Response to the Basel Committee on Banking Supervision's Consultative Document and Quantitative Impact Study: Capitalisation of Bank Exposures to Central Counterparties

Date: February 2011
Version 1.0

Contents

1. Background

EACH – the European Association of Central Counterparty Clearing Houses – has a long history in promotion of Risk Management Standards: In November 2001 EACH issued the "*Standards of Risk Management Control used by European Central Counterparty Clearing Houses*" with the aim of stimulating associated clearing houses to provide an objective disclosure of their risk controls and of their fulfilment of the Standards.

The EACH Standards have been subsequently recognized and cross-referenced by – the CPSS-IOSCO, ESCB-CESR, the European Central Bank and by the European Commission. Recently (November 2009) those standards have been superseded by the new EACH Supplementary (i.e. to CPSS-IOSCO and ESCB-CESR) Risk Recommendations.

EACH has 23 members:

CC&G (Cassa di Compensazione e Garanzia S.p.A.)
CCP Austria
CME Clearing Europe
CSD and CH of SERBIA
ECC (European Commodity Clearing AG)
EMCF (European Multilateral Clearing Facility)
Eurex Clearing AG
EuroCCP (European Central Counterparty Ltd)
HELEX AS
ICE Clear Europe
KDPW SA
KELER CCP Ltd
LCH.Clearnet Ltd
LCH.Clearnet SA
MEFF
NASDAQOMX
National Clearing Centre (NCC)
NOS ASA
NYSE Liffe
OMIClear
Oslo Clearing ASA
Romanian Clearing House SA
SIX x-clear AG

This document does not bind in any manner either the association or its members.

Responses to this paper should be addressed to:

Rory Cunningham
Chairman
rory.cunningham@lchclearnet.com
+44 (20) 7426 7093

Marcus Zickwolff
Secretary
marcus.zickwolff@eurexchange.com
+49 (69) 2111 5847

2. Capitalisation of Bank Exposures to Central Counterparties – Consultative Document and Quantitative Impact Study

Introductory Remarks

EACH welcomes the opportunity to comment on the proposals put forward by the Basel Committee on Banking Supervision and the opportunity to both provide feedback on the proposals, and to participate in the quantitative impact study (for those CCPs to whom it is relevant).

We share the Committee's view on the importance of a safe and sound capitalisation of risks to the financial system. EACH fully supports the contention that, in extremis, CCPs can, and should be able to, fail, and therefore that banks should be cognisant that CCP exposures are not risk free. However, in drafting its response EACH notes that the period allowed for consultation is significantly shorter than would be expected for a matter which has such a significant bearing on the financial system in general, and for CCPs and their bank members in particular. As a result of this short consultation period, there has been limited opportunity for CCP experts within the represented CCPs to formulate more detailed alternative proposals.

In light of the above, the comments provided by EACH should be considered preliminary. Furthermore, EACH requests that additional time be allowed for consultation on the proposals to allow EACH (and individual CCPs as necessary) to provide a more comprehensive response and possibly proposals.

3. Specific Comments Sought by the Committee

EACH's responses to the specific questions asked by the Committee are provided below, with further comments added in sections 4 and 5.

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.

EACH believes that the data and expertise required to complete the calculation proposed within the Consultative Document – or any alternative – are only held within the respective CCP. As such, it is likely that the calculation will need to be performed by CCPs on an ongoing basis.

In some cases CCPs will need to put in place new processes and procedures to perform the calculation, requiring additional resources both for implementation and ongoing support, ensuring verification and related quality control. EACH believes that this is a significant additional burden to place on CCPs, particularly considering that they are likely to be called upon to respond to enquiries from the supervisors of all their members and possibly also clients (para. 118), and this may have the knock-on impact of increasing the cost of clearing.

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

Bank supervisors currently must perform verification of banks' calculations and similar processes will continue. However if the requirements were to be implemented in a form such as proposed there will have to be enhanced collaboration and co-operation between the supervisors of banks and of CCPs.

