



THE BANK OF NEW YORK MELLON

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Ladies and Gentlemen:

The Bank of New York Mellon Corporation (“BNY Mellon” or “the Bank”) appreciates the opportunity to submit comment on the Consultative Document, “Capitalisation of Bank Exposures to Central Counterparties” (“the Proposal”) to the Basel Committee on Banking Supervision (“the Committee”).

As a custody and trust bank, BNY Mellon’s business profile is dominated by securities servicing and investment management businesses. The Bank is also a substantial provider of clearing services to the financial markets. The Clearing Services segment offers broker-dealer services including collateral management and clearance of fixed income and equity transactions in over 100 markets. As one of the two primary Clearing Banks in the tri-party repo market, BNY Mellon offers government securities clearing services to market participants. Additionally, Pershing provides comprehensive global prime brokerage services such as operational support, trading services, investment solutions including managed accounts, mutual funds and cash management, and practice management support. It supports financial intermediaries, broker-dealers, hedge funds and investment advisors.

BNY Mellon commends the Basel Committee for recognizing that central counterparties (“CCPs”) play an important role in the global markets as facilitators/guarantors of financial transactions. Incentives to use their services will likely lead to greater financial stability by promoting risk mutualization and by leveraging the information collected by CCPs to standardize processes and increase transparency. The Bank further supports the Committee’s efforts to ensure that as the financial system becomes increasingly reliant on CCPs, an appropriate risk regime is implemented to mitigate residual exposures and to protect the stability sought by these proposals.

Explicitly defined regulation, prudential supervision, and appropriate oversight of CCPs are all critically important to ensuring not only that risks are properly controlled but also that market participants receive the appropriate incentives for shifting current practices to a new framework. Furthermore, given the global nature of the OTC derivatives market, close coordination across regulatory bodies will ensure that there is minimal opportunity for competitive advantages and

regulatory arbitrage. Generally speaking, the Bank encourages continued cooperation with other international regulatory entities, including the Committee on Payments and Settlement Systems (“CPSS”) and the International Organization of Securities Commissions (“IOSCO”) to ensure proper CCP oversight such that risk is properly controlled at these institutions.

While BNY Mellon primarily supports the intent of the Proposal, we’d like to address a number of concerns in this letter and identify several issues that warrant further clarification before a reasonable assessment of the potential impact can be made. BNY Mellon has provided comments in the following section on specific elements of the proposal.

Specific Comments on Proposed Reforms:

Qualifying CCPs and Trade Exposures

BNY Mellon is primarily concerned that the definition of a “qualifying CCP” contained in the Committee’s proposal is too broad. The Proposal states that “where a CCP is compliant with CPSS-IOSCO standards and is able to assist clearing member banks in properly capitalizing for CCP exposures...such a CCP is considered to be a “qualifying CCP”.” The Bank understands that the Proposal seeks to encourage the trading of OTC derivatives through central counterparties (as is now required in the U.S. under Dodd-Frank) and that the reforms are designed to incentivize such activity. Although the Proposal does address capital treatment of payment and other spot transactions, it remains unclear whether the proposed reforms are intended to apply to all CCPs (including cash market CCPs) regardless of the underlying transaction being conducted between the clearing member and the CCP. BNY Mellon requests that the Committee confirm whether the definition of a “qualifying CCP” is intended to apply to CCPs outside the scope of clearing OTC derivative contracts.

Specifically, after considering the definitions of “qualifying CCP” and “custodian” as laid forth in the Proposal, it is unclear whether BNY Mellon’s clearing exposures to the DTCC’s Fixed Income Clearing Corporation (“FICC”) as a Clearing Bank in the repo market are subject to the treatment of this Proposal. In repo transactions, the Bank acts as an agent between two external counterparties in the transaction and holds the collateral underlying the transaction. The CCP (FICC), provides a utility to the trade by granting access to collateral and ensuring that a government securities trade will be completed on its original terms. The CCP interposes itself as a party to the trade, and, as a result, provides the same type of risk reduction benefits as those offered for OTC derivative clearing (i.e. multi-lateral netting benefits).

