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Via E-Mail: baselcommittee@bis.org

Basel Committee on Banking Supervision
Bank for International Settlements
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10178 Berlin, 4 February 2011
Burgstrasse 28
Ref. ZKA: BASEL
Ref. BdB: C 17 - Sz/Ha

Consultative document on the *Capitalisation of bank exposures to central counterparties*

Dear Madam/Sir,

We are grateful for the opportunity to comment on the above-mentioned consultative document and wish to do so as follows:

General remarks

At their Pittsburgh summit in September 2009, the G20 countries resolved to strengthen the incentives to use central counterparties (CCPs) for clearing eligible OTC derivatives. In addition, the capital requirements for derivates not cleared centrally, i.e. not cleared through a CCP, are to be raised. We support the initiatives in this respect by the Basel Committee on Banking Supervision and the European Commission. In its document *Basel III: A global regulatory framework for more resilient banks and banking systems* (Basel III) of December 2010, the Basel Committee adjusted the rules on the measurement of counterparty credit risk in OTC derivative transactions and at the same time raised the corresponding capital requirements significantly. The Basel Committee proposals are to be transposed into European law by amending the Capital Requirements Directive (CRD) accordingly.

Furthermore, the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) are working on a realignment of their principles for payment, clearing and settlement systems that is to be completed this year. These principles will establish requirements for CCPs and their supervision. In Europe, the European Commission published on 15 September 2010 a proposal for a European Parliament and Council Regulation on OTC derivatives, CCPs and trade repositories (European Markets Infrastructure Regulation [EMIR]). Besides setting regulatory and organisational standards for CCPs, the aim is to have all OTC derivatives defined as eligible cleared through a CCP by the end of 2012 at the latest. In our view, the initiatives outlined above take full account of the G20's wishes.

The proposed increase in the capital requirements for exposures to CCPs is only justified in our view if the current zero weighting understates risk. We have no empirical evidence of this, however. In fact, the system of CCPs and clearing houses established for the futures and repo markets has proved itself in different crisis situations. The first derivatives clearing houses were set up in the 19th century to clear commodity contracts, since at that time hedging against counterparty credit risk in the real goods markets was of paramount importance to industrial companies and particularly to the agricultural sector. The London Produce Clearing House (LPCH) was, for example, established in 1888, while margin-based clearing of grain futures was launched on the Chicago Mercantile Exchange as early as 1865.

Thanks to their layers or lines of defence and the fact that they are largely independent of government control, clearing houses have managed to survive crisis situations such as the Great Depression of 1929 and the subsequent banking crisis, various cases of sovereign bankruptcy and debt rescheduling, the abandonment of the gold standard and, last but not least, the current economic and financial crisis. Most recently, the failure of US bank Lehman Brothers, which was heavily involved in clearing business, showed that CCPs can also transfer or liquidate large exposures quickly and efficiently in a crisis.

The ongoing further development of layers of defence is probably also a reason why no collapse of a CCP has been witnessed during the past decades. This further development has been driven, on the one hand, by increasing regulatory requirements, most recently mainly by the 15 principles of the CPSS and IOSCO *Recommendations for Central Counterparties* of 2004, which are currently being reviewed particularly in relation to derivative transactions. On the other hand, significant further development of the layers of defence has been made possible by the progress in information technology in recent times. For example, a number of clearing houses have set up real-time exposure monitoring systems during the last few years or converted computation of daily margin requirements (adjustment of initial margins due to new types of transaction, variation margins) to more accurate, more computationally intensive risk models.

The stronger use of CCPs in future will undoubtedly increase their systemic importance. Whether this means that CCP default risk will increase at the same time is something that still has to be examined, however. If the existing layers of defence are insufficient for the new scale of trading, the weaknesses identified would have to be eliminated accordingly, particularly by way of regulatory standards for CCPs. With its draft EMIR, the European Commission is moving in the right direction. We therefore do not believe that taking into account any weaknesses in CCP layers of defence within the framework of capital requirements for banks is the right approach.

As we see it, the proposed extremely high capital requirements for qualifying CCP default fund exposures if the CCP's own financial resources are less than its hypothetical capital are designed to ensure that CCPs are adequately capitalised. In the process, capitalisation of CCPs and their default funds is be determined in future using a standardised approach for measuring the capital requirements for banks (mark-to-market method) and not, as has been the case so far, using CCPs' sophisticated internal models. The attempt to regulate CCPs indirectly via the capital requirements for banks is wrong in our view for regulatory and policy reasons. That goes particularly in view of the fact that the scope banks have for influencing the organisation and capitalisation of CCPs is limited, as they will be legally obligated in future under corresponding regulatory provisions to use CCPs for certain transactions, and no discretion will thus be allowed (see, for example, EMIR). This means that they will have no way of indirectly exerting pressure on CCPs either. Adequate capitalisation and a high level of system stability should be achieved via carefully designed qualitative and quantitative requirements for CCPs and monitoring of compliance with these by regulators and not indirectly via CCP users.

