

Room 525, 5/F., Prince's Building, Central, Hong Kong  
Telephone: 2521 1160, 2521 1169 Facsimile: 2868 5035  
Email: info@hkab.org.hk Web: www.hkab.org.hk

香港中環太子大廈5樓525室  
電話：2521 1160, 2521 1169 圖文傳真：2868 5035  
電郵：info@hkab.org.hk 網址：www.hkab.org.hk

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By email: [baselcommittee@bis.org](mailto:baselcommittee@bis.org) & post

Secretariat of the Basel Committee on Banking Supervision  
Bank for International Settlements  
CH-4002 Basel  
Switzerland

Dear Sirs

**Consultative Document on Capitalisation of bank exposures to central counterparties**

We refer to the Consultative Document, "Capitalisation of bank exposures to central counterparties" published by the Basel Committee on Banking Supervision (BCBS) in December 2010. On behalf of our members, we set out our views on the Consultative Document:

**1. Severity of Default Fund capital charge for two of three scenarios (page 4 & 5)**

One of the main goals of the proposed rule changes is to create incentives to use central counterparties (CCPs). Sections 9(g)(ii) and 9(g)(iii) provides capital treatments for two of the three possible scenarios for a bank's pre-funded and unfunded default fund contributions:

- (ii) *To the extent that the CCP's prefunded financial resources equal the CCP's 'hypothetical capital', the portion of member-provided prefunded default contributions should be capitalized at a 100% rate (ie based on a 1250% risk weight and the assumption of 8% total capital);*
- (iii) *To the extent that the CCP's prefunded financial resources are less than the CCP's 'hypothetical capital', where members have an obligation to contribute additional funds to cover the losses of a CCP, they should recognize a higher exposure, based on 120% of the amount expected to be drawn/called from members according to such obligation. Such exposure should also be capitalized at a 100% rate.*

The above capital treatments are equivalent to dollar-for-dollar capital deductions, which are significantly more punitive than normal corporate/financial institution exposures, and as such, we are of the view that these proposed rules would potentially *discourage the use of CCPs* instead, as equivalent over-the-counters (OTC) transactions would require lower capital charges.

Chairman Bank of China (Hong Kong) Ltd  
Vice Chairmen The Hongkong and Shanghai Banking Corporation Ltd  
Standard Chartered Bank (Hong Kong) Ltd  
Secretary Eva Wong Mei Seong

主席 中國銀行（香港）有限公司  
副主席 香港上海滙豐銀行有限公司  
渣打銀行（香港）有限公司  
秘書 黃美嫦

## 2. Reporting Frequency for CCP capital charge

The reporting frequency for the proposed CCP capital charge is not mentioned in the document. We seek clarifications on whether it should match the normal Capital Adequacy Ratio (CAR) reporting frequency, or it is to be left at the discretion of each clearing members' home bank supervisor.

## 3. Exercise of national discretion (page 10, paragraph 107)

When local regulators are allowed to add more capital requirements for banks dealing with CCPs, we recommend that clear criteria be established as to how the additional capital is required.

## 4. Definition of Qualifying CCPs (page 3)

Section 9(a) defines "qualifying CCPs" as follows:

*Qualifying CCPs [para. 113, 114, 117, and 118] : Where a CCP is compliant with CPSS-IOSCO standards and is able to assist clearing member banks in properly capitalizing for CCP exposures (by either undertaking the calculations and/or making available sufficient information to its clearing members, or others, to enable the completion of capital calculations (see next bullet point (g) on the CCP's hypothetical capital calculation), such CCP is considered to be a 'qualifying CCP' [see paragraphs 113 and 118 of the proposed rules text]. Exposures to 'qualifying CCPs' should benefit from lower capital charges.*

- 4.1 We seek confirmation on whether the BCBS is to provide a list of qualifying CCPs and their respective supervisors, and whether local regulators have the discretion to modify the list.
- 4.2 With the international nature of most of the banking portfolios in international financial centres, including Hong Kong, multiple CCPs from varying jurisdictions are often used, and determination of whether a specific CCP meets the above definition may not be a straight-forward exercise. It is, therefore, essential that local regulators provide ongoing lists of frequently-used qualifying CCPs and non-qualifying CCPs to standardize and facilitate such assessment.

## 5. Best-equipped parties to manage information and complete calculations (page 3)

In response to the BCBS' request for comment under section 9(a):

*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.*

We are of the view that, as banks do not have access (or very limited access) to information of counterparty credit risk exposures and other financial information of the CCPs, banks will not be in a position to calculate the hypothetical capital requirement of the CCPs.

