

2 February 2011

Via Email: [baselcommittee@bis.org](mailto:baselcommittee@bis.org)

Basel Committee on Banking Supervision  
Bank for International Settlements  
Centralbahnplatz 2  
CH-4002 Basel  
Switzerland



Dear Sir,

**FEEDBACK ON BASEL COMMITTEE ON BANKING SUPERVISION'S  
CONSULTATIVE DOCUMENT, CAPITALISATION OF BANK EXPOSURES TO  
CENTRAL COUNTERPARTIES**

1. We refer to the consultative document paper in relation to the capitalisation of bank exposures to central counterparties released in December 2010.
2. We welcome the opportunity to give feedback on the proposed regulatory capital adequacy rules, set out in the consultative document, which support the requirement for banks to more appropriately capitalise their exposures to CCPs, including both trade and default fund exposures to CCPs. Our response to the consultation document is attached.
3. If you require further clarification, please do not hesitate to contact Mr Zhang Changhao (Email: [changhao.zhang@sgx.com](mailto:changhao.zhang@sgx.com)).

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Agnes Siew'.

AGNES SIEW  
HEAD, RISK MANAGEMENT  
SINGAPORE EXCHANGE

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## CONSULTATIVE DOCUMENT ON CAPITALISATION OF BANK EXPOSURES TO CENTRAL COUNTERPARTIES

### SGX Comments

2 February 2011

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#### 1. INTRODUCTION

- 1.1. Singapore Exchange Limited (“SGX”) welcomes the opportunity to submit its comments on the Basel Committee on Banking Supervision’s (“BCBS”) consultative document issued in December 2011 in relation to the capitalisation of bank exposures to central counterparties (“CCPs”).
- 1.2. SGX operates two clearing house entities in Singapore, namely the Singapore Exchange Derivatives Clearing Limited (“SGX-DC”) and the Central Depository (“CDP”). SGX-DC provides clearing services for exchange-traded derivatives contracts and over-the-counter (“OTC”) commodities and financial derivatives contracts. CDP provides clearing services for securities and security-based derivatives contracts. The two clearing house entities are regulated by the Monetary Authority of Singapore as designated clearing houses under the Securities and Futures Act of Singapore.

#### 2. GENERAL COMMENTS

##### 2.1. Scope of Proposal

The proposed capital adequacy rules (“**proposed rules**”) will modify the Scope of application under Annex 4, Section II. Exposures to central counterparties arising from OTC derivatives, exchange traded derivatives and SFTs transactions will be subject to the counterparty credit risk treatment in paragraphs 106 to 120.

SGX agrees that cash trades should be excluded from the scope of paragraphs 106 to 120, as Annex 3 of Basel II already prescribes the capital treatment for failed trades and non-DVP transactions<sup>1</sup>. Any additional requirements for CCPs over and above Annex 3 will impose more onerous standards for CCPs vis-à-vis other counterparties. We feel that this is not warranted as CCPs

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<sup>1</sup> SGX understands that there are currently no changes proposed for Annex 3 of Basel II.

generally have processes to reduce and manage failed settlement, and ensure timely deliveries.

## **2.2. Low risk weight for trade-related exposures to a qualifying CCP**

Paragraph 114 of the proposed rules requires banks to apply a risk weight of 2% to their trade-related exposures with a qualifying CCP.

SGX supports a low risk weight for bank trade-related exposure to CCPs, because they are fundamentally different from other counterparties covered under the Basel framework.

The risk profile of a CCP is inherently low as it sits between offsetting trades. The practice of margining, and the maintenance of a default fund further reduces the risk profile of a CCP. BCBS had recognised that CCPs pose low risk, and allowed a zero risk weight under Basel II.

In light of the expectation that banks and financial systems will be increasingly reliant on CCPs, SGX is of the view that a risk weight of 2% or lower is appropriate.

## **2.3. Bankruptcy Remoteness**

Paragraph 115 of the proposed rules specifies the circumstances under which posted collateral that is held by a CCP need not be subjected to capital requirements.

SGX agrees that posted collateral held in bankruptcy remote manner should not be subjected to capital requirements, as it is free from the credit risk of the CCP.

## **2.4. Netting Rights of CCPs**

Paragraph 117 of the proposed rules require that Current Exposure Methodology (“CEM”) be used to calculate credit exposures. CEM, as laid out in Part VII of Annex 4 in the Basel II Framework, only recognises partial netting of 60%. SGX understands that this is due to BCBS’ concerns over possible unbundling of positions by liquidators.

SGX disagrees that netting can only be recognised partially. CCPs may have much stronger netting rights than banks, specifically carved out under the law which allow its default proceedings to take precedence over the usual laws of insolvency. This greatly reduces the likelihood of unbundling by a liquidator.

SGX is of the view that the full benefits of netting, i.e. 100%, should be recognised for these CCPs in the calculation of exposures.

## **2.5. Confidentiality Restrictions**

Paragraph 118 specifies requirements on the computation of capital requirements for default fund:-

- The CCP, trade repository, bank, supervisor or other body with access to the required data make the calculations in such a way to permit the supervisor of the CCP to oversee those calculations.
- Sufficient aggregate information<sup>2</sup> must be made available to the home supervisor of any bank clearing member to review and confirm such calculations.

The Consultative Document invited comments on how verification and related quality control of the computations can be assured.

SGX is concerned that the proposed rules will cause confidentiality restrictions to be breached. In particular, neither a bank clearing member nor its home supervisor should have access to information pertaining to other members.

In this regard, SGX proposes that the onus of verification ought to rest with the CCP's supervisor. Bank clearing members and their home supervisors may rely on a representation from the CCP's supervisor for assurance.

