate the introduction of the Risk Factor Group to the “Idiosyncratic Jump-to-Default Requirements” section.¹⁵

In addition, ICC proposed changes to the “Guaranty Fund Methodology” section. ICC’s current Guaranty Fund Methodology includes, among other things, the assumption that up to three credit events, different from the ones associated with Clearing Participants, occur during the considered risk horizon. ICC proposed expanding this approach to the Risk Factor Group level by assuming that credit events associated with up to three Risk Factor Groups, different from the ones associated with the Clearing Participants and the Risk Factors that are in the Risk Factor Groups as the Clearing Participants, occur during the considered risk horizon.¹⁶

Other proposed changes to the Risk Management Model Description Document included clarifications to the calculation for the Specific Wrong Way Risk component of the Guaranty Fund. Currently, for a given Clearing Participant, the Specific Wrong Way Risk component of the Guaranty Fund is based on self-referencing positions arising from

¹⁴ Id.

¹⁵ Id.

¹⁶ Id.

one or more Risk Factors. ICC proposed clarifying this approach to be based on the Risk Factor Group level instead.¹⁷

ICC proposed certain conforming changes to its Risk Management Framework, Liquidity Risk Management Framework, and Stress Testing Framework, to reflect the LGD enhancements described above. With respect to the Risk Management Framework, ICC proposed revisions to the “Jump-to-Default Requirements” section to note that the worst LGD associated with a Risk Factor Group is selected to establish the portfolio idiosyncratic JTD requirement. ICC also proposed revisions to the “Guaranty Fund” section of the Risk Management Framework to reflect the Risk Factor Group LGD enhancements related to ICC’s Guaranty Fund calculation.¹⁸

Regarding its Stress Testing Framework, ICC proposed changes to its stress testing methodology to incorporate reference entity group level changes (also referred to by ICC as the Risk Factor Group level). Currently, ICC utilizes scenarios based on hypothetically constructed (forward looking) extreme but plausible market scenarios augmented with adverse credit events affecting up to two additional reference entities per Clearing Participant affiliate group. ICC proposed expanding its adverse credit event analysis to include up to two additional reference entity groups, and also proposed that the selected Risk Factor Group for stress testing purposes must contain one or more reference entities displaying a 500 bps or greater 1-year end-of-day spread level in order to be subjected to credit events. ICC also proposed changes to its reverse stress testing, general wrong way risk, and contagion stress testing analyses, to be at the Risk Factor

¹⁷ Id.

¹⁸ Id.

Group level, and proposed removing Risk Factor level references under its Recovery Rate Sensitivity analysis to be consistent with the proposed changes related to Risk Factor Groups.¹⁹

Finally, with respect to ICC's Liquidity Risk Management Framework, ICC proposed changes to base the liquidity stress testing methodology on the reference entity group level (also referred to as the Risk Factor Group level). Currently, ICC utilizes scenarios based on hypothetically constructed (forward looking) extreme but plausible market scenarios augmented with adverse credit events affecting up to two additional reference entities per Clearing Participant affiliate group. ICC proposed expanding its adverse credit event analysis to include up to two additional reference entity groups. Similar to the Stress Testing Framework, ICC also proposed that the selected Risk Factor Group for liquidity stress testing purposes must contain one or more reference entities displaying a 500 bps or greater 1-year end-of-day spread level in order to be subjected to credit events. ICC also proposed adding additional language to the Liquidity Risk Management Framework detailing the rationale behind the selection of the 500 bps threshold to be consistent with its Stress Testing Framework.²⁰

III. Discussion and Commission Findings

Section 19(b)(2)(C) of the Act directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder

¹⁹ Id.

²⁰ Id.

applicable to such organization.²¹ For the reasons given below, the Commission finds that the proposal is consistent with Section 17A(b)(3)(F) of the Act, and Rules 17Ad-22(b)(2) and (b)(3).

A. Consistency with Section 17A(b)(3)(F) of the Act

Section 17A(b)(3)(F) of the Act requires, among other things, that the rules of a registered clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions and, to the extent applicable, derivative agreements, contracts, and transactions, to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible and, in general, to protect investors and the public interest.²² The proposed rule change will provide for the clearance and settlement of the Standard European Senior Non-Preferred Financial Corporate, a new type of transaction that is similar to contracts already cleared by ICC.

Separately, as described above, the proposed rule change would also provide for certain revisions to ICC's risk management methodology with respect to ICC's LGD methodology. These changes entail (i) incorporating a more consistent approach with respect to ICC's recovery rate scenarios through the application of the same recovery rate scenarios to risk factors that form part of the same Risk Factor Group, (ii) combining the results of the "expected" and "extreme" P/LGD outcomes in order to calculate the total LGD for each Risk Factor, (iii) expanding ICC's LGD analysis to a new Risk Factor Group level, (iv) revising the calculation of the Uncollateralized Loss Given Default to incorporate the Risk Factor Group level LGD approach, and (v) modifying ICC's

²¹ 15 U.S.C. 78s(b)(2)(C).

²² 15 U.S.C. 78q-1(b)(3)(F).

Guaranty Fund Methodology to expand the credit event analysis to include the Risk Factor Group approach.