Alternatively, we propose the following approaches be explored :

- a. for trade exposures, each clearing member uses Current Exposure Method (CEM) methodology to calculate its own trade exposures since clearing member possesses the best knowledge of their own portfolios, and the expertise and experience in using the CEM calculation methodology.
- b. for the calculation of a CCP's hypothetical capital, each clearing member provides its own exposure amount using CEM methodology to the CCP or CCP overseers, who will aggregate all members' exposure amounts, and then share its hypothetical capital requirement with all members.
- c. for the calculation of the capital requirement for each clearing member, CCPs and CCP overseers assemble and manage the necessary information and complete this calculation, as these parties tend to possess the most updated information and comprehensive views of all their clearing members.

#### **6. Availability, timeliness and frequency of update for information required to perform calculations (page 4)**

From section 9(g) and section 117 of Annex A (the proposed capital rule text), it is apparent that the following information are required for each CCP in order to calculate the capital requirement for default fund for each clearing member :

- total exposures for all clearing members, calculated using CEM
- DF<sub>CEM</sub>: prefunded default fund contributions from all clearing members
- DF<sub>CCP</sub>: the CCP's prefunded own funds and financial resources (e.g. contributed capital, retained earnings etc)

However, we have concerns over the availability, timeliness and frequency of updating of the above information, as CCPs are not currently required to disclose the information on a monthly basis, some are currently only disclosing on a quarterly basis.

In addition, while section 118 of Annex A requires CCPs and their local regulators to synchronize information update and CAR reporting, we do not see the requirements for regulators from different jurisdictions for synchronization of



CCP information updates. Given the fact that most banks use global CCPs from other jurisdictions, this may result in these banks using outdated/non-synchronous information from CCPs in different jurisdictions for CCP charge calculations.

Another aspect of the concerns is that, given the composition of a certain CCP's default fund in relation to a particular bank's portion can change significantly over time, which may in turn result in significant changes on capital charges to the individual bank. For example, the addition of a large bank as a CCP's new member can alter the CCP's hypothetical capital and total default fund contributions significantly, potentially leading to different capital treatments, such as changing from a 1.6% capital charge to a 100% capital charge for the bank's default fund contribution.

With the recently enacted U.S. Dodd-Frank Act, the European Commission's proposed regulation of OTC derivatives and the recent development of a local trade repository (TR) in Hong Kong, the above scenario is likely to occur in the near future, when regulators require banks to move OTC transactions to central clearing via CCPs.

## **7. Current Exposure Method (CEM)**

### **7.1 Risk sensitivity of CEM**

Capital requirement for default fund exposures employs the CEM, which differentiates contracts based on their types (e.g. FX, Interest Rate, Equity etc) and residual maturity in the potential exposure component. While relatively easy to compute, we are concerned that this two-dimensional method may not be risk sensitive enough. We suggest BCBS to also explore / consider other more risk sensitive methods for exposure calculation.

### **7.2 Scope of application (page 10)**

Annex 4, Section II has been modified to include exposures to CCPs arising from exchange traded derivatives. We seek clarifications on how to calculate credit exposures for each kind of exchange traded derivatives, exchange traded futures and options products under the CEM approach.

## **8. Exposures to central counterparties of home country and foreign countries**

Under the proposed framework, we suggest BCBS to consider the possibility of different capital treatments between exposures (both trade and default fund



related) to CCPs of home country versus those to CCPs of foreign countries due to greater regulatory transparency and effectiveness for CCPs in the home country.

**9. Scope for applying Standardised Approach (page 15, paragraph 119)**

Paragraph 119 stated “the category of the counterparty”. We seek clarifications on whether this refers to the CCP or the original OTC counterparty, and the treatment of those trades that are rejected by the CCP.

It would appear that only the Standardised Approach (for credit risk) is allowed but not the IRB Approach. We have concerns that this may have impact to the minimal IRB coverage requirement imposed by local regulators.

From the consultation paper, we are under the impression that exposures to qualifying CCPs are classified under the IRB approach and included in the scope of IRB coverage. Please state explicitly in the Paper.

**10. Operational Risk capital charge for CCP**

This consultation paper addresses counterparty credit risk only. In the event of a counterparty default, the CCP would seek to unwind its trades. Unwinding costs can be significant for illiquid products. To this end, we seek information on whether there are plans for a corresponding change in Operational Risk capital charge for trades using CCPs for clearing.

We hope you will find the above comments useful.

Yours faithfully

Eva Wong  
Secretary

c.c. Ms. Karen Kemp, Executive Director (Banking Policy), Hong Kong Monetary Authority