European Securities Forum

Submission to the Basel Committee on Banking Supervision

The New Basel Capital Accord

The European Securities Forum (ESF) is an organisation established by the major users of Europe's clearing and settlement infrastructure. ESF was established in response to rationalisation initiatives within the industry, to act as a neutral and objective facilitator of a rapid progression towards a powerful, efficient European capital market infrastructure. For more information on ESF and its activities, see our website at http://www.eurosf.com/.

ESF welcomes this opportunity to comment on the proposals by the Basel Committee for revisions to the 1988 Capital Accord. ESF's current initiatives are focused on driving down the costs that result from Europe's fragmented clearing and settlement industry. In particular, ESF wants to see the creation of a single, user owned and governed pan-European central counterparty in the clearing sector and further consolidation in the settlement sector. The comments in this paper are, therefore, confined to those parts of the proposed new Accord that are relevant to the clearing and settlement infrastructure.

Executive summary

In summary:

Capital treatment of banks' exposures to clearing houses

Because the services offered by clearing houses constitute an extremely important tool for the reduction of risk, market participants should be encouraged to clear their transactions through clearing houses:

- *the new Capital Accord should specifically address the treatment of exposures to clearing houses, both in relation to on-balance sheet and off-balance sheet claims;*

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- *bank supervisors should be allowed to apply special treatment to exposures to recognised clearing houses that acknowledges the risk management framework within which they operate;*

- *direct claims on recognised clearing houses (e.g. for initial margin or for free deliveries of securities) should be accorded a preferential risk weighting. Recognised clearing houses should be treated in the same way as banks (under Option 1). However, at national discretion, national supervisors should be able to assign a 20% risk weighting to claims on unrated recognised clearing houses (i.e. one category more favourable than the treatment available to exposures to unrated banks in Option 1) and a 0% risk weighting to recognised clearing houses which have the benefit of an AAA rating or which otherwise meet very high standards of robustness. This treatment should apply both in respect of banking book and trading book claims;*

- *off balance sheet claims on recognised clearing houses and exchanges in respect of on-exchange derivative contracts which are subject to daily margining should continue to be treated as representing zero exposure;*

- *claims on recognised clearing houses in respect of OTC derivative contracts and repurchase and securities lending transactions should, in general, be treated in the same way as direct claims (i.e. given the benefit of the proposed preferential risk weighting). However, there should be flexibility to waive the requirement for capital charges for potential future exposure in fully collateralised systems;*

- *the Basel Committee should give some guidelines for recognition of clearing houses and for the assignment of the proposed preferential risk weighting;*

- *in the IRB approach, exposures to recognised clearing houses should be treated in the same way as exposure to banks;*

- *the Basel Committee should encourage clearing houses to provide transparency as to the risk management practices and procedures of clearing houses (this might be made a condition of their recognition);*

- *in relation to the measurement of exposures on OTC derivative contracts, national supervisors should have discretion, in the case of fully collateralised systems, to waive the requirement to include charges for potential future exposure;*

- *if the "w" factor remains as a feature of the new Accord, the new Accord should recognise the very high degree of legal certainty afforded by cleared exposures in a properly organised clearing system and a zero "w" should be applied in relation to exposures between a recognised clearing system and its participants;*

Capital treatment for claims on settlement systems

- *consideration should be given to allowing national supervisors to apply (under Option 2) a 20% risk weighting in the standardised approach to claims on unrated recognised settlement systems operating as banks;*

Capital regulation of clearing and settlement systems

- *although the capital regulation of clearing and settlement systems is outside the scope of the new Accord, the ESF is concerned that the principles laid down in the new Accord might be applied to entities such as clearing and settlement systems. The imposition of inappropriate operational risk charges could significantly affect the capital requirements of clearing and settlement systems. Such systems are also unlikely to benefit significantly from any reduction in credit risk charges consequent upon the introduction of the new Accord.*

Capital treatment of banks' exposures to clearing houses

The risk management and netting services offered by clearing houses constitute an extremely important tool for the reduction of risk (particularly systemic risk). As such, market participants should be encouraged to clear their transactions through clearing houses.

