RBS
The Royal Bank of Scotland

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

**Global Banking & Markets**
GBM Risk
135 Bishopsgate
London
EC2M 3UR

www.rbs.com/gbm

2 February 2011

Dear Sirs

**Capitalisation of Bank Exposures to Central Counterparties**
**Response by The Royal Bank of Scotland Group**

I enclose The Royal Bank of Scotland Group ('RBS') response to the above consultation paper and welcome the opportunity to provide feedback. RBS has been an active participant in the joint trade association response, of which we are fully supportive.

## Background

The wider use of CCPs is being actively encouraged by G20 and regulators, for example through the Dodd-Frank Wall Street Reform and Consumer Protection Act and European Market Infrastructure Regulations. Under the current European Commission Banking Consolidation Directive[1], the capital requirement for trade exposures (but not default fund exposures) to CCPs is set to zero; the Basel Committee now propose that credit institutions hold Pillar 1 capital against trade exposures and set a prescribed standardised approach for risk weighting default fund exposures.

The probability of incurring credit losses from such exposures is clearly non-zero, however the structure of CCPs are designed to minimise the likelihood of such losses through, for example, daily margining and pre-funded default funds that are set using sophisticated market event scenario tools; losses to clearing members would be expected to occur only under extreme market events.

We urge regulators to ensure that the level of capital held against exposures to CCPs properly reflects the risk of such exposures and the nature of supervision of CCPs.

## Key Observations

The risks associated with CCPs should be managed through a variety of tools and the appropriate capitalisation of bank exposures to CCPs should be just one aspect of this framework. Since CCPs must be regarded as systemically significant, it is crucial that they are subject to sufficiently robust standards covering supervision, liquidity and disclosure standards and requirements on financial resources. Indeed, we consider that a key element of managing systemic risks associated with CCPs is the establishment of appropriate minimum standards for the level of equity required by CCPs; this will help in aligning the interests of equity holders with that of the CCP.

We consider that any framework for capitalising CCP exposures should be consistent with the desire by governments and national authorities to increase the usage of CCPs. In this regard we encourage the Basel Committee to work with other rule-making bodies to ensure that the infrastructure and capital framework for CCPs is coherent and consistent.

[1] This rule is set out in point 6 of part 3 of Annex III to European Commission Directive 2006/48/EC

In respect of the specific proposals set out in the consultation paper, our main points are:

- We seek further clarity on a number of areas on the capitalisation of trade exposures to qualifying CCPs including the determination of the 2% risk weight, the appropriate treatment for segregated assets and the approach to capitalising client cleared trades.
- We suggest that the current European Commission approach for capitalising pre-funded default fund exposures to CCPs is retained. We have a number of concerns on the proposed hypothetical capital approach, both conceptually and in the use of punitive risk weights.
- We suggest that unfunded default fund commitments to CCPs be capitalised as contingent liabilities.
- We question the appropriateness of a binary capital treatment between qualifying and non-qualifying CCPs: cliff edge effects can result in undesirable outcomes.

We set out further details of our observations in the annex to this letter.

We look forward to working with supervisors in developing an effective, balanced and coherent approach to capitalising bank exposures to central counterparties.

Yours faithfully

David Coleman
Chief Risk Officer, Global Banking & Markets

Enc:
Annex – Discussion of Key Observations

## Discussion of Key Observations

There are a number of ideas and proposals set out on the consultation paper that we consider should be subject to further review to help in the development of a fair and coherent prudential capital framework for bank exposures to CCPs. We set out in this annex a number of observations that we hope will serve to trigger dialogue between regulators and industry.

Our observations cover the following areas:

- It difficult to opine on the appropriateness of the 2% risk weight applied to trade exposures without further information although we believe that there may be a case for a range of risk weights depending on the legal treatment of collateral posted to CCPs.
- We seek further clarification of the capital treatment of segregated assets and of centrally cleared client trades.
- We consider the conditions for clearing member clients to gain capital relief on centrally cleared trades to be inappropriate and may introduce incentives to avoid the use of central clearing.
- We consider that the proposed approach to risk weighting pre-funded CCP default fund exposures could lead to overstatement of capital requirements compared to the underlying risks due to the use of potentially punitive risk weights and a simplistic approach to estimating hypothetical capital.
- We have a number of concerns on the use of a hypothetical capital approach and suggest a simpler approach in line with the current requirements set out in the current Banking Consolidation Directive.
- We suggest that the binary approach of the capitalisation of exposures to qualifying CCPs against non-qualifying CCPs may introduce undesirable consequences and recommend dialogue on a more granular approach.

