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Banking supervision
And Accounting issues Unit
The Director

Paris, February 4th 2011

French banking Federation comments on the BCBS Consultative Document on the capitalisation of banks to central counterparties (BCBS 190)

Dear Sir,

The French Banking Federation (FBF) is the professional body representing over 430 commercial, cooperative and mutual banks operating in France. It includes both French and foreign-based organizations.

The French Banking Federation appreciates the opportunity to provide its views on the issues raised in the Basel Committee consultation on the capitalisation of bank exposures to central counterparties (CCPs).

We believe market infrastructures in general and CCPs in particular are central to the financial system and the rules governing the CCP itself or through the capital charged for the counterparty credit risk inherent in clearing through a CCP demand careful analysis to avoid any possible race to the bottom between CCPs.

In this context, we wish to express our overarching concern on the timing of this consultation and its lack of coordination with other structuring regulatory developments related to CCPs, undertaken either at the international level (joint initiative by the Committee on Payments and Settlement Systems 'CPSS' and the International Organization of Securities Commissions 'IOSCO') or in specific jurisdictions, in particular the European Union's European Market Infrastructure Regulations (EMIR) and the United States' Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

Mr Stephan WALTER
General Secretary
Secretariat of the Basel Committee
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We understand indeed from the Consultative document that the Committee intention is to publish its final report to BCBS on the consultation and impact study in July 2011 with the view of publishing the final CCP-related rules provisions in September 2011. By contrast, CPSS/IOSCO are planning to issue revised CCP standards for consultation on March 2011 and neither the European Market Infrastructure Regulation ("EMIR") nor the Dodd-Frank rule-making on CCPs will be finalized before July 2011 (not taking into account level 2 regulation by ESMA within the EU).

This is a major concern as those legislations are likely to have significant impacts on CCPs standards and we believe any capitalisation of banks exposures to CCPs must be fully consistent with those standards.

We also think that the proposed approaches to CCPs should be underpinned and calibrated based on robust and comprehensive quantitative studies and we can only express our concern on the quality of the data that banks and CCPs will manage to contribute in the extreme tight deadline imposed for the QIS.

You will find in the annexes attached our general comments and our answers to the issues raised in the consultative document.

We thank you for your consideration of our remarks and remain at your disposal for any questions or additional information you might have.

Yours sincerely,

Jean-Paul CAUDAL

French Banking Federation general comments on BCBS 190

Definition of qualifying CCPs:

We believe that the concept of qualifying CCPs is too general and we would appreciate that it does not rely exclusively on the CPSS/IOSCO standards which are still under discussion. By contrast, there is no apparent articulation with other regulatory initiatives related to CCPs, in particular with EMIR in Europe and Dodd-Frank in the US, though they are expected to significantly increase the level of regulation for CCPs.

As a matter of example, under Dodd-Frank, a derivative clearing organization needs to comply with 18 core principles in the Commodity Exchange Act (CEA) as well as CFTC regulations, detailing the level of risk management controls, monitoring of positions by counterparties and general transparency. Under EMIR, a CCP should be authorized by ESMA and comply with EMIR requirements, including a minimal capital of €5m, robust risk management and governance arrangements, control of credit and liquidity risk, limited investment policy, controlled default waterfall, stress testing.
As a result, both regulations will settle higher standards than the minimal IOSCO requirements.

In this context, we believe that the concept of qualifying CCPs is not granular enough and that consideration should be given to the introduction of one more category that would be the 'highly qualifying' CCPs designated by ESMA (under EMIR) and by US authorities under Dodd-Frank, based on criteria such as quality of the membership, nature of the cleared products, robustness of the risk model, etc..

Having a two-step set of capital requirements will prompt CCPs to raise their practices above the CPSS-IOSCO minimum standards. In order to avoid a race to the bottom or limit any "adverse selection" effects created by a common level of capital for all CCPs compliant with minimal international standards, we would therefore strongly advice the Committee to consider developing a more granular approach.