Specific remarks

<u>Definition of a CCP</u>
The Basel Committee intends to extend the current definition of a CCP in Annex 4, Section 2, paragraph 6 to include the requirements that a clearing house be licensed as a CCP and prudentially supervised. Supervisors are to enforce compliance with the (reviewed) CPSS/IOSCO Principles for Financial Market Infrastructures on an ongoing basis. A clearing house that fails to comply with the CPSS/IOSCO principles would consequently not be a CCP.

The present proposals lead to four different categories of clearing house:
- Clearing house that is not a CCP
- Qualifying CCP which meets the requirements set out in paragraph 106
- Qualifying CCP which does not meet the requirements set out in paragraph 106
- Non-qualifying CCP.

Depending on how the clearing house is categorised, different rules are to apply for calculating the capital requirements for trade exposures and default fund exposures. This is a highly complex approach for which we see no reason. We therefore request further explanation.

Furthermore, the consultative document only contains proposals on the capitalisation of exposures to qualifying and non-qualifying CCPs. We therefore wonder how the capital requirements for trade exposures and default fund exposures to a clearing house that is not a CCP would be calculated. If the provisions on bilaterally agreed derivates transactions are to apply in this case, we wish to point out that the capital requirements for default fund exposures to a clearing house which does not comply with the CPSS /IOSCO principles and is thus not a CCP would be lower than the capital requirements for the default fund of a non-qualifying CCP (proposed risk weight of 1250% in paragraph 120) which complies with the CPSS/IOSCO principles. This would be inappropriate in our view. We suggest retaining the current CCP definition and inserting the proposed additional requirements under (b) in the definition of "*qualifying*" in paragraph 113.

If a CCP supervisor does not publicly disclose whether a CCP complies with the CPSS/IOSCO principles, banks are to conduct analysis of their own in regard to compliance. Such analysis by banks is highly time and cost-intensive and, because the information required is not all available, probably impossible in some cases. For this reason, the supervisors represented in the Basel Committee on Banking Supervision and in IOSCO should undertake to publicly disclose the names of CCPs in their jurisdiction which comply with the CPSS/IOSCO principles. Even more efficient would be continuously making available and regularly updating this information centrally, e.g. on the IOSCO website.

The draft EMIR also provides for regulatory requirements for CCPs as well as a licensing process. The newly established European Securities Markets Authority (ESMA) is to play a key role in the licensing and supervision of CCPs. To avoid any distortion of competition and any unnecessary burdens due to diverging rules and regulations, the regulatory requirements for CCPs in the different jurisdictions should be consistent. The international bodies CPSS and IOSCO should therefore work together closely with the European Commission and other national or supranational regulators. European banks should expect CCPs that are licensed under EU rules to also comply with the CPSS/IOSCO principles.

Discretion of national supervisors

Under paragraph 107, national supervisors are entitled to require that banks in their jurisdictions hold more than the minimum capital requirements for exposures to CCPs. We are opposed to such national discretion, as it leads to a distortion of international competition. Moreover, if

internationally coordinated regulation of CCPs is adopted, there should be no need for such discretion at least for exposures to qualifying CCPs.

Capital requirements for non-clearing members

We welcome the Basel Committee's intention to give also non-clearing members access to preferential capital charges for exposures to qualifying CCPs. The conditions for this are set out in paragraph 112: (a) clear segregation of the assets of the non-clearing member from those of the clearing member, with such segregation resulting in bankruptcy remoteness and (b) a legal safeguard for the non-clearing member to the effect that another clearing member will take over the exposures of the non-clearing member in the event of the default or insolvency of the (originally mandated) clearing member.

May we first say that both conditions should be laid down within the framework of CCP regulation. At the same time, we take a critical view particularly of the second condition. We believe that the condition under (a) calling for segregation of assets (besides the existing margin, default fund contributions and contractual obligations to provide additional funding) is already sufficient on its own to achieve an effective reduction in counterparty credit risk. This is comparable in legal status to an asset pledge. A requirement for exposures to be taken over by another clearing member appears practically unfeasible, on the other hand. A clearing member would have to make a contractual commitment in advance to take over all of another clearing member's exposures changing over time. Such binding commitments are likely to be difficult to obtain, however. If the conditions cannot be fulfilled, application of preferential capital charges for CCP-cleared derivatives to non-clearing members is not possible in practice. It should also be borne in mind in this context that it is sufficient in order to protect the clearing member if the exposure is terminated and the proceeds from termination are used in the marketplace to take on a substitute exposure. We therefore request deletion of condition (b).

