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February 4, 2011

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Via Electronic Mail

Basel Committee on Banking Supervision
c/o Bank for International Settlements
CH-4002 Basel
Switzerland

Re: Consultative Paper – *Capitalisation of Bank Exposures to Central Counterparties*

Ladies and Gentlemen:

The Depository Trust & Clearing Corporation (DTCC) appreciates the opportunity to provide comments to the Consultative Paper (the "Paper") dated December 2010 and issued by the Basel Committee on Banking Supervision (the "Committee") entitled *Capitalisation of Bank Exposures to Central Counterparties.* DTCC, through its regulated subsidiaries, operates several central counterparties (CCPs), and the capital treatment proposed by the Paper may significantly, whether directly or indirectly, affect relationships between the CCPs operated by DTCC and their respective participants. DTCC recognizes and supports the risk mitigation concerns that motivated the capitalization proposal, and understands that it is part of the larger effort of the Basel III Framework to assure that banks are appropriately capitalized for the risks they take on in their business. We applaud the Committee's effort and thought in developing the Paper, and hope that the suggestions contained in this response will assist the Committee in addressing these risk concerns.

Overview of DTCC

DTCC, through its wholly-owned subsidiaries, provides clearing, settlement and information services for equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments and over-the-counter derivatives in the U.S. and globally. Of most relevance to the Paper, in its implications for the risk profiles and capitalization of CCPs, DTCC owns three CCP subsidiaries: National Securities Clearing Corporation (NSCC) and Fixed Income Clearing Corporation (FICC), each a registered clearing agency under the Securities Exchange Act of 1934, as amended (the "Exchange Act") and, accordingly, regulated by the Securities and Exchange Commission (the "SEC"), and European Central Counterparty Limited (EuroCCP), a U.K.-based CCP and recognized clearing house regulated by the Financial Services Authority (FSA). In addition, DTCC owns a 50% equity interest in

New York Portfolio Clearing, LLC (NYPC),[1] which has recently been granted registration as a Derivatives Clearing Organization by the U.S. Commodity Futures Trading Commission ("CFTC").

NSCC currently processes substantially all broker-to-broker equity and corporate and municipal bond trades in the U.S. (which, over the past 12 months has averaged 41 million trades daily worth roughly $870 billion per day). NSCC provides clearing, risk management, central counterparty services, and a guarantee of completion for a broad range of transactions.

FICC processes the bulk of all trading in the U.S. fixed-income marketplace, the largest and most liquid financial market in the world. It operates two divisions: the Government Securities Division (GSD), and the Mortgage-Backed Securities Division (MBSD). The GSD is the leading provider of automated trade comparison, netting, settlement and risk management services for transactions in U.S. government securities, clearing original auction purchases of Treasury and agency securities, buy/sell trades and repurchase agreements (repos) in U.S. Treasury bills, notes, bonds, STRIPS, zero-coupon securities and book-entry non-mortgage-backed agency securities, as well as GCF Repos® (General Collateral Finance repurchase agreements) in Treasury, agency and agency mortgage-backed securities. The average daily value of GSD's trades in-net was $4.4 trillion in 2010. The MBSD provides real-time automated trade matching, trade confirmation, risk management, netting and other services to the market for mortgage-backed securities issued by the Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). The average daily value of MBSD trades in-net was $264 billion in 2010. The MBSD has a rule filing pending with the SEC to begin offering CCP services to this market.

EuroCCP currently provides pan-European clearance services for equity transactions in 19 markets and in 9 currencies.

NYPC intends initially to clear Eurodollar and U.S. Treasury Futures for NYSE Liffe U.S., the U.S. derivatives exchange of NYSE Euronext. NYPC has a cross-margining arrangement with FICC's GSD to provide for cross-margining of GSD's fixed income cash products with their related offsetting NYPC derivative trades in a "single pot", which is currently under review with the CFTC and the SEC. Pending regulatory approvals, NYPC expects to begin operations in late first quarter 2011.

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[1] NYSE Euronext owns the other 50% equity interest.