### Trade Exposures

*Risk Weight*
The risk of loss against a trade exposure with a CCP is associated with either (1) default of clearing member(s) against which the aggregate of defaulting member(s) margins, member pre-funded default funds as well as the CCPs own capital base was insufficient to cover losses or (2) CCP losses arising for other reasons such as investment of collateral, liquidity risks, settlement risks, etc. Either of these situations must be considered as low risk, albeit non-zero.

It would be helpful to understand the approach that Basel took to arrive at the proposed 2% risk weight as this would allow for more considered dialogue on the appropriateness of this risk weight.

We note that the 2% risk weight applies irrespective of the nature of the collateral posted and legal status of such collateral under a default scenario. For example, cash collateral tends to be treated as an unsecured and non-cash collateral may or may not be subject to rehypothecation rights. It may be appropriate to have a more granular set of risk weights that varies according to the legal rights under a credit event.

*Segregated Assets*
Paragraphs 115 and 116 of the proposed Basel provisions on the capitalisation of banks' exposures to CCPs deal with the treatment of segregated assets. The provision states that such exposures are not subject to a capital requirement for counterparty credit risk to the custodian.

The provision is unclear as to whether counterparty credit risk capital is required to be held against a third party entity or institution in which the CCP, as a bankruptcy remote custodian, places the assets or collateral. If such capital is required to be held by banks, this would introduce disincentives to using segregated accounts, something that is being actively encouraged through, for example, EMIR.

*Treatment of Client Cleared Transactions*
For institutions that are capitalised under FSA rules, the counterparty credit risk capital requirement for client exposures where a clearing member is acting as a broker is based on the outstanding margin posted by the client falls short of that required by the central counterparty which is aligned with the underlying risks of the transaction.

We would recommend that Basel clarifies its capital treatment for such transactions and whether a CVA risk capital charge is required to be calculated against centrally cleared client exposures. In order to properly align to the overall objectives of encouraging the use of central clearing and to ensure capital is aligned to the underlying risks, we suggest that the existing approach to capitalising client cleared transactions is retained.

*Client Exposures to Clearing Members*
The Basel proposal for client trades set out in paragraph 112 allows clearing member clients to receive the same capital treatment as the clearing member if two conditions are satisfied: segregation of assets such that they are bankruptcy remote and guaranteed portability such that another clearing member is required to assume the client obligations in the event of their clearing member defaulting.

Clearing members will be strongly encouraged by clients to provide such guarantees so that the clients can benefit from the more beneficial capital treatment. We do not consider it appropriate for such a condition to be applied under all circumstances since there are scenarios under which it would be undesirable for another clearing member to be forced to assume the positions. These might include:

- The client may have a poor credit position at the time of transfer, possibly even triggered by their clearer's default;
- The client portfolio may be unpalatable for the clearing member;
- The clearing member's liquidity position may mean that they cannot easily fund the related margin and default fund contributions.

We believe that the condition relating to segregation of assets as sufficient to enable clients to use the revised capital treatment for CCP exposures. Certainly we do not consider that requiring an all encompassing guaranteed portability that could lead to a possible deterioration in a clearing member's risk, capital and/or liquidity position is appropriate.

**Pre-funded Default Fund Exposures**

*Summary*
At the time of writing this response, we do not have the information to assess the quantification of the Basel proposals on the capital treatment of pre-funded default fund exposures; our views on the proposed approach should therefore be considered preliminary.

We believe that the current approach adopted under European Commission legislation which requires capital requirements to be applied to pre-funded CCP default fund exposures using the existing credit risk framework to continue to form the most appropriate method of capitalising such exposures. Under this approach, all appropriate quantitative and qualitative factors may be incorporated into assessing an appropriate risk weight which might include membership admission criteria, clearing members margin and default fund requirements and operational/settlement risk.

We consider the suggested hypothetical capital approach to result in potentially inappropriate capital requirements that are not aligned to the underlying risk of credit losses of default fund exposures.

