Eurex Clearing AG

Comment Paper on the Basel Committee of Banking Supervisors consultative document “Capitalisation of bank exposures to central counterparties”

Agenda

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B. General Perspective and answers to questions
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A. Introductory remarks

Eurex Clearing is one of the world's leading Clearing Houses. We offer fully automated and straight-through post trade services for derivatives, equities, repo, energy and fixed income transactions. As a central counterparty, our focus is to increase market integrity. Our offering comprises flexible trade management functions, advanced risk management services, efficient collateral and delivery management tools.

Eurex Clearing is a wholly owned subsidiary of Eurex Frankfurt AG and is jointly operated by Deutsche Börse AG and SIX Swiss Exchange. Eurex Clearing acts as the central counterparty for Eurex, Eurex Bonds, Eurex Repo, European Energy Exchange (EEX) the FWB® Frankfurter Wertpapierbörse (the Frankfurt Stock Exchange) - both Xetra® and floor - and the Irish Stock Exchange.

Eurex Clearing serves more than 120 clearing members located in 10 European countries and manages a collateral pool of approximately EUR 45 billion. In 2010, Eurex Clearing processed more than 1.9 billion transactions, ranking it the largest CCP in Europe.

Eurex Clearing is a company incorporated in Germany and licensed as a credit institution under supervision of the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) pursuant to the Banking Act (Gesetz für das Kreditwesen). The Financial Services Authority (FSA) has granted Eurex Clearing status as a Recognised Overseas Clearing House (ROCH) in the United Kingdom.

Eurex Clearing very much welcomes the opportunity to provide comments on the Basel Committee on Banking Supervision (BCBS) consultative document "Capitalisation of bank exposures to central counterparties" as well as to participate in the "quantitative impact study on Capitalisation of exposures to Central Counterparties" issued 21 December 2010.

We are of the opinion that the Basel framework will contribute to safety and integrity in financial markets. Especially central counterparty clearing has proven its value proposition as a stabilizing element for financial markets during recent market turmoil. Based on comprehensive risk management processes it effectively reduces systemic risk, and improves both transparency and operational efficiency for centrally cleared products and markets.

In order to achieve the overall goal to incentivise the use of CCPs Eurex Clearing would appreciate the opportunity of working more closely with the Committee in further discussing and finalizing the Basel Consultation Paper.

Finally, Eurex Clearing is supportive of the views outlined in the Comment Paper of the European Association of Clearing Houses (EACH) on the same subject.

B. General Perspective and answers to questions

In the following we would like to contribute our perspective to the consultation paper in general and to the questions in particular (see boxes).

Our argumentation goes along the lines of the following key aspects:

The aim of the G20 leaders to create incentives to use CCPs needs to be reflected properly in the future regulations. In order to attain that goal it is imperative to ensure that the overall sum of direct and indirect costs of CCP utilization is not exceeding the costs for bilaterally conducted business. In contrary, a clear cost advantage of CCP utilization needs to be achieved. Only this will create the market forces, which are needed to increase the use of CCP clearing.

In that respect it is not only necessary to closely align the Basel framework for CCPs with the current development of higher standards for CCPs through CPSS-IOSCO and the upcoming European Market Infrastructure Regulation but also to take these higher standards into consideration when determining risk weights for the CCP exposures of CM banks.

It needs to be ensured that all regulatory initiatives CCPs have to comply with are sufficiently coordinated. Otherwise, this would inevitably increase the costs for usage of a CCP contradicting the supported overall objectives.

In light of the above the Committee should be properly balancing

- the future expected requirements for CCPs and the resulting requirements to fund the lines of defence by both the Clearing Members as well as the CCP,
- the capital charge for counterparty risk on CCP and non-CCP cleared transactions,
- the concepts on the calculation of capital charge including a low complexity and a reasonable cost to calculate and finally the overall cost (including cost for collateral, that cannot be used elsewhere) associated with the usage of a CCP,
- the calibration of parameters that are necessary to ensure that risk are not only adequately identified but also realistically measured, e.g. proposed treatment for default fund contributions both already contributed / deposited and contingent.