Moreover, given the importance of the repo market, the Federal Reserve Bank coordinated with industry participants to implement significant reforms over the last year. These reforms will substantially reduce the amount of risk in the repo markets by reducing exposures and strengthening margins. Considering these reforms as well as the short-term, highly-collateralized nature of these trades, BNY Mellon feels that it would be unnecessary to subject these exposures to the capital treatment outlined in this proposal. In any case, without

knowledge of whether DTCC/FICC will be a qualifying CCP, it is difficult for the Bank to determine the true nature of the impact that these reforms will have on our business.

Designation of “Qualifying CCP”

It is important that the Committee clearly identify who has responsibility for determining the qualification status of a CCP. While paragraphs 107 and 108 of the Consultative Document state that the ultimate responsibility of ensuring that enough capital is held against such exposures falls on the banks and their regulators, the language stops short of identifying who shall ultimately determine if a CCP meets the “qualifying” criteria. Ensuring that risks are properly managed requires clear knowledge at all times whether a CCP is a “qualifying CCP.” To achieve this, it is necessary that the Committee promote adequate transparency and disclosures as well as coordination among agencies during the determination process. BNY Mellon recommends that the Committee amend the Proposal to identify whether this responsibility lies with a CCP’s supervisor or with a bank’s supervisor. It is additionally important that the Committee delineate between home and host regulators regarding this responsibility.

Such clarity is important because BNY Mellon believes that a CCPs “qualifying” status should be reviewed and certified on a periodic basis (i.e. annually) to assure that the CCP continues to meet the expectations of the regulators and the financial markets. It is also important that the Committee give consideration to cases in which a “qualifying CCP” ceases to carry that status and formulate clear guidelines for such an event. Given that the Committee proposes CCP qualification as the basis for capital requirements, it would have severe implications for clearing members if each had to suddenly and without warning hold additional capital against exposures to a particular CCP. BNY Mellon recommends that the Committee consider implementing a gradual phase out of a CCP’s “qualifying” status as to minimize the financial impact on both the CCP (who may potentially lose clearing member business) and the banks (who may need to hold more capital or switch to a different CCP).

The volume and breadth of trades that flow through central counterparties is substantial, and CCPs have been maintaining transaction records and collecting other relevant data on clearing members for many years. Regulatory authorities have often relied on these entities to share such data in a useful manner. Considering their experience with these operations, BNY Mellon believes that CCPs should have the responsibility to assemble and manage the data necessary to ensure they meet the qualification standards. CCP regulators should have the responsibility of requiring them to do so and that the information is available to clearing members. While banks may have the expertise to calculate capital requirements related to certain activities, this process is not possible without first being able to collect the data in an organized and timely manner. The most logical approach would be for a CCP to submit the data to its regulator and the regulator would subsequently be responsible for distributing the data to banks to calculate their capital requirement. This will also help to form a streamlined and standardized process.

Risk-weighting of Trade Exposures

BNY Mellon recognizes that the previous zero risk-weighting for exposures to CCPs under Basel II inadequately reflected the residual risk inherent in exposures to CCPs. The Bank believes that a 2% risk-weighting for trade exposures is likely appropriate if the Committee's intention is for the Proposal to apply only to OTC derivatives cleared through a CCP. If, on the other hand, clearing exposures as described above are additionally subject to this capital treatment, BNY Mellon believes that this risk weight is too high and should be re-evaluated.

Non-qualifying CCPs

Paragraph 119 of the Proposal states that "banks must apply the Standardized Approach for credit risk in the main framework...to their CCR EAD to a non-qualifying CCP or to those transactions to a qualifying CCP that do not meet the requirements in paragraph 106 of this Annex." BNY Mellon requests that the Committee clarify how banks currently using an approach different than the Standard Approach (and therefore have a different infrastructure) are expected to compute the capital requirement for exposures to non-qualifying CCPs.

Bankruptcy Remote Collateral (Segregation) and Trade Portability

In order to achieve the degree of risk reduction desired in the financial system, it is important to provide safeguards for all market participants. To this end, BNY Mellon acknowledges the Committee's attempt to protect members and end-users by incentivizing the segregation of customer collateral and ensuring portability of trades to another member in the event of a single clearing member's default.