The second condition set by the Committee for qualifying CCPs is the ability to undertake calculation and/or provide sufficient information to the clearing members to enable the completion of capital calculation.
With the efforts made to increase the use of CCPs and hence, banks exposures to CCPs, and considering the Committee's proposal in terms of potential role of CCPs in providing banks with inputs for their capital calculation, we believe that strong regulation and effective oversight of CCPs become of the utmost importance. In particular, CCPs should comply with at least the same standards than those applying to banks in terms of audit and validation of their valuation and risk management models.

As the CCP calculations will directly impact banks capital requirements, we also think that banks should have the ability to verify and have full access to CCPs figures and banks regulators should play a role in assessing the suitability of these calculations.

Trade exposures definitions and proposed 2% RW

We first seek clarification of the trade exposures definitions and urge the Committee to issue precise guidelines for their determination, especially as far as listed derivatives are concerned. We also believe that at CPP level it is important to differentiate the customer positions from proprietary positions under the clearing member umbrella.

We also seek confirmation from the Committee that those exposures should be excluded from the large exposure regime as long as they are held against a qualifying CCP.

With regard to the 2% proposed risk weight to trade exposures, we understand that the Committee motivation is to prompt banks to clear their trades on CCPs, yet not forgetting that CCPs are not risk-free.

We agree that CCPs are likely to develop exponentially in the next years, hence aggregating a very high level of systemic risk. We question however the rationale and efficiency of addressing this macro-systemic risk through the micro-prudential supervision of banks. We think that CCPs systemic risk would be better addressed through appropriate regulation of CCPs, high risk management standards including robust margining, risk controls and transparency, strong membership's standards, and emergency access to central banks liquidity.

We expect CCPs that would be subject to EMIR/Dodd-Frank ('the highly qualifying CCPs') or that would be qualified as SIFIs to satisfy the criteria mentioned above and we believe that for those, the 2% proposed risk-weight is too high and does not provide the right scale of risk-sensitivity.

As a consequence, there will no natural incentive to clear a trade realized with a counterparty benefiting from a good credit quality as:

- The trade exposures to the CCP are higher than OTC trade exposures as, usually, banks do not post initial margins with their banking counterparties and the exchange of variations margins reflecting the mark to market is symmetrical
- The bulk of cleared trades tend to be short term (e.g. front month or front quarter) which makes the 2% Risk Weighting even less attractive.

We would therefore recommend at least lowering the proposed RW for the 'highly qualifying' CCPs defined above and for CCPs designated as SIFIs.

Hypothetical capital

The Committee proposes to capitalise banks default funds exposures according to an approach that is based on CCPs 'hypothetical capital' that is an information provided by CCPs.

We have several concerns on the 'hypothetical capital' concept.

First of all, we view the dependency of banks on CCPs to get the hypothetical capital estimation as a major point of attention in the proposed framework and reiterate our call for very robust valuation and risk management models at CCPs level complemented by tight regulation and oversight.

As mentioned in the 'qualifying CCPs' section, should CCPs calculate capital requirements or inputs to capital computations, we strongly believe that banks should have the possibility to check and challenge their computations. We note that under the formula proposed by the Committee, the exposure of banks through the default fund is not fully in line with their margin calls relative share in the common participation at the CCP level, making the check very difficult to achieve on the basis of this information. To overcome this difficulty, we suggest that CCPs provide each clearing member with its contribution to the hypothetical capital using a more economic allocation (proportional to the clearing member exposure) as well as the market parameters used for consistency checks purpose.

In addition, should CCPs compute the hypothetical capital themselves, we recommend allowing them to use alternative options to the CEM method. The CEM method has clearly the merit of simplicity but is overly conservative compared to alternative approaches, in particular the IMM method, and hence is very likely to lead to levels of hypothetical capital requirements that are much higher than the initial margins usually computed using more sophisticated approaches. This might unnecessarily leads to an increase in the initial margins, increasing therefore the cost of clearing and thereby, creating a disincentive to clear transactions.