From a more detail-level perspective, we suggest an amendment within the methodology to derive the risk weights for default fund contributions by also permitting the use of the more risk-sensitive CCR Standardised Method in the computation of the 'hypothetical capital' of a CCP (for a detailed proposal and reasoning, please refer to part C.). It seems advisable that for measuring the real risk exposure of a CCP even the more risk-sensitive CCR Standardised Method could be enhanced.

Answers to the questions:

Paragraph 9 subsection (a) – Qualifying CCP

Question 1:
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.

Answer:
Given adequately well defined models as a prerequisite we would assume that CCPs are not only best equipped to provide necessary data but also to conduct the required calculation. Data protection aspects might need to be considered.

Question 2:
The Committee invites comments on how such verification and related quality control can be assured.

Answer:
The verification of the calculation and the performance of the quality control should be established under the responsibility of the home market supervisory authority.

Paragraph 9 subsection (g) – Qualifying Default Fund Exposure [para. 117]

Question 1:
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.

Answer:
Before elaborating or discussing other possible methods for calculating the exposure or hypothetical capital we suggest to await the first results of the latest BIS quantitative impact study (and perhaps even further studies) to better assess the impact of any kind of parameters or methods.

Whereas we appreciate the Committee's general idea to establish a risk-sensitive way of treating default fund exposures (where a CCP's margining framework and strength of lines of defence indirectly influence the risk weights of the default fund exposures), we regard a risk weight of 1250% as highly, if not overly conservative. Comparing default fund exposures in a qualifying CCP to classical equity exposure risk-weighted by 400% at a maximum, we are not aware of evidence demonstrating that relative riskiness between the two exposure types is well characterized by the relationship of the regulatory risk weights.

From a more fundamental perspective, it needs to be assessed whether the proposed risk weighting of default fund exposures is compatible with the overarching goal of promoting derivatives trading activity through CCP's. It is important that an economic incentive towards the CCP-cleared derivatives holds both at a single trade level and at an

overall level, where the latter criterion is strongly influenced by the risk-weights for default fund exposures.

In that respect, we would like to highlight the processes in case of the default of a clearing member. For example Eurex Clearing AG's resources by means of lines of defence are:

1) offsetting positions (hedging),
2) margin collaterals of the defaulting member
3) Clearing Fund deposits of the defaulting member,
4) Eurex Clearing AG fund,
5) remaining default funds contributions of the non-defaulting members
6) replenish default funds contributions of the non-defaulting members
7) Eurex Clearing AG equity capital.

In terms of the above ordering of the lines of defence, we recognize that the proposed treatment set out in paragraph 117 is sufficiently flexible to reflect the case in which the CCP's default fund contribution (item 4 above) strictly precedes the default fund contributions of the non-defaulting CM's (item 5 above) in the order of loss absorption. To our understanding, the proposed treatment does not account for the fact that the defaulting CM's default fund contribution (item 3 above) strictly precedes all other default fund contributions (items 4 and 5 above). The term denoted "$\sum DF_{CM}$" as defined in para. 117 appears to implicitly assume an identical rank order position of the items 3 and 5 above. We would suggest considering a further refinement of the treatment set out in paragraph 117 to endow it with the necessary flexibility to fully capture the ordering characterized above by explicitly accounting for the priority of the defaulting CM's default fund contribution in loss absorption. This might be introduced into the algorithm described in paragraph 117 e.g. by a suitable kind of initial offset between an individual CM's default fund contribution on one hand and the respective CM's 'contribution' to the quantity K_{CCP} on the other hand.

In addition, as an alternative method within the derivation of risk weights for the default fund exposure the Committee might take the CCR Standardised Method as additional optional method into consideration. Please see also a detailed proposal and justification in section C "Proposed Amendments to the consultation text".

Question 2:
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.