BNY Mellon feels, however, that more details around these proposals are necessary. There are several segregation techniques and models used in trading with CCPs. Additionally, because insolvency regimes and definitions of "bankruptcy remote" are implemented by individual jurisdictions, they vary slightly across regulatory authorities and countries. The Proposal's current suggestions on segregation requirements are too broad to capture all of these variances. Furthermore, clarification is needed to illustrate the required capital treatment for cases in which the collateral holder is a third party custodian and not the CCP or its clearing member.

While it is clear that the capital relief granted "where collateral posted by a bank in connection with trades with a compliant CCP has been segregated and is remote from the bankruptcy of the firm holding the collateral" applies to trades between a clearing member and a CCP, it is unclear whether this capital relief is intended to apply to transactions in which a clearing member clears OTC derivative trades with a central counterparty on behalf of its clients. CCPs may pool the collateral of a clearing member and its affiliates so the collateral cannot be sufficiently "segregated" per the Proposal's definition in trades where a bank is a client of the clearing member.

The proposal additionally requires the portability of trades whereby an institution's trades will be automatically and seamlessly assumed by another clearing member in the event of a single member's default. BNY Mellon requests that the Committee clarify whether such portability needs to be explicitly guaranteed by a CCP or if it is sufficient for CCPs to provide this only as an option in the process of unwinding a defaulted clearing members trades. Explicit guarantees may unintentionally cause moral hazard among market participants.

Capitalisation of Qualifying Default Fund Exposures

BNY Mellon believes that the Committee should consider means of incorporating the loss waterfall among clearing members into the capital calculation of default fund exposures. Different CCPs prioritize losses among members in different ways depending on the structure of each. At some CCPs, the Default Fund is held as a single amount across all cleared markets, with members in each market making a proportional contribution to the fund depending on the risk within their own portfolios. Other CCPs hold Default Funds against specific cleared markets and do not mutualize this pool. In cases where default-driven losses are not immediately mutualized from the first dollar of losses, the risk to each member bank will be unique depending on the cleared markets within which each participates.

For this purpose, BNY Mellon feels that the Committee should consider methods of computing capital that depend only on the clearing member's portfolio and not on the total exposures of the CCP. The Bank further supports permission for banks to use internal models currently being used for computing counterparty credit risk (assuming that CCPs provide all necessary information as discussed above). BNY Mellon feels that simpler methods which assume capital is based on the sum of the CCPs exposures to all clearing members (which relies on total margin and total hypothetical capital rather than segregating risk of loss) does not accurately reflect the risk in these exposures. Allowing banks to make these calculations internally would additionally take the responsibility of calculating hypothetical capital off the CCPs who, as the Proposal states, "may not have the CEM [or other model] experience."

Hypothetical Capital Calculation (CEM Method)

Regardless of the risk waterfall applied to the capital requirement (either compensating for priority of losses or maintaining the total exposure approach), BNY Mellon feels that more sophisticated models should be permitted for computing the hypothetical capital of a CCP. The use of the Current Exposure Method (CEM) has several limitations in computing capital for cleared OTC derivatives including its lack of risk sensitivity and inability to consider frequency of margin calls through holding period assumptions.

If it is the case that the hypothetical capital calculation is the responsibility of the CCP, then CCPs should be permitted to use more sophisticated models under the approval of regulators. As discussed below, the systemic importance of CCPs is rising as more trades move to these platforms. CCPs should be held to the same if not more stringent risk management standards as

those of banks and other systemically important financial institutions. A component of this requires the adoption of advanced modeling techniques that most accurately capture the risks inherent in operations. Management of CCPs should feel competent in their ability to handle the calculations internally.

In any case, the hypothetical capital number should be reviewed by the supervisor(s) and recalibrated on a periodic basis but no less than annually. BNY Mellon feels these periodic reviews should be made publically available as to maintain transparency of the process.