If our request for deletion of the condition proposed in (b) cannot be accommodated, we propose that the mere possibility of exposures being taken over by another clearing member should be regarded as sufficient as long as there is nothing (such as empirical experience) to indicate that such exposures will not be taken over by another clearing member.

Capitalisation of trade exposures

In paragraph 114, the Basel Committee proposes a risk weight of 2% for trade exposures to qualifying CCPs, including any posted collateral. When calculating the Exposure at Default (EAD), netting agreements can be taken into account in addition to variation margins. Due to the reference to paragraphs 96 (i) and 96 (ii), only close-out netting would be recognisable for calculating the net replacement cost, however. Close-out netting agreements, which are geared to

the default of a clearing member or CCP, are only partially used by CCPs, however. In most cases, payment netting is used in dealings between CCP and clearing members. Because payment netting is not recognised for regulatory purposes, the gross amounts would have to be included in calculation of the EAD. Despite the moderate risk weight of 2%, high EADs would lead to high capital charges for CCP-cleared transactions cleared that would strongly overstate risk. We therefore propose giving CCPs sufficient time to adapt their netting agreements accordingly. It may also be necessary to adjust and further harmonise the insolvency framework for CCPs in all relevant legal regimes to ensure the legal enforceability of close-out netting and all other measures in connection with the default of clearing members for the clearing system. Only then should the proposed new rules enter into force. Alternatively, restricted recognition of payment netting agreements for transactions with CCPs could be considered.

Under the newly inserted paragraph 41 (i) (see document *Basel III: A global regulatory framework for more resilient banks and banking systems*, p.40), the margin period of risk for trading activities where the number of trades exceeds 5,000 at any point during a quarter is to be 20 business days. This rule should not be applied to transactions cleared through CCPs, as it would run counter to the intended incentive to use CCPs.

We request clarification on what is meant by "*net receivable position*".

<u>Bankruptcy-remote collateral</u>
Under paragraph 115, assets and collateral posted with CCPs are not subject to capital requirements if these (i) are kept separate from the assets of the CCP or, in the case of non-clearing members, kept separate from the assets of the clearing member and (ii) are not affected by the default of the custodian. We believe that both conditions are basically appropriate. Some CCPs are currently working on the segregation of collateral that is called for also in, among other things, the draft EMIR. What is more difficult in our view is ensuring the bankruptcy-remote safekeeping of collateral. To achieve this, the general provisions of civil law and insolvency law in different jurisdictions would, in turn, have to be adapted and further harmonised.

We wish to point out that compliance with both conditions is not at the discretion of banks. Instead, CCPs must adjust their rules and regulations accordingly. We therefore propose accommodating the demand for bankruptcy-remote safekeeping of collateral within the scope of CCP regulation, e.g. in the CPSS/IOSCO principles. For collateral posted with CCPs, the zero weight could then continue to be applied when measuring the counterparty credit risk. In addition, we generally suggest making clearer that further adaptation and harmonisation of the general provisions of civil law and insolvency law governing CCPs is an indispensable basic condition for effective and efficient regulation.

<u>Method for calculating the capital requirements for default fund contributions</u>
The <u>method</u> proposed in paragraph 117 for calculating the capital requirements for default fund contributions is highly complex. Operative implementation of this method would impose a burden on both banks active as clearing members and CCPs that would not, in our view, be in reasonable proportion to its benefits.

The Basel Committee's proposals state that, depending on the amount of financial resources held by the CCP (DF_{CCP}) itself in proportion to its hypothetical capital (K_{CCP}), the <u>risk weight</u> for default fund contributions is between 20% and 1250%. In case (i) in paragraph 117, if the total loss-bearing resources are (DF) < K_{CCP}, an additional capital charge for the difference (K_{CCP}–DF) is provided for. The difference is to be multiplied by the factor $\mu = 1.2$, so that 120% of the contractually guaranteed default fund contribution would have to be deducted from capital. As a result, default fund contributions would be treated worse in regulatory terms than an equity exposure (of more than 10%) by a bank in another bank. The proposed risk weights of 1250% and 1250% × μ respectively are not sufficiently risk-sensitive in our view, so that we strongly oppose them.

The Basel Committee proposals ignore in our view the fact that CCP credit counterparty risk exposures to all its clearing members must be fully collateralised on a daily basis (see paragraph 106 a). Exposures are collateralised by means of a margin system (initial margin, variation margin, intra-day margin calls). Clearing houses generally calculate margin using scenario-based, carefully calibrated value-at-risk approximations (usually with a confidence level of 99% - 99.7%), taking into account netting agreements. This method adequately captures the (market) risk of a position and thus of the actual potential future exposure. In addition, some clearing members validate the initial and variation margin called for by clearing houses on a daily basis using their own internal market risk models and could also present the results of such validation on request.