*Risks Attributable to Pre-funded Default Funds*
Before commenting on the proposed approach for capitalising pre-funded default fund exposures, it is worth considering the risks associated with such exposures. Generally, it would be expected that losses on default fund exposures would occur under volatile market conditions such that margining fails to capture actual market moves in the event of a clearing member default.

Probability of Loss for a Default Fund

The probability of loss (PL) associated with a clearing member's pre-funded default fund exposure to a CCP is associated with two scenarios:

- The default of one or more clearing members where losses are not covered by mechanisms higher in the waterfall (such as margins, insurance, CCP capital, etc.). The PL associated with the default fund would be based on the probability of default (PD) of the clearing members. For a default fund exposure to an individual CCP, the PL would be the determined from the PD across the set of clearing members which will be partly dependent on the correlation between clearing members. The PL would therefore be expected be higher than the PD of any individual clearing member.
- The CCP becomes insolvent (for example due to investment risk, liquidity issues, etc.) and the default fund becomes part of the amount owed to the clearing member as an unsecured creditor. This scenario depends on the nature of segregation or rehypothecation rights associated with the default fund. Given the current risk management and operational tools and controls employed by CCPs and the increasing amount of supervision to which they are subject, the PL associated with a CCP default must be considered remote.

Amount of loss

If we assume that a default fund is required to be utilised, we can also consider the loss given utilisation (LGU), which is conceptually identical to the normal loss given default (LGD).

In the first scenario set out above, default of clearing members, there are a number of factors that might affect the LGU over and above the LGDs associated with the individual clearing members, including:

- The approach to determining clearing member margins and default funds as an indication of the extent to which defaulting member margins and default funds will cover their losses
- Membership criteria which provides an indication of the financial health of potential clearing members
- The number of clearing members as an indication of the extent to which losses might be mutualised
- Level of CCP capital as an indication of the extent to which losses may be covered by the CCP ahead of using default funds (depending on the actual waterfall for the CCP)

Given the various risk management mechanisms in place, we might expect that the LGU to be lower than the equivalent LGD associated with individual clearing members. Of course, there is a risk (aligned to the correlation of clearing members) that more than one clearing member might default in a short period of time which could result in a potentially higher LGU.

In the second scenario, a CCP default, the LGD associated with the default fund will, of course, depend on the nature of the default and to what extent exposures are segregated or subject to rehypothecation rights.

*Default Fund Risk Weights*

The proposed capital treatment of pre-funded default fund exposures uses two risk weights: 20% and 1,250% depending on whether the hypothetical capital is covered by the CCPs own capital. There is also a 20% scaling on any shortfall of capital measured against total CCP financial resources.

Ignoring the conceptual use of a hypothetical capital approach, on which we comment below, we agree that the level and nature of capitalisation of a CCP should be a factor that influences the risk weight associated with default funds as it clearly impacts the LGU.

However, we do consider that the risk weights proposed under the hypothetical capital approach to be excessive:

- On the assumption that the CCPs own capital were sufficiently large to cover losses (as measured by hypothetical capital) then the LGU might be assumed to be zero since the default fund would not be needed to cover the losses. Hence a 20% risk weight would appear high.
- On the assumption that the default fund exposure would be required to cover losses (as measured by hypothetical capital), the Basel Committee suggest that a risk weight of 1,250% is appropriate which effectively assumes that the default fund would be subject to a 100% loss with absolute certainty. Given the underlying risks, as described above, we would consider the proposed risk weight to be punitive.

*Use of the Hypothetical Capital Approach*
We understand the rationale for differentiating risk weight according to the level of capitalisation of the CCP relative to a level of required capital but we have a number of concerns with the details of the hypothetical capital approach as is currently proposed:

- The measure used to calculate hypothetical capital is simplistic and is unlikely to correspond to the techniques and models used by CCPs to determine appropriate levels of margin and default funds. A material discrepancy between the assessment of hypothetical capital and the assessment actually made by CCPs could result in a significant distortion of perceived view of the level of adequate capital. This would lead to inappropriate risk weights being applied to default fund exposures that are not aligned to the underlying risk.
- One of the key aspects of the proposed approach is a determination of whether default fund exposures comprise an element of hypothetical capital (in which case a 1,250% risk weight applies). Under this scenario, the suggested approach calibrates default fund exposures to equity risk. We would contend that the CCP model is distinct from that of a bank and that default funds work in a very different way to equity capital (for example only being available to cover clearing member defaults). We therefore question the validity of this aspect of the hypothetical capital methodology.
- Although the Basel Committee is clear that the hypothetical capital is not supposed to represent the actual level of capital adequacy, the use of hypothetical capital in determining risk weights for default fund exposures will result in it becoming a de facto measure of actual capital adequacy. We would suggest that any approach for measuring a CCP's capital adequacy for credit institution capital purposes should be consistent with any approach set out by CCP supervisors.
- There are a number of factors and scenarios that result from hypothetical capital deviating from other measures of capital and economic costs/rewards that could induce inappropriate behaviour. We consider this to be a complex area that requires further time and effort to assess possible implications. We set out some examples of areas to consider:
  - The motivation for infusing a CCP with equity capital may depend on the type of shareholder. For example, a shareholder that is not a financial institution would look to minimise the amount of equity capital required and maximise the amount of default funds. On the other hand, a shareholder that is also a clearing member may need to consider the relative costs of equity capital and default funds in assessing an optimal balance.
  - If the level of hypothetical capital deviates from either a capital adequacy framework implemented by CCP supervisors or the measure of economic capital determined by the CCP itself, there will be a potentially complex optimisation of the level of equity capital and default funds and the likely introduction of arbitrage possibilities.
- The hypothetical capital approach does not incorporate a number of factors that might influence the probability and amount of possible loss on default fund exposures including membership admission criteria, number of members, diversity of products, investment criteria, liquidity risks, etc. All of these factors could be incorporated into the determination of an appropriate risk weight using the current approach (for firms using an internal ratings based approach).
- Reliance on information from CCPs to be able to ascertain the risk weight is somewhat cumbersome, particularly in view of the potential inaccuracy arising from the simplicity of the suggested approach.

We believe that there are more appropriate and more practical approaches for risk weighting CCP default fund exposures relative to the proposed hypothetical capital approach suggested by the Basel Committee.

*Exposure*
We believe that the current default fund exposure value, as currently set out under European Commission legislation, is the most appropriate measure of exposure to be used to determine risk weighted assets for pre-funded CCP default fund exposures.

We do not believe that it is appropriate to add a seemingly arbitrary 20% scaling factor to exposures where the total level of prefunded capital is deemed to be too low in comparison to the measure of hypothetical capital. Aside from the crudeness of the suggested hypothetical capital measure, which may lead to a distortion of the real adequacy of capital for a CCP, we do not consider there is justification for applying a blanket scaling factor to the perceived shortfall.

We suggest that the potential calls for further default funds should be treated separately as contingent liabilities (see next section).

**Unfunded Default Fund Contributions**
Contingent liabilities are capitalised under the existing prudential capital framework based on an appropriate exposure and the application of a factor based either on whether the contingent liability is full, medium or low risk under the standardised rules or based on a firm's own assessment under the internal ratings based approach.

We would suggest that unfunded default fund contributions are captured under the framework dealing with contingent liabilities. We do not believe that an approach based on a measure of shortfall based on the proposed hypothetical capital and incorporating a fixed and arbitrary 20% scaling factor is an accurate measure of potential contributions nor does the level of capital reflect the underlying risks.

**Treatment of Non-Qualifying CCPs**
The proposed capital treatment of CCP exposures incorporates a binary approach between those CCPs that meet the qualifying standards set by CPSS-IOSCO and those that do not. We believe that the capital requirements should be aligned to underlying risks and do not consider a binary approach as being an optimal design of the framework in this respect. We suggest two potential undesirable outcomes of such an approach:

- There is a distinct risk, particularly where gaining a competitive advantage is desirable, that CCPs will generally look to meet minimum standards but are unlikely to go beyond this given the cliff effect of a binary approach.
- There is a risk that a binary approach could form a barrier to entry as it may take time for prospective CCPs to comply with all requirements ahead of which they become highly undesirable to use due to punitive capital requirements.

A more granular approach to capitalising exposures to CCPs that better reflects the quality of the CCP could avoid both of these issues. We would welcome further dialogue on a prudential capital framework that better reflects both the quality of a qualifying CCP and the benefits of a CCP that might fail to meet all the conditions that might be set out by CPSS-IOSCO later in the year.