Oversight and Regulation

In light of mandates and incentives to move OTC derivative clearing to central platforms on a mass scale, the systemic importance of CCPs is rising. As more contracts move to CCPs and counterparty exposures to these institutions grow, so do the risks and potential spillover effects associated with a CCP default. Such potential underscores the importance of effective regulation and risk management practices governing CCPs. While many CCPs already have strict requirements for clearing membership and multi-layered financial resources as a means of protection against clearing member default, BNY Mellon feels that in many cases these requirements should be further strengthened. These enhancements should include, at a minimum, adoption of sophisticated risk modeling capabilities, contingency and crisis management plans, and plans for emergency liquidity support.

In the U.S., CCPs that provide similar services are regulated by different entities depending on their legal structure. For example, ICE Trust is subject to the banking supervision of the Federal Reserve Bank of NY because it is chartered as a limited purpose liability trust company in New York, but DTCC/FICC and NSCC are regulated by the SEC, and therefore are subject to different sets of rules and regulations. This issue is exacerbated when considering internationally active CCPs and the jurisdictions of regulators in cross-border transactions. Without consistent guidelines to which all CCPs must adhere, competitive distortions and hence greater systemic risks are possible. In order to ensure effective CCP regulation, prudential supervision and oversight, there should be a clear legal basis that explicitly assigns the role of the regulator, prudential supervisor, and systemic risk overseer, with appropriate coordination and division of labor in light of their competencies.

Over the past year, substantial reforms have been passed by a number of authorities across jurisdictions requiring financial institutions to modify and increase the stability of operations. Managing the implementation of these reforms requires a high degree of coordination to ensure that changes are made in an efficient and unburdening manner as not to dis-incentivize the process. To this end, BNY Mellon feels that the Committee should further clarify how these proposed reforms are intended to interact with other regulatory changes in the financial services sector, including the Dodd-Frank Wall Street Reform and Consumer Protection Act being implemented in the U.S. For example, the Dodd-Frank act has rendered the Principal-based

approach to derivatives clearing essentially unfeasible in the U.S which is causing many institutions to switch to an Agent-based approach. As such, the Proposal should clearly identify whether both approaches would qualify as “trade exposures” for the purpose of these capital requirements.

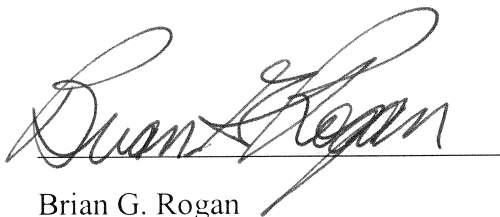
Conclusion

BNY Mellon sincerely appreciates the opportunity to provide comment regarding the capitalisation of CCP exposures and fully supports the Committee’s efforts to bring transparency and greater stability to the financial system. As always, BNY Mellon believes that enhanced risk management and regulatory supervision are the most promising resources to address the issues of the next crisis.

In order to achieve the desired magnitude of risk reduction in trading over-the-counter products, however, it is critical that proposed reforms are explicitly clear in their objective, scope, and form. This will ensure that financial institutions receive the proper incentives to make efficient adjustments to business practices without unnecessarily disrupting markets or creating opportunities for regulatory arbitrage. It is the belief of BNY Mellon that, to achieve this, the Proposal needs to include more detail surrounding several key issues noted above including whether capital treatment of exposures is meant to extend beyond OTC derivatives.

It is impossible to underscore the importance of cooperation and coordination across regulatory entities and other authorities. This is the basis for efficient international regulatory reform and is the only way to truly reduce risks inherent in the financial system. Such reforms must sufficiently account for variances in regulatory oversight, central bank powers, and insolvency laws across countries which can be challenging. Without proper coordination and clear delineation of roles and responsibilities, it becomes possible for competitive advantage to undermine the entire system. BNY Mellon is encouraged by the Committee’s efforts made to date to coordinate with CPSS-IOSCO, and stresses the importance of carrying these mutual efforts forward to protect the reforms intended by this proposal.

Sincerely,

A handwritten signature in black ink, appearing to read "Brian G. Rogan", written over a horizontal line.

Brian G. Rogan

Vice Chairman