1. General Comments

As noted above, DTCC supports the underlying premises of the Paper to identify CCP risk exposures of bank participants and to protect banks by appropriate capitalization measures with respect to those risks. We also understand that, given the schedule for implementing the Basel III Framework, the proposal needs to be appropriately calibrated and finalized within a tight timeframe so that it can be implemented at the beginning of 2013. Accordingly, DTCC offers this comment letter to identify, initially, those issues and suggested solutions which are most readily determinable within the time afforded for comment. Our review also highlights several provisions of the Paper where we believe clarification is required before more definitive analysis of the proposal may be provided.

DTCC notes that the Paper is one component of a major review of standards applicable to CCPs currently being conducted by regulators and industry groups worldwide. This broad reform includes development of regulations in the U.S. to promote clearance of derivatives transactions by the Federal Reserve, the SEC, and the CFTC under the recent Dodd–Frank Wall Street Reform and Consumer Protection Act; the developing European Markets Infrastructure Regulation initiative within the European Union; and the current review of recommended standards for CCPs being undertaken by the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) (collectively "CPSS-IOSCO"). DTCC respectfully requests — and believes it is critical — that the Committee adopt a timeline for final adoption of capital rules in this area that allows for thorough coordination and interaction with these other efforts, most particularly with the revisions to the CPSS-IOSCO standards expected to be published later this year.

DTCC would like to preface our more detailed comments regarding the proposal with two fundamental observations regarding their application as currently drafted:

First, the framework and methodology underlying the proposed formulae presuppose a CCP collateralization structure whereby initial margin and variation margin are calculated and held separately from a default (i.e. loss mutualization) fund. That, however, is not the structure utilized by DTCC's equity and fixed income CCPs, which aggregate collateral covering margin and other exposure amounts into a single "clearing fund". As a result, and as more fully discussed under section 6 of this letter below, when the calculations proposed in the Paper are applied to a CCP with this type of fund structure, it appears that the resultant exposure amounts would exaggerate true exposures, potentially causing excessive capital charges for its participants and creating an inaccurate perception of the actual risks posed by participation in the CCP. The proposal thus needs to be calibrated so as to appropriately reflect different CCP collateralization structures and not penalize an approach that has proven effective in a major securities market.

Moreover, the proposal appears to contemplate that derivatives and securities financing transactions are, or would be, margined by CCPs discretely, without reference to other types of related or offsetting transactions. While the proposal is understandably based on current methods used by banks under the Basel II Framework for calculating bilateral OTC derivative counterparty credit risk exposures, such an approach does not accurately reflect (and is inconsistent with) sophisticated CCP risk models in use that calculate exposures and related margin on a common portfolio basis (for example, where margin for cash transactions and related financing transactions are calculated in a common and aggregate basis), or that calculate margin across asset classes to appropriately reflect related hedges or offsets that effectively reduce risk. Cross-margining methodologies are employed by a number of CCPs under regulator-approved cross-margining arrangements designed to better reflect the overall risks of a participant's activities and provide efficiencies — including reduced liquidity pressures — to common participants. DTCC believes that as the use of CCPs expands, so will efforts to margin transactions on a collective portfolio basis which recognize the true economic relationships between and among transactions and assets. The proposal should not, in the interest of simplicity, impose constraints that would inhibit the evolution of more appropriate and effective CCP risk margining techniques.

2. Scope of Intended Coverage

While the consultative narrative describes the need for banks to capitalize their exposures to CCPs generally, the actual text of the proposed requirements is set forth as amendments to Annex 4 (Treatment of Counterparty Credit Risk and Cross-Product Netting) of the Basel II Framework. Thus we read the proposal as requiring measurement of counterparty credit risk exposures to CCPs arising only from transactions in OTC and exchange-traded derivatives, and Securities Financing Transactions (SFTs) (as defined in Annex 4, which includes transactions in repurchase and reverse repurchase agreements, securities lending and borrowing and margin lending transactions). Accordingly, DTCC believes the proposal would benefit by clarifying that it is not intended to cover, and does not otherwise affect, CCP exposures relating to the cash equities or fixed income markets, or exposures for settlement risk (which is covered in Annex 3 of the Basel II Framework).