Answer:
The suggested alternative methodology is clearly inferior in our view from both a conceptual view and in terms of its practical consequences. A regime shift-type model may imply sharply discontinuous movements in regulatory capital requirement at the level of the CM's (in particular, when the privileged CCP risk weight of 2% for trade

exposures changes to a standard risk weight of at least 20%). In addition, an excessive reliance on the "hypothetical capital" of the CCP (denoted "K_{CCP}") would be introduced, where the appropriateness of the computation methodology for K_{CCP} is still under investigation and empirical evidence about the volatility of K_{CCP} over time has not yet been gathered.

C. Proposed amendments to the consultation text:

Proposed rules text, paragraph 117, lit (i), Definition of „exposure amount":

Proposed amendment:
We suggest adding the following sentence after the sentence "Each exposure amount …": "*Subject to fulfillment of the conditions specified therein, a qualifying CCP may alternatively calculate the CCR exposure amounts for its derivatives business using the Standardised Method as set out in Annex 4, Section VI. The chosen method must be applied for the entirety of derivatives positions of the CCP (without prejudice to the provision in Annex 4, Section VI, paragraph 89) and consistently over time.*"

Reasoning:
In our view, it should be admissible for a qualifying CCP to compute the exposure amounts for its derivatives business based on the Standardised Method (for CCR) instead of the Current Exposure Method. Given that banks may choose between the two methods in quantifying their CCR exposure amounts from derivatives (subject to consistency requirements), the proposed amendment would put a qualifying CCP into a position comparable to banks. Secondly, and more importantly, the conceptual limitations of the Current Exposure Method (as compared to a sophisticated risk measurement methodology in the spirit of the Internal Models Method for CCR) have a particularly significant impact in the case of the derivatives portfolios a CCP has with its Clearing Members, where less pronounced distortions can be expected under the Standardised Method.

It is important to observe that the prototypical portfolio of derivatives between a CCP and a Clearing Member generally contains both long and short positions in the same underlying financial instrument. Such derivatives portfolio structure is particularly typical in cases where the Clearing Member acts as a financial intermediary that provides Non-Clearing Members (indirect) access to the CCP. The multiplicity of trading intents of the latter group implies differences in the position-taking (long vs. short) with regard to individual financial instruments / issuers of financial instruments, which in turn creates a 'balanced' portfolio of both long and short positions in the same underlying financial instrument between the Clearing Member and the CCP. Apart from basis risk, the resulting positions are – to the extent that long positions match short positions in absolute value terms – approximately risk-free.

The Current Exposure Method in our view suffers from a conceptual shortcoming which produces results for CCR exposure amounts that sharply differ from this observation. The shortcoming lies in the way in which the add-on amount (representing potential

future increases in counterparty exposure beyond current replacement cost) for a set of derivatives forming one netting set is determined. As specified in detail in Annex 4, Section VII, paragraphs 96(iv) and 96(v) of the Comprehensive Version of the Basel Framework, the add-on for the netting set ("A_{Net}") is determined as a function of two quantities referred to as "A_{Gross}" and "NGR", respectively. The quantity "A_{Gross}" is defined as the sum of individual add-on amounts over the set of trades belonging to the netting set. By its definition, "A_{Gross}" is completely invariant to the degree of interconnectedness of the potential future price movements of the derivatives in the netting set. Assuming equality of the respective notional values, "A_{Gross}" for a netting set consisting of one long call and one short call, both on the equity of firm X, with slightly different maturity dates (or strike prices) equals "A_{Gross}" for a netting set consisting of two long calls on the equity of firm X. It is evident that this result is at odds with any quantification of potential future exposure increases based on a more sophisticated CCR measurement model.