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.

See 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.

While EACH accepts the 2% trade exposure weighting proposal, (so that the charge is 2% * 8%, or 0.16% of transaction exposure), it has concerns over the proposal in relation to default funds.

CCPs have developed sophisticated algorithms for calculating initial margins and default funds which are more appropriate to cleared markets than the Basel Annex 4 risk

weightings. Furthermore they are subject to common CPSS-IOSCO guidelines and national supervision.

As noted in the introduction, EACH believes its member CCPs have been given insufficient time to formulate detailed alternative proposals. However, in the paragraphs below we suggest a number of such alternatives, each of which we believe to more accurately reflect the risk a member bank faces with its exposures to a CCP and at the same time recognise both the importance of the CPSS-IOSCO recommendations as well CCPs' more appropriately risk sensitive approach to managing risk via their margin algorithms. An important aspect of the latter is their inherent flexibility and risk sensitivity, not mirrored by the risk weightings in Basel Annex IV, which thus provides an improved solution for banks and their supervisors alike.

With this in mind, we ask you to consider the following suggestions.

For the calculation of capital requirements in respect of exposure to default funds our tentative proposal that would be significantly simpler to implement while being consistent with both the CPSS-IOSCO and BCBS approaches would be to apply a 1.6% charge (20% risk weight * 8%) for exposures in respect of default fund contributions to CPSS-IOSCO compliant CCPs and an 8% charge (100% risk weight * 8%) for exposures in respect of default fund contributions to non-compliant CCPs.

This has the advantage of passing the onus to CCPs to be compliant with CPSS-IOSCO Recommendations/Principles rather than adjusting their initial margin requirements and reorganising their default "waterfall" (including mutualised default fund) sizes to fit a hypothetical capital derived from factoring position notionals against an arbitrary netting calculation and a fixed set of risk weightings.

Another feasible possibility would be that the default fund contribution should be weighted similarly to collateralized exposures such as covered bonds, which receive a risk weight that is one category better than non-collateralized exposures to the same counterparty with a minimum risk weight of 10%.

Similar to banks, who can choose between simple and more complex methods, a comparable optional regime could be envisaged for CCPs, to more accurately calculate the risks associated with exposures to the default fund. This would enable those CCPs that are able to demonstrate that the actual risk in their default fund is even lower than what would be derived from the standard approach to implement a more risk-sensitive calculation method. As the margin calculation algorithms used by CCPs are already sophisticated, a method at least as sophisticated would be needed to calculate the actual residual risk in the default fund. Such a method could possibly be based on an internal model method type of calculation, although we recognise the potential difficulties that would be faced by regulators in agreeing to recognise internal as opposed to standard models. Then the part of the default fund Contribution that must cover the risk by this advanced method would need to be

weighted with an appropriate weight (e.g. 20%) and the remainder would be weighted with a reduced weight (e.g. 2%). This suggestion is offered in order to stimulate further debate and consideration, as in practice it may not be feasible for banks to assess different models in respect of every CCP that they are members of.

We however believe that in order to provide a more articulated proposal based on further analysis and assessment of the impact on CCPs and banks, the consultation period should be extended at least until the end of March 2011. This would enable CCPs to formulate an appropriate proposal or proposals in respect of the contingent liabilities that banks have to loss-mutualisation.

Therefore any method deviating from a simple risk weight approach would need to take into consideration a way to make the risk weighting of such exposures manageable for users and end-users. EACH is ready to work with the RMMG of the BCBS in order to determine the most suitable approach.

4. Further Comments – Consultative Document

Qualifying CCPs

The proposed treatment depends on the CCP to which a bank has exposure being designated as a "Qualifying CCP" – "qualifying" being defined *inter alia* as being "compliant with CPSS-IOSCO standards". Under the existing CPSS-IOSCO Recommendations, CCPs are assessed on whether they observe, broadly observe, partly observe or do not observe each Recommendation. To our knowledge, there are different procedures implemented globally to assess a CCP's compliance with each Recommendation.