3. Qualifying CCPs

The proposal is structured such that exposures to "qualifying CCPs" are capitalized on a lower basis than exposures to those CCPs that are not deemed "qualified", thus incentivizing banks to use those CCPs that meet the qualification standards.

The Paper points to two criteria as determinative in ascertaining whether the CCP is a *qualifying* CCP: a CCP's compliance with CPSS-IOSCO Principles for Financial Market Infrastructures (the "CPSS-IOSCO Standards"), and its ability to assist its clearing members by providing the information needed for them to determine

their capital requirements.[2] Issues relating to a CCP's ability to assist its clearing members with necessary information are addressed under subsection 4(c) of this letter, below.

(a) *Compliance with CPSS-IOSCO Standards.* As for the first criterion, DTCC believes that with respect to the determination of compliance with the CPSS-IOSCO Standards, the Paper may unintentionally intrude on the proper jurisdictional allocation of regulatory responsibility by potentially allowing multiple and inconsistent determinations among competing regulatory bodies. Accordingly, DTCC submits that:

• Finalization of any criteria for determining whether or not a CCP is considered "qualified" should logically be delayed until completion of the current CPSS-IOSCO Standards review, particularly as qualification is proposed to be tied to those Standards.

• Whether or not a CCP is considered "qualifying" for purposes of the proposal should be a determination made by that CCP's home supervisor, so long as the home supervisor substantially enforces the CPSS-IOSCO Standards, and publicly discloses that it does so. DTCC further submits that "qualifying" status should be considered conclusive for these purposes as long as the CCP is licensed and permitted to operate by the home supervisor and continues to be a supervised entity within that jurisdiction. The home supervisor is the regulatory body best qualified to make that judgment, particularly where determination of compliance is based on an intimate understanding of the CCP's operations and an evaluation of gradations of compliance with the CPSS-IOSCO Standards. And, while DTCC recognizes and supports the goal of greater transparency, this determination should be readily and objectively ascertainable by all market participants; any question as to whether the status is justified, whether by banks, bank supervisors, or others, is most appropriately directed to the home supervisor. Any other approach creates the risk of uncertainty on the part of participants and regulatory bodies alike, and might undermine regulatory functions and create additional risk.

(b) *Requirement to be "Fully Collateralized".* Paragraph 106(a) of the proposed addition to Annex 4 requires that, in order for a CCP's participant to benefit from the reduced capitalization treatment afforded by the proposal, a CCP's counterparty credit risk exposures to its clearing members must be "fully collateralized" on a daily basis. Although this provision is not specifically included as a criterion for status as a "qualifying CCP", the language, as currently drafted, effectively imposes full collateralization as an additional qualifying criterion.

The term "fully collateralized" is not defined and the intended meaning is, in DTCC's view, unclear. DTCC requests the Committee to confirm and clarify that this

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[2] *See* paragraph 9(a), and Annex A, proposed additional language to Annex 4, Section 1, General Terms-clause (b) of the proposed definition of a central counterparty, and Section II, proposed paragraph 113.

language does not impose a quantitative requirement or any other specific requirement that is not set forth elsewhere in the Paper. More importantly, we submit that the Committee should recognize the collateralization requirements within the CPSS-IOSCO Standards, and in particular that compliance with recommendations 3 and 4 of the Recommendations for CCPs, should suffice for determining appropriate collateralization. Consistent with our views above as to the determination of a "qualifying CCP", the evaluation of adequate collateralization (especially if it constitutes a required element for qualification) should be determined by the CCP's home supervisor.

4. Issues Related to the Relevant Calculations

Calculation of a CCP's "hypothetical capital" is at the center of the proposal, and will be crucial to the proposed capitalization by banks of default fund exposures. DTCC would like to address the Committee's specific requests for comment, as well as additional issues identified by DTCC, related to this calculation and the recommended verification of this calculation.