Based on a review of the Notice, the Commission believes that the Standard European Senior Non-Preferred Financial Corporate transaction type is substantially similar to other contracts cleared by ICC. As such, the Commission believes that ICC's existing clearing arrangements, and related financial safeguards (including as further modified by the proposed rule change), protections and risk management procedures will apply to this new product on a substantially similar basis to the other contracts currently cleared by ICC.

Moreover, the Commission believes that the proposed changes to ICC's risk management framework described above will enhance the manner by which ICC considers and manages the risks particular to the range of contracts it clears, including the new Standard European Senior Non-Preferred Financial Corporate contract, because such changes will enable ICC's ability to more accurately consider the particular risks of each type of security-based swap ("SBS") product it clears. Therefore, the Commission finds that the proposed rule change is intended to promote the prompt and accurate clearance and settlement of securities transactions and derivatives agreements, contracts, and transactions, as well as to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible and, in general, to protect investors and the public interest, and is therefore consistent with Section 17A(b)(3)(F) of the Act.²³

²³

Id.

B. Consistency with Rule 17Ad-22(b)(2)

The Commission further finds that the proposed rule change is consistent with Rule 17Ad-22(b)(2). Rule 17Ad-22(b)(2) requires, in relevant part, a registered clearing agency that performs central counterparty services to establish, implement, maintain and enforce written policies and procedures reasonably designed to use margin requirements to limit the registered clearing agency's credit exposures to participants under normal market conditions and use risk-based models and parameters to set margin requirements.²⁴ As described above, the proposed changes would (i) amend the manner in which ICC calculates its Risk Factor-level LGD, (ii) expand the LGD analysis to the Risk Factor Group level, and (iii) amend the approach to calculating the Uncollateralized LGD to incorporate the Risk Factor Group level approach. Specifically, ICC would calculate, for each Risk Factor, an extreme outcome as the sum of the worst Risk Sub-factor P/LGDs across all scenarios, and an expected outcome as the worst sum of all Risk Sub-factor P/LGDs using the same scenarios, and then add the two components to determine the total LGD for each Risk Factor.

The LGD analysis would also be modified to group individual Risk Factors into Risk Factor Groups, and would result in the total LGD being the sum of the P/LGDs for each Risk Factor within the Risk Factor Group. The Commission believes that by making these changes, ICC will augment its ability to more accurately consider the risks associated with the SBS products it clears, including the Standard European Senior Non-Preferred Financial Corporate transaction type.

²⁴ 17 CFR 240.17Ad-22(b)(2).

As a result, the Commission believes that the proposed rule changes will enable ICC to more accurately determine and collect the amount of resources necessary to limit its credit exposures under normal market conditions, including credit exposures resulting from clearing the new transaction type, through the use of risk-based models. Therefore the Commission finds that the proposed rule change is consistent with Rule 17Ad-22(b)(2).²⁵

C. Consistency with Rule 17Ad-22(b)(3)

The Commission further finds that the proposed rule change is consistent with Rule 17Ad-22(b)(3). Rule 17Ad-22(b)(3) requires, in relevant part, a registered clearing agency that performs central counterparty services for SBS to establish, implement, maintain and enforce written policies and procedures that are reasonably designed to maintain sufficient financial resources to withstand, at a minimum, a default by the two participant families to which it has the largest exposures in extreme but plausible market conditions.²⁶ As described above, the proposed rule change would amend certain assumptions in ICC's Guaranty Fund Methodology, and the calculation of the Specific Wrong Way Risk component, by incorporating the new Risk Factor Group level analysis. Specifically, ICC would expand its current approach to assume that credit events used in the guaranty fund analysis occur at the Risk Factor Group level, and would also base the specific wrong-way risk component of its guaranty fund methodology on the Risk Factor Group approach.

²⁵ Id.

²⁶ 17 CFR 240.17Ad-22(b)(3).

As with the changes to the LGD approach, the Commission believes that the proposed changes to ICC's Guaranty Fund Methodology will permit ICC to consider the particular risks associated with the products it clears, including the Standard European Senior Non-Preferred Financial Corporate transaction type that will be cleared as a result of the proposed changes to ICC's Rules described above. As a result, the Commission believes that the proposed changes will enable ICC's to more accurately measure the risks of associated with the products it clears and thereby improve ICC's ability to collect and maintain the level of financial resources necessary to address the risk of default by its participants. Therefore, the Commission finds that the proposed rule change is consistent with Rule 17Ad-22(b)(3).²⁷

IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act,²⁸ and Rules 17Ad-22(b)(2) and (3) thereunder.²⁹

²⁷ Id.

²⁸ 15 U.S.C. 78q-1.

²⁹ 17 CFR 240.17Ad-22(b)(2) and (3).

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2) of the Act³⁰ that the proposed rule change (SR-ICC-2018-001) be, and hereby is, approved.³¹

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³²

Eduardo A. Aleman
Assistant Secretary

³⁰ 15 U.S.C. 78s(b)(2).

³¹ In approving the proposed rule change, the Commission considered the proposal's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

³² 17 CFR 200.30-3(a)(12).

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