Current provisions of the 1988 Capital Accord

Off balance sheet contracts traded on an exchange are currently excluded from the framework of the 1988 Capital Accord, provided that they are subject to daily receipt and payment of margin that has the effect of reducing a contract's current exposure to zero.[1] However, while exchange traded positions are excluded from capital requirements, claims directly on exchange clearing houses are risk weighted, as are the gross obligations arising from contracts traded on exchanges where there is no daily payment and receipt of cash variation margin.[2]

In 1996, the Committee issued an interpretation of the Capital Accord addressing the treatment of a bank that participates in a multilateral netting arrangement for foreign exchange contracts.[3] This 1996 paper suggested that in a case where a clearing house operated a fully collateralised system (using collateral that has a zero risk weight under the Accord), banks could in certain circumstances risk weight both the current and potential future exposure to the clearing house under the relevant foreign exchange

[1] See Annex 3 to the amended Capital Accord.

[2] See footnote 2 to the Basel Committee paper "Interpretation of the Capital Accord for the multilateral netting of forward value foreign exchange transactions" (April 1996).

[3] See footnote 2 above.

contracts at zero per cent. That paper also suggested that, in the longer-term, a more comprehensive review of the risks inherent in multilateral netting systems and other types of exchanges and clearing houses could lead to a formal amendment of the Capital Accord.

EU treatment

It may also be helpful to outline the EU treatment of exposures to clearing houses. The EU Consolidated Banking Directive follows the Accord by excluding off-balance sheet contracts traded on recognised exchanges from the requirements applied in relation to equivalent OTC contracts.[4] In addition, that directive also permits member states to exempt (until 31 December 2006) from that methodology OTC contracts cleared by a recognised clearing house under conditions similar to those set out in the Basel Committee's 1996 paper.[5]

The EU Capital Adequacy Directive also addresses the capital treatment of exposures to "recognised clearing houses". Claims on recognised clearing houses (and exchanges) may be assigned the same risk weighting as those assigned to banks.[6] Thus, for example, exposures on OTC derivative instruments and exposures in the form of margin in exchange-traded futures and options contracts may, where they are to recognised clearing houses, be assigned a 20% risk weighting.[7] However, the EU directives dealing with large exposures do not give any special treatment to large exposures to recognised clearing houses or exchanges.

Taking the UK as an example of the implementation of the EU approach, claims on recognised clearing houses and exchanges, including initial cash margins and and surplus variation margins at futures exchanges or clearing houses are treated as 20% risk weighted items.[8] Contracts traded on exchanges subject to daily margining requirements are exempted from the counterparty risk requirements applicable to OTC derivatives transactions.[9]

The proposed new Basel Capital Accord

In contrast, the new Capital Accord does not specifically address the treatment of exposures to clearing houses.

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[4] See Article 43(3) Consolidated Banking Directive.

[5] See Article 43(3) Consolidated Banking Directive.

[6] Article 2(9) Capital Adequacy Directive.

[7] See paragraphs 5 and 6 of Annex II to the Capital Adequacy Directive.

[8] See paragraph 3.2.4(g) of Chapter BC of the FSA's Banking Supervisory Policy Guide.

[9] See paragraph 4(a) of Chapter TC of the FSA's Banking Supervisory Policy Guide.

The standardised approach broadly preserves the current framework for calculating credit exposures on off-balance sheet transactions.[10] Thus, it would seem that it would preserve the current exclusion of exchange traded transactions subject to daily margining from the framework of the Accord. However, there is no special treatment for direct claims on clearing houses. It would seem that these are to be treated in the same way as claims on corporates (except where the clearing house is a bank). If a clearing house has the benefit of an external AAA/AA rating, exposures to the clearing house would benefit from a 20% risk weighting. However, in the case of an unrated clearing house, it would seem that the new Accord envisages a 100% rating in the same way as an exposure to an unrated corporate.

It is unclear whether the new Accord proposes similarly to exclude exchange traded off-balance sheet items from the framework for the internal ratings based (IRB) approach.[11] However, presumably, claims directly on clearing houses would be treated in the same way as other exposures[12], and thus it would be up to banks to estimate the probability of default and (in the advanced IRB approach) the LGD applicable to the exposure for the purposes of applying the relevant calculations. We would expect that banks would generally assign exposures to the major recognised clearing houses to the highest internal rating grade and (in the case of banks following the advanced IRB approach) a lower LGD.