(a) *Appropriate Parties to Perform Relevant Calculations*. The Committee has requested comments with respect to which party is most appropriate to perform the relevant calculations — which include calculating (using Basel II's current exposure method (CEM) calculation methodology) the aggregate exposure of a CCP to/from all its participants, and using that amount to calculate a "hypothetical capital" amount. In particular, the consultation requests, "… 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 complete this calculation."

We would recommend that the CCP undertake the hypothetical capital calculation internally, as the information necessary to complete this calculation naturally resides with the CCP. Moreover, CCPs are likely to be subject to certain confidentiality restrictions, under their own binding rules and/or within applicable regulations, restricting them from providing the necessary raw data to an external party. Furthermore, a CCP is in the unique position to provide a single hypothetical capital calculation, and thereby ensure the calculation is performed efficiently and is consistent for all bank participants of that CCP, as well as being able to provide the relevant participant-specific position data to its own bank participants that they will need in order to complete the capital calculations from their side.[3] And, while the narrative

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[3] Assuming a CCP is a "qualifying CCP", the hypothetical capital calculation would be performed by the CCP using a 20% risk weight and an 8% capital ratio. Bank participants may then use this total hypothetical capital calculation in performing their capital charge calculations.

notes that CCPs may not be familiar with the CEM methodology (as banks are, being subject to the Basel II requirements provided in Annex 4), CCPs are certainly well experienced in applying complex risk management methodologies, so application of the finalized (calibrated) calculation methodology should not pose an issue for CCPs.

(b) *Recommended Timing and Frequency of Relevant Calculations and Verification of Calculations.* The Paper does not address timing or frequency of the hypothetical capital calculations to be provided by the CCPs, and the banks' subsequent capital charge calculations. We suggest that the timing and frequency of these calculations be clarified and addressed in the final proposal. This is important because as CCPs will be providing data to their participants, they will need to do so within a timeframe that enables those participants to timely complete their own calculations. Furthermore, this needs to be consistent across jurisdictions, because CCPs may have participants from multiple jurisdictions.

(c) *Issues Related to Dissemination of Information and Procedures for Verifying Calculations*. The proposal states that verification of the calculation of a bank's exposures will be essential. The Committee has requested feedback related to procedures for verification of the relevant calculations, requesting on page 3 of the Paper, "... comments on how verification of these calculations and related quality control can be assured."

Paragraph 118 of the proposed addition to Annex 4 states, "[t]he CCP, trade repository, bank, supervisor or other body with access to the required data, must make a calculation of K_{CCP}, DF_{CMi}, and DF_{CCP} in such a way to permit the supervisor of the CCP to oversee those calculations, and it must share sufficient information of the calculation results to permit clearing members to calculate their capital requirement for the default fund and for the bank supervisor of such clearing member to review and confirm such calculations." The paragraph further states, "[i]n particular, the CCP, trade repository, bank, supervisor or other body that did the calculations must make available to the home supervisor of any bank clearing member sufficient aggregate information about the composition of the CCP's exposures to clearing members and information provided to the clearing member for the purposes of the calculation of K_{CCP}, DF_{CMi}, and DF_{CCP}."

DTCC believes the following information should be sufficient to enable a qualifying CCP's bank participants to perform their capital charge calculations: (1) the total, aggregate hypothetical capital calculation (using a 20% risk weight and an 8% capital ratio); (2) the amount of the CCP's total default fund, on an aggregate basis; (3) the amount of the CCP's financial resources, on an aggregate basis; (4) the CCP's loss allocation waterfall methodology; and (5) to each bank participant, that particular participant's contribution to the default fund. With regard to the methodology by which a CCP determined its EAD under the CEM, the CCP would need to disclose the types of included transactions and the model used in the exposure calculation.

We agree that a CCP should be required to provide the data necessary to perform a verification of its hypothetical capital requirement calculation, but such data should be provided to the CCP's own supervisor. CPSS-IOSCO Standards addressing operational risk are expected to require CCPs to institute appropriate internal procedures designed to assure accurate calculations, and the CCP's home supervisor is best positioned to evaluate and verify the calculation procedures. Further, as noted above, any information a CCP is required to provide to a third party for purposes of verification of calculations must conform to a CCP's existing confidentiality obligations within its own binding rules and/or within applicable regulations.