We understand that there is to be a consultation this year on enhancements to the Recommendations which will form part of new Principles for Financial Market Infrastructures. At this stage it is unclear when they will be published and when compliance can be implemented and assessed. This may have a significant impact on CCPs' ability to meet the date of January 2013 for full compliance to the CPSS-IOSCO Principles, thereby ensuring that their member banks can obtain benefit from the reduced capital charges foreseen by the Committee's proposal.

An ideal structure would be to ensure a more harmonised implementation timeframe and as a norm a standard assessment by CPSS-IOSCO of whether supervisors' rules are compliant with the CPSS-IOSCO Principles and, if so, any CCP authorised by that supervisor is therefore deemed "qualifying" and not be challenged by a regulator in another jurisdiction where that CCP may also be carrying on business.

Calculation Basis for the Hypothetical Exposure

EACH notes that the proposed capital charge for default fund contributions hinges on a regulatory calculation aimed at determining the adequacy of margining (and by extension, the level of residual risk in the default fund). This calculation utilises a simple approach to risk-weighting, netting and collateral haircut calculation.

By contrast, the margining and collateral haircut algorithms developed by CCPs are complex, tailored specifically to the asset classes and risks in which they operate, and have the ability to react to changing market conditions. Furthermore, such margining techniques have been tested extensively, validated by regulators and proven as adequate throughout financial crises.

From the beginning of 2013, EU CCPs will also be obliged to meet minimum standards for confidence interval and holding period for margins, and also standards for the calculation of mutualised default fund and other financial resources calibrated to withstand multiple member defaults. These will be published by ESMA in line with the requirements of the new European Markets Infrastructure Regulation ("EMIR"), and be cognisant of similar rules currently under development in the US. The BCBS proposals need to be synchronised with the EMIR and international requirements in order to avoid CCPs being subject to differing global standards.

As such, EACH believes that the proposed calculation is an inaccurate benchmark and may overstate the risk associated with positions and portfolios which are, and will continue to be, demonstrably adequately margined. The proposed method is based on a different approach to risk measures and is therefore not adequately risk sensitive as aimed for in the proposal.

To the contrary, it appears to depend more on the composition of the portfolio than on the actual risk of the portfolio itself and therefore it is impossible to forecast in capital planning the impact of the proposed approach on banks' exposures to CCPs.

To give a specific example, it is our opinion that the use of notional principal amounts for the calculation of exposure under the CEM is not the most appropriate risk indicator for different types of derivatives, in particular for interest rate derivatives; as a matter of fact for many instruments – e.g. options – the risk is linked to the premium and not to the underlying notional amount.

A further example of where this method would produce inaccurate results depending on the content of the portfolio being assessed would be where there are two equally risky portfolios, one portfolio containing futures where the underlying always has a positive price, and the second a portfolio that contained basis/spread instruments where the prices of these derivatives can be zero or negative. The risk/volatility, and therefore the initial margin held in respect of the two portfolios, could be identical but the notional value would be significantly different as the second portfolios notional value could be close to zero.

On another point, it is not clear to EACH that the application of the net-to-gross ratio presented in para. 96 (iv) of Annex 4 of the Basel Framework to default fund exposure is relevant. We fear that this would result in disproportionately large hypothetical capital calculations.

Also we seek clarification of what is meant in para. 114 in the sentence "When the respective exposure methodology allows for it, margining can be taken into account."

