Response: CFTC Request for Information on Climate-Related Financial Risk – October 07, 2022

Background

The World Federation of Exchanges (WFE) is the global trade association for regulated exchanges and clearing houses. We represent the operators of over 250 market infrastructures, spread across the Asia-Pacific region (37%), EMEA (43%) and the Americas (20%), with everything from local entities in emerging markets to international groups based in major financial centres. In total, member exchanges trade around $100 trillion a year and are home to some 60,000 companies, with an aggregate market capitalisation of around $120 trillion. The 50 distinct central counterparty (CCP) clearing services (both vertically integrated and stand-alone) collectively ensure that traders put up $1 trillion of resources to back their risk positions.

With extensive experience of developing and enforcing high standards of conduct, WFE members support an orderly, secure, fair and transparent environment for all sorts of investors and companies wishing to invest, raise capital or manage financial risk.

Founded in 1961, the WFE seeks outcomes that maximise financial stability, consumer confidence and economic growth. We also engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in an internationally integrated financial system.

If you have any further questions, or wish to follow-up on our contribution, the WFE remains at your disposal. Please contact:

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WFE response to CFTC's Request for Information on Climate-Related Financial Risk

September 2022

The WFE welcomes the opportunity to comment on the CFTC's Request for Information (RFI) on Climate-Related Financial Risk[1] to share perspectives and feedback on behalf of our members. Note that given the nature of our membership, we refer to CCPs in our response (not only derivatives clearing organizations). Our response is focused on how climate-related financial risks are already assessed by current risk management practices of CCPs, as part of and consistent with, the current regulatory framework applied to CCPs.

Efforts on climate-related financial risk must clearly recognise the distinct purpose and function of the various types of entities noted in the RFI. The fundamental role of a CCP is to manage the risk arising from its capacity of becoming the buyer to every seller and the seller to every buyer. Accordingly, **focus towards assessing climate-related financial risk should in no way distract from or undermine this fundamental role and the related risk management practices that are already in place at CCPs (eg, approaches to margin, stress testing and clearing member default management practices). In thinking about the potential for climate-related financial risk for CCPs, there should therefore be a clear focus on plausibility and the relevance of any related events to a CCP in its fundamental role**, including, as an example, the nature of products that form its clearing services.

It is critical that any efforts with respect to assessing climate-related financial risk clearly recognise the risk management practices that CCPs already employ to effectively manage and mitigate climate-related financial risks. We believe that the focus should be less on any one specific event or transition risk(s), but rather on ensuring that the CCP has effective approaches to manage and mitigate the potential impact of such events, risks, and developments more broadly, whether that be through margining, stress testing, or other risk-management practices a CCP employs as part of its risk management framework.

- Related to the *transition risks*[2] described in the RFI, margining and stress testing for CCPs rightly has a short-term perspective, aligned to a liquidation period that corresponds to the types of products it clears (typically less than five days). When considering the period of time in which transition risks could materialise, we believe that it is highly unlikely to be over this short period of time.

[1] https://www.cftc.gov/sites/default/files/2022/06/2022-12302a.pdf

[2] "Transition risks generally are characterized by stresses to certain financial institutions or sectors that result from shifts in policy, regulations, customer and business preferences, technology, credit or insurance availability, or other market or social forces that can affect business operations." *Id* at 4 citing Financial Stability Oversight Council ("FSOC"), "Report on Climate-Related Financial Risk 2021" (Oct. 21, 2021), available at *https://home.treasury.gov/system/files/261/FSOC-Climate-Report.pdf* ("FSOC Report"), at 12-13

- Related to the *physical risks*[3] described in the RFI, a CCP's disaster recovery planning, together with other measures in place to address operational risks, will clearly be relevant to its overall resilience in the face of physical and other similar risks. Therefore, we believe that there is no justification to separate such physical climate risks from overall operational risk and the existing approaches to how they are managed.

The WFE recognises that climate change is a global consideration for financial markets, however international standards already exist for CCPs' risk management practices which ensure that a CCP identifies, monitors, and manages the range of risks to which it is exposed, and which establishes the expectation that CCPs consider and account for the potential impacts of climate-related financial risks (ie, the CPMI-IOSCO PFMIs set out in April 2012).