5. Bankruptcy Remote Custodian

The Paper discusses the concept of a bankruptcy remote custodian (largely contained in paragraph 9(d) of the Paper and paragraph 115 of the proposed additions to Annex 4). While DTCC understands from these provisions a general desire to protect collateral posted by CCP participants against the claims of other creditors, the terminology of these provisions is not well defined or even internally consistent. These provisions can be interpreted inconsistently and, as a result, we suggest that the Paper's text ventures too deeply into legal concepts, resulting in uncertainty as to its purpose and effect.

These provisions could be read to refer to the exposure of a participant to the CCP itself and the manner in which the CCP holds clearing members' collateral assets. Alternatively, these provisions could be read to embody a proposal for capital relief of the CCR exposure to a "custodian" holding "collateral" on behalf of a CCP, separately from the bank's CCR exposure to the CCP itself. The Committee's intention, on this basis, could be to reduce or eliminate additional capital charges where the collateral is protected against competing claims of other claimants to the assets of the custodian. The latter reading is probably more consistent with the thrust of CPSS-IOSCO's Recommendation 7 of Recommendations for CCPs.

Whichever reading is correct, we believe the proposal attempts a greater level of legal specificity than is feasible or advisable at this juncture. It is important to note that collateral may be held in a manner under applicable law that is protected from claims of other creditors, even when that collateral is not fully segregated. For example, under U.S. law there is a well-developed range of options for protecting assets held in custody from the bankruptcy risk of the custodian. The appropriate choice depends on the underlying transaction, the legal position of the counterparties, the perceived risks and the intended use of the collateral as provided under the CCP's rules and operating model.[4] U.S. bankruptcy law reflects policies that may diverge fundamentally from the

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[4] When assets are held by a financial institution, these options include trust or custody accounts; reliance on laws (which include "safe harbors" under the bankruptcy laws) which validate closeout enforcement and exemptions from automatic stay, rejection of executory contracts, and other bankruptcy measures;

insolvency laws of other countries. There is no "one-size-fits-all" standard for mitigating insolvency risk in a multilateral arrangement involving multiple legal systems. Moreover, CCPs need to be able to access margin collateral and default funds for the purposes for which they are intended under their rules and operating model, including for liquidity and prompt closeout purposes. Thus, we caution the Committee against adopting an approach that may, directly or indirectly, hamper such access or conflict with those purposes, which may result in increased systemic risk.

We would suggest that this aspect of the proposal is best reserved for guidance under the CPSS-IOSCO Standards as they may be revised, especially CCP Recommendation 7. The CPSS-IOSCO Standards will be implemented by the CCP's home supervisor. That home supervisor is best positioned to pass on the adequacy of these measures, since the CCP's own legal system would be the primary setting for legal analysis.

6. Alternative Methodologies for Determining Exposures/Hypothetical Capital

The proposal seeks to require banks to capitalize both their trade exposure and their default fund exposures to CCPs. Generally, trade exposures to a qualifying CCP will receive a 2% risk weight, while exposures to CCP default funds are to be capitalized "in accordance with a risk sensitive waterfall approach (based on a CCP's actual financial resources and hypothetical capital requirements." The Committee is aiming for a method that "consistently and simply" estimates the risk arising from such default fund, and it invites comments on other practicable, simple and supervisable methods for calculating such exposure, as well as on adjustments to the current exposure method that could improve its utility as a proxy for CCP exposures to its participants. Finally, the Committee asks whether an alternative methodology exists to properly reflect the risk of being a clearing member in a CCP where that CCP's default funds are less than its hypothetical capital.

DTCC is actively studying the components of the proposed formulae and may have further suggestions on this subject. For purposes of this comment letter, however, we have the following observations:

(a) The "risk sensitive waterfall" must be sensitive enough to take into account (i) that the full resources of a defaulting participant — that is, the totality of its margin and default fund contributions (or its aggregate "clearing fund" contribution, if applicable) — will likely be fully utilized before any non-defaulting participants' contributions would be used in a loss situation, and (ii) if a CCP's loss allocation formula is not strictly pro rata, then the calculation must be adjusted to appropriately reflect the CCP's loss methodology.

