

The Clearing Corporation of India Ltd, Mumbai

Response to Document on Capitalisation of Bank Exposures to central counterparties, December '10

We refer to the December 2010 Consultative Document on “Capitalisation of Bank Exposures to central counterparties” published on the BIS website.

We congratulate you on working out a comprehensive document dealing with various aspects of exposures of Clearing Participants on a Central Counter-party(CCP) and formulating a suggested approach for arriving at Capital Requirements of banks & other institution for their exposures.

We operate in India as a CCP for OTC financial market products since 2002 as an authorized Payment & Settlement System Service Provider authorized by Reserve Bank of India, the central bank of India. We presently provide CCP clearing for mainly institutional trades in Government Securities, Foreign Exchange – both spot market and forward trades, trades in domestic money market through our own product Collateralised Borrowing & Lending Obligation (CBLO). We are also in the process of offering CCP settlement of Indian rupee denominated trades in Interest Rate Swaps by using the trade warehouse on such swaps created by us.

Being a CCP offering clearing exclusively in OTC markets where netting efficiency and costs of margin and capital play very important roles in the decision making of the settlement participants in using or otherwise of the CCP services, we feel that the current G 20 approach of encouraging CCP clearing through incentives and mandates can go a long way in making the markets safer. The subject of current consultation therefore can have a significant bearing on the final outcome of the efforts to have CCP clearing for settlement of OTC derivative trades.

It will perhaps be pertinent to observe that various international regulatory bodies including CPSS-IOSCO is reviewing and re-drawing standards for CCP risk management. This is also likely to push up margin requirements and cost thereon for the users of CCP services.

The time available for responding the consultation was not adequate considering that the proper assessment of impact of the proposals was not possible in a short time. However, considering that the deadline is 4th February '11, we are submitting our comments based on our current understanding. We suggest that a further period of consultation be allowed after the initial views are included in the document so that the conclusions could be more meaningful and appropriate.

Responses to the questions asked in the consultation

The Committee invites comments on whether CCPs, CCP overseers, clearing members, transaction repositories or other sources of information and expertise are best equipped to assemble and manage the necessary information and to complete this calculation.

We believe that CCPs are the best equipped to carry out any such proposed (or alternative) computation. This will be imperative, if the computations are to be VaR based, as suggested in detailed comments below.

The Committee invites comments on how such verification and related quality control can be assured.

Bank supervisors currently perform verification of banks' calculations and similar processes will continue. However for verification of the proposed computations there will have to be enhanced collaboration and co-operation between the supervisors of banks and of CCPs. In reality, regulator of CCPs can verify the computation and then make it available to all related entities.

The Committee specifically invites comments on other practicable, simple and supervisable methods for calculating such exposure or hypothetical capital and on adjustments to CEM that could improve its utility as a proxy for CCP exposures to its members.

Please see detailed comments below.

Comments are invited with respect to whether an alternative methodology, such as requiring bilateral capital treatment for trade exposures to a CCP where its default funds are less than its hypothetical capital, exists to properly reflect the risk of being a clearing member in such a CCP.

Please see detailed comments below.

Detailed Comments

1. Exposure Computation

It appears that the proposed consultation requires computation of exposures (both trade exposures and exposures for computation of hypothetical capital requirement for CCPs) based on CEM (current exposure method) as per Annex 4 of Basel II framework.

Para 96(iv) under Section VII of Annex 4 of Basel II framework of Basel II, counterparty exposure on CMs for computation of CCP will apparently be guided by Para 186 of Basel II framework (referred in CEM of Annex 4 of Basel II framework Basel II framework).

As per Para 186, under the Current Exposure Method, the calculation of the counterparty credit risk charge for an individual contract will be as follows:

counterparty charge = $[(RC + \text{add-on}) - C_A] \times r \times 8\%$

where:

RC = the replacement cost,

add-on = the amount for potential future exposure calculated according to paragraph 92(i) and 92(ii) of Annex 4 of Basel II framework,

C_A = the volatility adjusted collateral amount under the comprehensive approach prescribed in paragraphs 147 to 172, or zero if no eligible collateral is applied to the transaction, and

r = the risk weight of the counterparty.

Where add on will be derived using Para 96(iv) of Annex 4 of Basel II framework.

As per Para 96(iv), Credit exposure on bilaterally netted forward transactions will be calculated as the sum of the net mark-to-market replacement cost, if positive, plus an add-on based on the notional underlying principal. The add-on for netted transactions (ANet) will equal the weighted average of the gross add-on (AGross) and the gross add-on adjusted by the ratio of net current replacement cost to gross current replacement cost (NGR). This is expressed through the following formula:

$ANet = 0.4 \times AGross + 0.6 \times NGR \times AGross$

where :

NGR = level of net replacement cost / level of gross replacement cost for transactions subject to legally enforceable netting agreements.