The WFE maintains the view that principles-based approaches, as the CFTC has embraced, allow CCPs to effectively identify and address the unique risks of their products and markets, which includes climate-related financial risks. It is important to also recognise that CCPs clear very distinct products and markets, and the extent to which climate-related financial risks impact them will demonstrably vary – therefore it is not something that should be assessed, managed, or overseen by policymakers in a prescriptive or uniform manner. Fundamentally, CCPs require the appropriate level of flexibility, as is provided for in the CFTC's current regulatory framework, to tailor its risk management practices to the unique risks of their products and markets. The CFTC has long-embraced a principles-based regulatory framework, understanding that it is the role and responsibility of the CCP to manage the risks which it is subject, but that "…DCOs have discretion with respect to how they identify, label, and address such risks." Broadly, CCPs are best suited to appropriately design their risk management practices in a manner that captures the unique risks and characteristics of their market(s), products cleared, and market participants served.

The following two sections include the WFE's feedback to the questions within the RFI related to CCP Scenario Analysis and Stress Testing and CCP Risk Management.

I. CCP Scenario Analysis and Stress Testing (Questions 4, 5, 6, and 7)

Stress testing for CCPs rightly has a short-term perspective that is aligned to and commensurate with, the applicable period of risk for the products it clears (eg, a period of risk between one and five days, typically). Where climate-related financial risks could develop within the applicable period of risk <u>and</u> meet the standard of extreme but plausible, they would be considered as part of a CCP's stress testing framework and other risk management practices (as/where relevant). With an appropriate focus on the short-term risks, it should be recognised that the likelihood of financial risks related to climate change materialising within this short period is minimal, specifically as it relates to transition risks.

Further, as transition risks are described in the RFI, it seems highly unlikely that "shifts in policy, regulations, customer and business preferences, technology, credit or insurance availability, or other

[3] "Physical risks generally are characterized by harm caused by acute, climate-related events such as hurricanes, wildfires, floods, and heatwaves; and chronic shifts in precipitation patterns, sea level rise, and ocean acidification" Id. at 3 citing Financial Stability Board ("FSB"), "The Implications of Climate Change for Financial Stability (Nov. 2020)," available at https://www.fsb.org/2020/11/the-implications-of-climate-change-for-financial-stability/, at 6.

market or social forces that can affect business operations" would occur in the short-term. Therefore, we consider that **transition risks would not materialise within the applicable period of risk and should be out of scope for CCP stress testing**. Broadly, we consider that assumptions that transition risks could arise over the short-term (eg, under five days) do not meet a plausibility standard in the context of CCP risk management frameworks and thus are not suitable for or consistent with the objective of CCP stress testing.

CFTC Part 39 Regulations

The current requirements adopted by the CFTC under Part 39 Regulations (consistent with the CPMI-IOSCO PFMIs set out in April 2012) already define appropriate considerations for CCPs regarding scenario analysis and stress testing. Therefore, we believe that it is important for the CFTC to recognise how and why CCPs use stress testing as part of and together with the overall risk management framework, and to reflect this within the context of this RFI. Specifically, consistent with CFTC Regulation 39.11(a)(1), the purpose of a CCP's stress testing is to size its financial resources such that it can meet its financial obligations to its clearing members notwithstanding a default by the clearing member (and commonly, the two largest clearing members) creating the largest financial exposure in extreme but plausible market conditions. That is to say that if climate-related factors become relevant and material within the applicable period of risk, there is already a framework in place to capture them within a broader, dynamic, framework for stress testing together with other risk management practices.

II. CCP Risk Management (Questions 8, 9, 10, and 11)

The CFTC should clearly recognise (and reflect within the context of this RFI) the risk management practices that CCPs already employ to mitigate and manage various forms of climate-related financial risks effectively and comprehensively. As described above, we believe that the risk management practices referred to in the RFI (eg, Question 8) already consider, where appropriate, climate-related financial risks (eg, margining, stress testing, disaster recovery planning, operational risk resilience). Therefore, we do not believe that any new or enhanced guidance is needed to provide assurance that such types of risks are considered by CCPs. Please also refer to the WFE's comments in the introduction on the benefits of a principles-based approaches to regulatory frameworks – we believe that CFTC should continue its longstanding history of acknowledging and embracing this approach.

Additionally, as noted in the introduction, CCPs are best suited to appropriately design their risk management practices in a manner that captures the unique risks (including those that are climate-related) and characteristics of their market(s), products cleared, and market participants served. Notwithstanding this and in reference to Question 10 of the RFI, it should be recognised that the risk management framework for CCPs does not vary by size, complexity, risk profile, or by existing enterprise risk management practices of the CCP as it relates to the consideration and risk management of the potential impact of any risk, including climate-related financial risks.

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