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and selection of custodians whose business model minimizes insolvency risk.

As noted under section 1 of this letter above, the proposed calculation methodology does not take into account a CCP collateralization structure where both margin and collateral covering other exposure amounts is held in a single aggregate "clearing fund". The approach that the Committee has set forth to calculate the banks' capital charges for default fund exposures would likely view the entire aggregate "clearing fund" of such a CCP as its "default fund", and thus require capitalization by its bank participants on a *pari passu* basis in the waterfall, without taking into account the adequacy of the defaulting participants' own clearing fund contributions that would be used to cover the CCP's closeout losses before a non-defaulting bank participant would be exposed to loss of its own contributions. As a result, the exposure amounts, and therefore the hypothetical capital requirement, will likely be distorted (higher) and produce an inappropriate result, even though logically the resulting summed CCP exposure amount should be the same as if it were calculated with margin and variation margin determined and held separately from a "default fund". Under either collateralization structure, the CCP's calculated exposure amount should be reduced by the amount of collateral collected from participants that would be used first to offset each such participant's own default before the remaining available collateral provided by non-defaulting participants could be applied to cover any excess closeout losses.

(b) Also as noted under section 1, CCPs are increasingly developing margining formulae that take into account the relationship and correlations among products they clear, including those transactions that operate as natural offsets or hedges for other related cleared transactions. Thus some SFTs may logically and appropriately offset other cash DVP transactions, for example, in a portfolio margining approach (the elements of which would be disclosed to participants as part of the CCP's risk management procedures, and be subject to review and approval by the CCP's supervisor). Applying the proposal's formula as written, it would appear that separate margin or default fund amounts must be allocated or be allocable to SFTs across the board. We believe that this may well distort the view of what the proper current exposure is — and in fact may likely overestimate that exposure and related risk. Further, the formula as set forth in the proposal could be inconsistent with the exposure calculation methodology determined by the CCP and its supervisor to be most appropriate for the CCP's business model.

(c) Similarly, DTCC believes the Committee should carefully consider the effect that the proposed formulae may have on certain types of beneficial arrangements, including cross-margining agreements that are currently in place between CCPs. Generally, cross-margining allows participating members to optimize their capital usage by permitting the relevant CCPs to view the members' positions at the two clearing organizations as a combined portfolio and to reduce margin requirements accordingly; therefore, the margining is based on the net risk of correlated positions. In effect, the CCPs that have agreed to engage in cross-margining have agreed to accept the correlated positions in lieu of supporting collateral. These arrangements bring

significant benefits to CCP participants, such as greater liquidity and more efficient use of capital, and their use is likely to increase as the number of CCPs increases.

(d) DTCC believes the Committee should also ensure that the method for calculation of exposure amounts is clear, consistent and uniform in the final proposal, so that it does not permit variation in its implementation or interpretation among jurisdictions. Failure to ensure such uniformity could cause CCPs with participants operating in multiple jurisdictions to be subject to multiple and/or inconsistent standards in calculating their aggregate exposures.

(e) Finally, we understand that risk models may be used by banks under both the Basel II and Basel III Frameworks, in place of the standard approach haircut models. We believe that the CEM and SFT haircut methodology for calculating potential future exposure does not really correlate all that well with the "initial margin" methodologies (which, considered broadly may include concentration, illiquidity charges, credit and other non-VaR type charges) that are appropriately employed by many CCPs. In any event, we believe the same alternative processes for capital calculation afforded to banks should also be available for hypothetical capital calculations used by CCPs.

Conclusion

DTCC appreciates the opportunity to comment on the Paper and looks forward to participating in the continuing development of the Committee's proposals. Should you wish to discuss these comments further, please contact me at (212) 855-3240 or lthompson@dtcc.com.

Regards,

Larry E. Thompson

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