Offsets between Cash and Derivative Positions

EACH notes that the application of the regulatory calculation currently applies to derivatives and repo positions only, with cash bond and cash equity positions captured elsewhere in the Basel calculation. This separation poses two issues:

- CCPs clearing both cash and derivative/repo trades on the same underlying may allow offsets in margining between these two positions. Separating the margining for these positions will require additional calculations to be performed by the CCP outside of the standard margining practices; and
- This same principle appears not to hold with reference to default fund exposures given that second part of para. 117 states that "*when a default fund is shared between products or types of business with settlement risk only (e.g. equities and bonds) and products or types of business…giving rise to CCR, all of the default fund contributions will receive the risk weight determined according to the formulae and methodology set forth below, without apportioning to different classes or types of business or products.*"
- The separate treatment of cash and derivatives will not recognise the offsets between such positions, effectively over-stating the risk faced by the Clearing Member.

Furthermore, EACH believes that it is logically inconsistent to apply a different treatment to, for example, cash bond purchases and short dated repos, as these have very similar if not identical risk characteristics.

Initial Margin and Default Fund Contributions

EACH believes that the presence of a layer of mutualisation of risk in the form of a default fund is an important reason for the continued success of CCPs' risk defences as it provides both protection against extreme and unpredictable market events which cannot be managed with margins alone, and an incentive for Clearing Members to closely scrutinise a CCP's Risk Management approach and governance.

As such, EACH notes that the current proposals may represent a disincentive for CCPs to maintaining robust default fund arrangements, due to the preferential capital treatment afforded to initial margins. Furthermore, any reduction in default fund arrangements to reduce the capital burden on Clearing Members may require CCPs to hold additional capital or unduly increase margins beyond the levels appropriate for the markets, increasing the overall cost of clearing.

In light of this, the Basel Committee on Banking Supervision is encouraged to give due consideration to the incentives created by the tiered capital treatments.

There is also a level playing field issue with the proposed calculation method of capital requirement for exposures to the default fund, given that in some jurisdictions not all clearing members are necessarily financial institutions subject to Capital Requirements. There is a danger that CCPs whose members are wholly or predominantly not subject to the Basel framework may be encouraged to increase DFs and reduce margins, because such CCPs

are likely to be under pressure from members to shift risk away from initial margins and into the mutualised default funds.

Qualifying Default Fund Exposures

The way CCPs are structured makes recourse to the default fund contributions of non-insolvent members extremely remote and this appears not to have been sufficiently considered in assigning risk weights to default fund exposures: CCP risk management consists of multiple layers of collateralisation (lines of defence) providing high coverage of CCPs' exposures to members and thus a very low probability for the usage of non-defaulters' default fund contributions:

- initial margins (aimed at covering at least 99% of the exposure by calculating actual market price variations over a significant time history and over an adequate holding period)
- the defaulter's contribution to the default fund and
- other lines of defence (daily variation margining, intraday margin calls etc).

As the risk in the default fund is therefore very low, we fail to see why such high punitive capital weights should be applied to the default fund contributions. Furthermore, the basis for the calculation contrasts significantly with the high impact of a possible capital deduction for default fund contributions.

Risk Weighting for Default Fund Contributions

The proposal suggests that e.g. in cases where the CCP's financial resources are equal to the hypothetical capital calculated under the regulatory approach, a 100% capital charge (which implies a 1250% risk weighting) should be applied.

The severity of this capital weighting together with the unpredictable character of the calculation (comparison between economic risk assessment and the regulatory formula) will make the capital utilisation of banks' clearing operations less predictable. Bank clearing members would need to hold large capital buffers against possible changes of the corresponding risk weight.

Furthermore, equity in general is not 1250% weighted, but usually 100-400% weighted. Only for financial institutions (and not all CCPs are considered financial institutions currently), and only under certain additional conditions (dependent on the percentage a bank owns of that financial institution), equity in that financial institution is weighted 1250% to avoid the artificial creation of additional capital in the banking sector. This purpose is not served by a default fund, and the weighting is therefore also not appropriate.

Margin Collateral Allocation

Under the proposed rules, ”bankruptcy remote” collateral pledged by Clearing Members at an (I)CSD receives a preferential capital treatment to title transfer cash and securities.