Alternatively, CCPs could be required to provide sufficient transparent public information to allow banks to assess their own contribution to the hypothetical capital under the supervision of their home regulators.

Default fund exposures and proposed capital treatment

The Committee proposes to capitalise banks default funds exposures according to a loss waterfall that seeks to take into consideration in a simple manner the risks associated to the default fund contribution.

We would like to draw the Committee's attention to the fact that CCPs default waterfalls are currently reviewed under EMIR and in the Dodd-Frank Act rule-making process. Any determination of the margin adequacy should be sensitive to the CCPs effective waterfall structures as imposed by those forthcoming regulations.

As an example, current European draft legislation suggests that in case of a default, it is first the initial margin and second, the default fund contribution of the defaulting clearing member that are used in priority to offset its own default. Only then the CCPs shareholders default fund and finally (or even simultaneously) the default fund contributed by other CCP members are called to off-set the losses.

In this context, we believe the treatment proposed by the Committee which considers the non defaulting clearing member default fund exposition as a first loss is not risk-sensitive enough, not to say overly conservative. We believe the 1250% proposed risk weight should be recalibrated based on empirical evidence drawn from the Lehman and Bear Stearn experiences;

One other point of attention is that the computation implies that the CCP members are posting regulatory capital in front of their own credit and counterparty risk. Depending on the concentration of the risks of the CCP on its members, this might have a very significant impact on the capital required for each clearing member. If the positions of the members are scattered, the proposed formula, while not technically perfect, has the merit of simplicity and is conceptually acceptable provided a more risk-sensitive risk-weight is applied in accordance with the point mentioned above. Conversely, if some members have significant positions the computation is likely to be a "double jeopardy" and should be reviewed. Due to the tightening of CCPs regulation and the high membership standards that will directly or indirectly result from that, we expect the second configuration to be the most frequent one. In this context, we believe that there is some rationale to remove the clearing member exposures from the hypothetical capital computation before computing its own share of this capital.

Finally, we note that the computation does not limit the capital requirement for the clearing member to the amount of its contribution, which may result in a highly unusual if not unique situation of an effective risk weighting higher than 1250%. While we acknowledge that the actual exposure of the clearing member may be higher than its pre-funded contribution to the default fund, we believe that the unfunded commitment of the clearing members should be measured and limited in amount. In any case, the unfunded commitment of clearing members is clearly senior to the pre-funded portfolio and should not attract the same risk weight.

Bankruptcy-remoteness of collateral and segregation issues

The Committee proposes a favourable treatment for 'bankruptcy-remote' collateral for clearing member as well as the favourable qualifying CCP risk weight for non-member banks exposures provided their assets are segregated and bankruptcy-remote from the clearing member. We would like to draw the Committee attention that the concept of bankruptcy-remote collateral is not aligned with the CCPs various segregation models prevailing today and relies too much on national bankruptcy laws which are far from being aligned. In addition, our understanding is that the concept of "bankruptcy remote" is only relevant for securities, cash being commingled. Therefore, we would suggest basing the most favourable treatment on a notion of "appropriate segregation" as the current legislation both in the EU and in the US will precisely define the level of segregation expected from CCPs.

As a general comment, we would like to stress that the incentives given by the Committee in relation to segregation deserve a careful analysis to avoid potential unintended consequences, like the creation of massive liquidity traps if a too high level of margins were to be segregated.

Attention should also be paid to CDS used by banks to hedge their loan books for which we urge the Committee to acknowledge that sub-accounts held separately by a bank for CDS hedging the loan book and for the trading book may be netted for the determination of Credit Event calculation and payments, and that CDS held in such accounts hedging the loan book will therefore fully qualify as guarantees received from the CCP.

Treatment of non qualifying CCPs

One important criterion to determine a qualifying CCP will be transparency. We understand from the Committee's proposals that non qualifying CCPs will be considered as not transparent enough and therefore the Committee proposes to use the standard method for credit risk to compute capital requirements on banks exposures to such CCPs.