ESF's proposals

ESF believes that the new Capital Accord should specifically address the treatment of exposures to clearing houses, both in relation to on-balance sheet and off-balance sheet claims. ESF also believes that the correct approach is to allow bank supervisors to apply special treatment to exposures to recognised clearing houses that acknowledges the risk management framework within which they operate.

Thus, we recommend that:

- In the standardised approach, direct claims on recognised clearing houses (e.g. for initial margin or for free deliveries of securities) should be accorded a preferential risk weighting. Thus, we would recommend that, in general, exposure to recognised clearing houses should be treated in the same way as exposure to banks (under Option 1). However, at national discretion, national supervisors should be able to assign a 20% risk weighting to claims on unrated recognised clearing houses (i.e. one category more favourable than the treatment available to exposures to unrated banks in Option 1) and a 0% risk weighting to recognised clearing houses which have the benefit of an AAA rating or which otherwise meet very high standards of

[10] Paragraph 42 of "the New Basel Capital Accord".

[11] Compare paragraph 230 of "the New Basel Capital Accord".

[12] It is unclear whether claims on clearing houses will be assigned to the corporate or bank exposure category.

robustness. This treatment should apply both in respect of banking book and trading book claims.

- Off balance sheet claims on recognised clearing houses and exchanges in respect of on-exchange derivative contracts which are subject to daily margining should continue to be treated as representing zero exposure (although at present the Accord allows this treatment more generally to claims on any clearing house or exchange in respect of exchange traded transactions).

- In addition, claims on recognised clearing houses in respect of OTC derivative contracts and repurchase and securities lending transactions should, in general, be treated in the same way as direct claims (i.e. given the benefit of the preferential risk weighting described above). However, there should be flexibility to waive the requirement for capital charges for potential future exposure in fully collateralised systems as under the Committee's 1996 paper.

- The Basel Committee should give some guidelines for recognition of clearing houses and for the assignment of the 20% or 0% risk weighting category. For example, it should be a condition of recognition that the clearing house is subject to some form of regulatory oversight. The criteria for 0% risk weighting might be similar to those described in relation to collateralised systems in the Committee's 1996 paper.

- In the IRB approach, exposure to recognised clearing houses should be treated in the same way as exposure to banks. It would, of course, be up to banks to assign a probability of default (PD) to the relevant clearing house (and in the advanced IRB approach, an appropriate LGD). However, it may be difficult in practice for banks to assess the PD or LGD for clearing houses unless they operate with a high degree of transparency. The Basel Committee should encourage clearing houses to provide transparency as to the risk management practices and procedures of clearing houses (this might be made a condition of their recognition). In relation to the measurement of exposures on OTC derivative contracts, national supervisors should have similar discretion to waive, in the case of fully collateralised systems, the requirement to include charges for potential future exposure.

- If the "w" factor remains as a feature of the new Accord, the new Accord should recognise the very high degree of legal certainty afforded by cleared exposures in a properly organised clearing system. A zero "w" should be applied in relation to exposures between a recognised clearing system and its participants.

Capital treatment for claims on settlement systems

There are likely to be direct claims on a settlement system only where the system operates in commercial bank money and otherwise offers banking facilities to its participants (i.e. where the settlement system operates as a bank). There seems to be

less justification, in such a case, for doing anything other than applying the general approach of the new Accord to such claims. However, in appropriate cases, national supervisors might be given the choice (under Option 2) to apply a 20% risk weighting in the standardised approach to claims on unrated recognised settlement systems operating as banks. This might better reflect the risk of such systems.

Capital regulation of clearing and settlement systems

The capital regulation of clearing and settlement systems is outside the scope of the new Accord, which is directed at internationally active banks. However, the ESF is concerned that the principles laid down in the new Accord might be applied to entities such as clearing and settlement systems. For example, this may be the case in the EU context as regards those systems organised as banks. In particular, the requirements for a specific operational risk charge could significantly increase the capital requirements of clearing and settlement sytems to an extent that is inappropriate having regard to the risks of the entity. The imposition of inappropriate operational risk charges could significantly affect the capital requirements of clearing and settlement systems. Such systems are also unlikely to benefit significantly from any reduction in credit risk charges consequent upon the introduction of the new Accord.

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