If that is so, even *under the best case scenario the Potential Future Exposure (PFE) will be at least 40% of the gross exposure based on notional value of the contracts* and multiplicants under Para 92(i) of Annex 4 of Basel II framework will have to be used.

However this CEM methodology is based on the assumption stated in Para 96(i) of Annex 4 of Basel II framework as under:

Quote

Careful consideration has been given to the issue of bilateral netting, i.e. weighting the net rather than the gross claims with the same counterparties arising out of the full range of forwards, swaps, options and similar derivative contracts. The Committee is concerned that if a liquidator of a failed counterparty has (or may have) the right to unbundle netted contracts, demanding performance on those contracts favourable to the failed counterparty and defaulting on unfavourable contracts, there is no reduction in counterparty risk.

Unquote

This is clearly not true in the case of exposure on CCPs. There cannot be any doubt with regards to the validity of the netting of contracts done by CCPs. Under the circumstances, the PFE calculation methodology as suggested in the consultation will hugely overstate the PFE with regards to the capital computation.

A more logical approach would be to *accept full netting* and having *VaR based exposure computation* using certain agreed upon confidence interval (say 99%) and holding period (say 1 to 5 days depending on the product type).

Trade related exposure on CCP by CMs will also be overstated and increase the capital requirement for the CMs to a very high level on account of the above stated methodology for computation of exposures as per Annex 4 of Basel II framework. Here again as the validity of netting is not in doubt, the methodology should allow similar VaR based approach as stated above.

2. Risk Weights

We think that a risk weight of 2% is too high for *trade exposures* and suggest that a *0.5% risk weight* would be more appropriate to facilitate the move towards CCP clearing. Even for the *hypothetical capital computation* we believe that a risk weight of 20% is too high, considering that this is a *risk weight for CCPs*, we suggest that 2% would be more appropriate. Such levels would incentivize CCP clearing and would also be more risk based (as CCPs donot take open exposures and are expected to be conservative in their risk management).

3. Capitalisation of CMs Default Fund Contribution

We believe that the Default Fund contribution of the non defaulting member is unlikely to be used ever by a CCP. Even during the Lehman crisis, LCH.Clearnet was not required to use this contribution to manage the default in Lehman account. Considering this proposition, we firmly believe that *there should not be any capital requirement on Default Fund contribution.*

However, if at all we have to capitalize member contributions to the default fund, the exposure of a member on this account should not be higher than that of its clean exposure on a non-bank customer of a good credit standing. As per the suggested model in the consultation a risk weight of 1250% (8% of 1250% = 100% which is the value of c2) is applied to the default fund contribution of the member and this is further multiplied by 1.2 in case of the unfunded part of default contribution. This is extremely high. We believe that even in the worst scenario, the default fund contributions should be treated as Clean credit on non-bank customer and assigned a 100% risk weight (meaning a 8% capital requirement on the same). Under the current proposal of the Committee a CM may be imposed with a 2X-3X capital requirement for a contribution of X towards the default fund, which is highly inappropriate.

4. Bankruptcy remote collateral

As per the consultation, collaterals placed by CM's with CCP and of their clients placed to CCP by CMs, if those are bankruptcy remote, will be exempted from counterparty credit risk capital charge. There is an apprehension that there may be legal issues and delays while accessing such bankruptcy remote assets. We may therefore suggest that legal changes for faster access to bankruptcy remote assets in time of crisis should be facilitated.

5. Apart from these responses we have the following suggestions for the Committee:

- While computing KCCP (hypothetical capital), CCP should be allowed to combine all the positions of a CM and its clients.
- Although quarterly computation would be ideal, considering that the extent of computation will be high and will have to be duly verified, a half yearly frequency for computation of such hypothetical capital for CCPs appears to be more appropriate.
- If banks are required to provide capital on LOCs, the availability of LOCs in many jurisdictions will come down drastically. Such an approach can endanger the stability of the CCPs or drastically reduce their abilities to provide safe clearing

services. Unless CCPs are allowed collateralised Central Bank liquidity, LOCs should be exempted from exposure computation and capitalization.

- The consultation defines a qualifying CCP as a CCP which is compliant with CPSS-IOSCO standards. We suggest the following with regards to qualifying CCPs:
 - a) The Regulator for each jurisdiction in which a CCP operates needs to authorise/licence the CCP independently as “qualified CCP”.
 - b) For such qualifying CCPs we suggest that a lower rate of say 0.5% (instead of suggested 2%) should be used for computation of capital requirements on trade exposures. This would ensure that the market entities would find CCP settlement cost effective.
 - c) Considering that a qualifying CCP can miss the qualification requirement by narrow margin in some jurisdiction or for a particular period, a special rate of much below 1250% (as suggested in consultation for non-qualifying CCPs) should be set for such exceptions. We suggest a risk weight of 100% under such situations.