We think a more risk-sensitive framework would be desirable to encourage non CPSS-IOSCO compliant CCPs the chance to fill the gap with more ancient and advanced CCPs and avoid entry barriers and avoid disincentives to a wider use of CCPs by financial institutions and their clients. More importantly, a more gradual and risk sensitive framework would avoid major disruptions should a CCP suddenly lose its status of qualifying CCP.

Indirect Access and capitalisation of Clients' exposure

Beyond segregation, we understand that an additional criterion to benefit from the favourable qualifying CCP risk weight is that the non-member bank must be 'legally ensured' that another CCP member will take over its trades if the original CM cannot perform (or so-called 'portability' concept). Even if the idea of the "legally ensured" portability of the trade is an interesting idea, we wonder how this will work in practice, as, the clearing member commitment to take the position implies taking a counterparty risk on the client. This risk will be unknown at the time of the commitment, creating exposures to counterparties that have not been vetted by the clearing member and will be realised in (most likely) stressed situations (default of a clearing member).

Under the Committee's proposed wording, if the condition of 'portability' can not be legally enforced, the clients will have no incentive to clear their trades as the capital required for their exposure will remain based on the clearing member and not on the CCP even if their initial margins are correctly protected and the mark to market of their position (if bilateral) daily provisioned. The CCPs practices and processes in case of default of a clearing member proved to be robust enough so far; we therefore propose to remove the term 'legally ensured' to keep the concept of 'portability' flexible enough to accommodate those practices.

French Banking Federation Answers to the Committee's requests for comment on BCBS 190

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 to complete calculation of exposures and capital

We believe banks are the best equipped to compute their exposures and capital requirements. CCPs should be required to provide all the necessary information in a fully transparent manner to allow banks to perform their own assessment of the building blocks of their capital requirements under the supervision of their home supervisors. As stated in the general comments, CCPs should be subject to very high risk management standards and regulatory oversight to ensure that the model outputs and data they will provide to banks to complete their exposure and capital computations are fully compliant with the regulatory standards applying to the banks themselves.

Should CCPs compute their hypothetical capital themselves, we strongly recommend that:

- CCPs overseers apply the same regulatory standards than those applying to banks including those applying to model validation
- CCPs provide each clearing member with its contribution to the hypothetical capital using a more economic allocation (proportional to the clearing member exposure) as well as the market parameters used to allow for a full consistency check

Comments on other practicable, simple and supervisable methods for calculating exposure or hypothetical capital and on adjustments to CEM that could improve its utility as a proxy for CCP exposures to its members

As stated in the general comments, we question the appropriateness of using the CEM method to determine the CCP hypothetical capital with regard to its lack of risk-sensitivity, the calibration of its add-on which does not factor-in the high frequency of margin calls for exposures to CCPs and the over-estimation of hypothetical capital needs which could unduly trigger an increase in initial margins and hence in clearing costs.

Should CCP be responsible for the hypothetical capital calculation, we would strongly recommend that more sophisticated approaches than the CEM method ("CEM") be allowed for them to use under the proper supervision of their regulator. At minima, the add on of the CEM method should be recalibrated in a way that is more consistent with the CCPs margining practices and frequency.

Comments with respect to whether an alternative methodology such as requiring bilateral capital treatment for trade exposures to CCPs 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

We do not support the proposal of requiring bilateral capital treatment for trade exposures to CCPs where its default fund is less than its hypothetical capital. We think the first priority is to make sure that the determination of the hypothetical capital is performed in a way that is economic enough to allow for a meaningful comparison with the CCP default funds and that any shortfall does not simply result from flawed risk assessments. Then after, we urge the Committee to consider a more risk sensitive waterfall and capital charges that are commensurate with the economic risk of each scenario. The industry would be happy to assist the Committee in the calibration of such economic risk weighting.