Contrary to the Current Exposure Method, the CCR Standardised Method delivers more appropriate results in such cases. As both the long call and the short call on the equity of firm X mentioned above would be mapped into the same hedging set within the Standardised Method calculation methodology, the potential offset in future price movements of the two derivatives would be captured. Whereas we view the provisions governing the formation of hedging sets set out in Annex 4, Section VI, paragraph 80 et seq. as quite conservative (e.g., in the case of a netting set consisting of one long call on the equity of bank Y and one short call on the equity of bank Z, the CCR Standardised Method would not grant a hedging benefit), we think it delivers results much better aligned with risk measures from internal risk measurement especially in the case of derivative portfolio structures prototypical for the CCP-CM-relationship.

Sample calculations based on Eurex Clearing's actual portfolio data as of Dec 31st, 2010 provide empirical evidence of remarkable clarity that allow for an identification of the core driver of the difference between the results obtained under the Current Exposure Method on one hand and the Standardised Method on the other hand. If the hedging set definition for the subset of equity derivatives is artificially altered and narrowed down from its actual version (allowing for intra-issuer offsets, disallowing any inter-issuer offsets) to the narrowest possible definition (allowing for offsets within a particular series of derivatives for a given issuer, but no offsets beyond), an increase in aggregate exposure amount of more than 400% occurs, where the resulting aggregate exposure amount figure is relatively close to the aggregate exposure amount obtained under the Current Exposure Method. In our view, these calculations clearly indicate that the Current Exposure Method performs poorly in the case of 'balanced' derivatives portfolios in the above sense by excessively overstating basis risk. Whereas also the Standardised Method misses to capture some reliable hedge relationships within a derivatives portfolio, it appears to be more aligned with economic risk measures for the types of portfolios considered here.

We therefore suggest amending the rules text to also allow for application of the Standardised Method for CCR in the computation of K_{CCP}.

D. Additional remarks to the consultation paper:

- **§ 112 [page 10 et sqq.]**

  We would like to ask the Basel Committee for clarification on the stated conditions for client's exposure receiving preferential treatment:

  a. On para. 112 (a) which refers to the identification of positions and assets belonging to clients and those of the CCP and from the Clearing Member. The legal definition of "segregation" is not clear. We would appreciate if the current proposal within the Basel Consultation Process could be aligned with the definitions and requirements currently discussed for the European Market Infrastructure Regulation as well as for the currently revised CPSS-IOSCO recommendations for CCPs.

  b. In addition, there is also lack of clarity in para. 112 (b) referring to "…ensure that the client's contracts … will be "taken over" by another Clearing Member…". It will be essential that in such cases a close-out and re-opening of transaction at unchanged conditions from the NCM perspective is deemed compliant with the notion of "taken over".

- **Paragraph 9 subsection (g) – Qualifying Default Fund Exposure [para. 117]**

  Proposed rules text, paragraph 117, lit (i), Definition of „exposure amount":

  The provision specifying how the exposure amounts are to be derived for purposes of computing K_{CCP} is restricted to derivatives exposures, thereby missing the case of exposures from SFTs (in particular, repo transactions). We suggest amending the provision accordingly and anticipate that such amendment would presumably refer to the methods set out in paragraphs 147 et seq. and 176 et seq. (including the definition of holding periods in paragraph 167), as applicable.

- **Paragraph 9 subsection (h) – Non-Qualifying Default Fund Exposure [para. 120.]**

  Proposed rules text, paragraphs 117 and 120:

  Based on the general principle that an exposure to a non-qualifying CCP should under no circumstances be treated more favorably than an otherwise identical exposure to a qualifying CCP, we suggest a clarification on the treatment of the unfunded part of a CM's default fund contribution. For qualifying CCP's, the multiplier $\mu > 1$ is introduced, where $\mu > 1$ invokes the idea of one CM having to provide additional funds beyond his primary obligation following the potential inability of other CM's to honour their respective obligations. We are not aware of an analogous treatment in the case of a non-qualifying CCP. Whereas the cap for the individual exposure amount in paragraph 120 per se appears reasonable, we suggest a clarification of the respective treatments based on an integrated perspective on both qualifying and non-qualifying CCP's.