Although EACH recognises the lower risk of loss associated with such arrangement, it should also be noted that there are negative consequences for CCPs in incentivising Clearing Members to pledge securities in place of cash transfers, namely:

- Cash is undoubtedly the safest form of collateral for CCPs (subject to management of currency risk). Incentivising the pledging of securities introduces an additional risk to CCPs, i.e. that the full value of such collateral cannot be realised in a default; and
- A reduction in the proportion of cash placed by Clearing Members will also have consequences for the liquidity of the CCP.

Special Treatment for Segregated Clients of a Clearing Member

There is uncertainty regarding a point about the “segregation” referred to in para. 112 (a) which refers to clients’ assets and positions being segregated from those of the Clearing Member and of the CCP. The legal definition of “segregation” specifically in relation to the CCP is not clear. We would welcome clarification on how this relates to the concept of segregation currently being proposed in Europe under the European Market Infrastructure Regulation (“EMIR”) and in the US under the Dodd-Frank Act.

There is also lack of clarity about how “legal certainty” (referred to in para. 112 (b)) of another Clearing Member taking over the contracts of clients of a defaulting Clearing Member can be achieved in practice, considering the costs, risks and the impossibility to foresee the position in advance for the other Clearing Member.

5. Further Comments – Quantitative Impact Study

Timing of the Study – Ensuring a Representative Sample

EACH welcomes the number of iterations (from December 2010 to June 2012) of the calculation proposed in the quantitative impact study. However, it should be noted that CCPs are currently managing market conditions which are not necessarily representative of the long-run trend.

These volatile market conditions, resulting in part from the current crisis in Eurozone sovereign debt are therefore not to be considered a reliable benchmark to establish the correct level of capitalisation over an economic cycle. Furthermore, it cannot necessarily be assured that the later iterations of the calculation will capture all possible market conditions which can be experienced by CCPs.

In particular, the various iterations of the impact study will be based on a situation before the introduction of the clearing obligation for OTC derivatives called for by the G20 and to be implemented in Europe by the proposed European Market Infrastructure Regulation ("EMIR"), which will bring potentially different contracts, more diversification, greater netting effects and higher volumes to CCPs from the OTC markets. It would be better to postpone the derivation of a new capital weighting regime until a large part of these positions have been moved to clearing, since the current results will not carry over to the post-EMIR period.

As the risk weightings set out in the 'Current Exposure Method' are fixed, but margin levels vary over time, the difference between the amount of margin and default resources held by CCPs and the amount of hypothetical capital calculated will vary according to market conditions. Margins and default funds will be higher in volatile conditions while the hypothetical capital calculated may vary little, if at all. It could be that all iterations of the quantitative impact study are completed under more volatile market conditions, when higher margins and default funds held by CCPs reduce the likelihood and extent of any shortfall between default resources and hypothetical capital, thereby reducing the impact on bank's capital requirements. This would mean that the study may significantly underestimate the capital charges which may be incurred by Clearing Members under more benign market conditions, when margins and default funds may be set at lower levels, and when there is more likely to be a shortfall in comparison with hypothetical capital.

These observations serve to emphasise that the measures proposed are static and not risk sensitive, in contrast with CCPs' existing protection mechanisms.

Additional Margin Calculation

Within the quantitative impact study, a request is made that each CCP provide an additional margin calculation, subject to standardised parameters (99% confidence interval, 5 day holding period).

EACH seeks to clarify that all CCPs apply different margining parameters for different products to address:

- Their expected default management timescales;
- The risk inherent in particular cleared asset classes, markets, and/or participants; and
- The desired balance between initial margin, default fund and capital.

Implementing an additional standardised margin calculation is a non-trivial exercise for all CCPs. In most cases this will incur significant operational burden, IT development and cost. As such, it is requested that this additional calculation is removed from the study.