## **3. COMMENTS ON METHODOLOGY**

SGX is concerned that parts of the methodologies specified within the proposed rules are inadequate or inappropriate for CCPs. In particular, a bilateral exposure methodology cannot be used directly in a CCP context without adaptation.

SGX recommends that BCBS sets up a workgroup to engage CCPs in determining appropriate modifications. If indeed set up, SGX would like to be part of this workgroup.

### **3.1. Current Exposure Methodology**

The Consultative Document invited comments on adjustments to CEM that could improve its utility as a proxy for CCP exposures to its members.

SGX is of the view that a consistent method for computing exposure should apply to all CCPs. This is important for minimising regulatory arbitrage due to different standards of risk practices across CCPs.

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<sup>2</sup> The composition of the CCP's exposures to clearing members, and information provided to the clearing member for the purposes of the calculation,

However, CEM in its current form is unsuitable for computing CCP exposures, as explained in the following paragraphs.

### 3.1.1. *Many CCPs realize mark-to-market profits/losses daily*

CEM relies on the assumption that mark-to-market profit/loss (“MTM P/L”) is collateralized, as in the bilateral context. However, many CCPs settle MTM P/L daily and there is no accumulation of credit exposures to the member across days.

SGX would like BCBS to confirm that in cases where MTM P/L is settled daily, credit exposures arising from MTM P/L from members may be recognised as zero.

SGX is also concerned that CEM would fail in cases that MTM P/L is settled daily, as the net-gross ratio (“NGR”) cannot be computed<sup>3</sup>. SGX strongly encourages BCBS to explore alternatives to NGR for CCPs that settle MTM P/L daily.

### 3.1.2. *Broad rates are unsuitable for calculating potential future exposure*

To estimate potential future exposures, CEM specifies flat rates by broad buckets of asset class and maturity.

SGX is of the view that this broad-brush approach does not make sufficient distinction between the risk profiles of different segments within the asset class. For example, the risk profile of an instrument based on equity indices is typically lower than that of an instrument on an individual stock. Under the CEM approach, both instruments would be classified under the equities asset class with the same flat rate. This leads to inaccurate profiling of the risk of CCPs, and penalises CCPs that clear contracts with relatively low volatilities.

SGX recommends that CCPs should be allowed to determine their own flat rates based on an appropriate confidence level, holding period, and look back period. Alternatively, BCBS should specify the flat rates to greater granularity, by taking into consideration the nature of the contracts.

### 3.1.3. *Inadequate recognition of customer-house segregation*

In many jurisdictions, clearing members and the CCP are required to segregate customer from house positions and assets. Typically, customer monies are protected in the event of a house origin default, while house monies may be used to cover losses arising from a customer origin default.

<sup>3</sup> CEM relies on NGR to estimate net exposures from gross exposures. NGR is computed as the ratio of net MTM P/L to gross MTM P/L, which are both zero for CCPs that settle MTM P/L daily. Hence, NGR would not be meaningful, and will cause a divide-by-zero error if indeed computed.

CEM is unable to capture this important relationship, as it treats the CCP-member relationship as a single bilateral relationship. This may lead to illogical results where the segregation concept is violated.

SGX strongly urges BCBS to explore methods to reflect aptly the customer-house segregation for CCPs.

### **3.2. Methodology for default fund capital requirements**

Paragraph 117 sets out the methodology for determining the capital requirements for a clearing member's exposures arising from its default fund contributions.

The Consultative Document invited comments on other practicable, simple and supervisable methods for calculating a clearing member's exposures arising from its default fund contributions, or hypothetical capital requirements ("HCR").

In general, SGX agrees with the following concepts:-

- (a) Capital factors that are risk sensitive, based on the likelihood of utilisation of clearing members' default fund contributions.
- (b) A low capital factor when the CCP's own contribution is sufficient to meet HCR. This reflects the lower risk that clearing members' contributions may be utilised. Here, 1.6% or lower is appropriate.
- (c) Equation (ii) can be adapted when a CCP's own contribution are used in combination with the clearing members' default fund contributions to cover CCP losses, on a pro rata or formulaic basis. This is in recognition that default funds may be structured differently across CCPs to take into account their respective business needs.

However, SGX finds that the methodology deserves refinement in several areas, as spelt out in the following paragraphs.

#### **3.2.1. *Sudden transition of capital factors may cause funding hassle***

SGX is of the view that the transition of capital factors from 1.6% to 100% is too sudden. This could cause capital requirements to fluctuate unnecessarily and become a funding hassle for both the CCP and bank clearing members. The problem is aggravated by the use of an inaccurate estimate, HCR, to determine the capital requirements.

In this regard, SGX recommends more gradual tiers of the capital factors.

### 3.2.2. *Excess default fund contributions not treated appropriately*

Lastly, SGX would like to highlight that clearing members generally fund their default fund contribution in excess of their requirement. In the event of a member default, excess funds of non-defaulting members may not be used as part of the waterfall.

SGX is of the view that the proposed rules do not address the excess contributions appropriately. The rules should be refined in the following manner:-

- (a) Capital factors should not be applied to excess contributions in determining capital requirements.
- (b) Apportionment of capital requirements to clearing members should be based on proportionate default fund contribution requirement, excluding the excess contributions.
- (c) The excess contributions, on the other hand, should be allowed to offset a defaulting member's exposure as computed under CEM.

## 4. CONCLUSION

- 4.1. SGX would like to thank the Committee for the opportunity to participate in the consultation process. Please do not hesitate to contact Mr Zhang Changhao (Email: [changhao.zhang@sgx.com](mailto:changhao.zhang@sgx.com)) if you have any questions. We look forward to be involved in future public consultations.