Default fund contributions from other clearing members would have to be used if (i) a clearing member becomes insolvent and (ii) at the same time the exposure held by it depreciates in value to such an extent that both the collateral posted by it (initial and variation margin) and its default fund contribution (possibly plus some of the CCP's own resources) would no longer be sufficient to cover the depreciation in value of its exposure in full. Thanks to the method used to calculate initial margin and default fund contributions, such a case is highly unlikely.

The waterfall approach adopted upon recourse to the default fund as a final step is, to our knowledge, implemented by most clearing houses worldwide. It is also proposed in the draft

EMIR. The low probability of recourse to the default fund should be reflected in the risk weight applied.

Recourse to the default fund might be necessary if major operational risks (e.g. model risk, human failure, legal risk) were to materialise. However, the CCP's operational risk should not be covered in our view by way of the capital requirements for counterparty credit risk applying to banks. Qualitative requirements for handling operational risk and any rules on adequate capitalisation should, on the other hand, be part of CCP regulation. If adequate capitalisation of CCPs is ensured, the proposed waterfall approach is not necessary in our view. A risk weight of 20% should therefore be applied to all default fund contributions.

Although we are in favour of dropping the waterfall approach, we should nevertheless like to comment on the planned calculation of hypothetical capital. The <u>CCP's hypothetical capital</u> K_{CCP} is to be calculated using the mark-to-market method in accordance with Annex 4, Section VII. The relevant add-on factors for the potential future exposure set out in tabular form in paragraph 92 (i) of Annex 4 are calibrated to residual maturities of non-cleared OTC derivatives of several months to several years. The add-on factors do not, in particular, take into account the daily variation margining (mark-to-market) for futures contracts, as a result of which the residual maturity is set from a credit risk perspective at one day. The add-on factors thus strongly overstate risk. In addition, the existing netting agreements are taken into account too imprecisely, without reflecting the actual economic effect of risk reduction. Because of the weaknesses outlined, we believe that the mark-to-market method of calculating the exposures held by a CCP whose counterparty credit risk stems almost exclusively from derivatives positions is inadequate. We therefore propose allowing CCPs to additionally use the Internal Model Method (IMM). In our view, CCPs should be able to use the IMM.

Distribution of the total capital requirements to the individual clearing members is to be based on the prefunded default funds. Consequently, a member that only contributes unfunded default funds would not be assigned any capital requirement. In our view, calculation of capital requirements taking unfunded default funds into account and distribution based on the total default fund contributions would be more risk-sensitive. The formula should also reflect the fact that the maximum amount of the bank's default fund exposure is limited to the sum total of prefunded and unfunded default funds, as is explained at several junctions in the text.

<u>Making the calculation</u>
According to paragraph 118, the CCP, trade repository, bank, supervisor or other body must make the required calculation of K_{CCP}, DF_{CMi} and DF_{CCP}. In our view, only the CCP has the information needed to allow such calculation. Calculation by the individual clearing banks would not only be

inefficient but may also pose problems under existing data protection rules. Furthermore, the CCP would have to provide the required data in this case, too.

For cost-benefit reasons, we also propose that the hypothetical capital minus the CCP's own financial resources should by no means have to be calculated daily, but only on certain dates (such as end of quarter/reporting dates). We request clarification to this effect.

<u>Application of the Standardised Approach for exposures to non-qualifying CCPs</u>
Under paragraph 119, banks must calculate the capital requirements for exposures to non-qualifying CCPs or qualifying CCPs that do not meet the requirements set out in paragraph 106 according to the Standardised Approach for credit risk. Consequently, banks which are licensed to use the Internal Ratings-Based Approach (IRBA), would only have to apply Standardised Approach risk weights to exposures to non-qualifying CCPs. There is no technical justification in our view for using Standardised Approach risk weights for non-qualifying CCPs. The IRBA risk weight should apply; the risk is also captured adequately through calculation of the EAD. In addition, holding different regulatory risk weights would impose a heavy burden on banks for which we see no justification. We therefore request deletion of paragraph 119.

<u>Capital requirements for default fund contributions to non-qualifying CCPs</u>
We are against the risk weight of 1250% for default fund contributions to non-qualifying CCPs called for in paragraph 120. From a risk standpoint, we do not understand why default fund contributions to non-qualifying CCPs should have to be backed with more capital than default fund contributions to a clearing house that is not a CCP. At 370% (if no capital deduction is made), the risk weight for equity exposures to a clearing house would be lower than the risk weight for default fund contributions to a non-qualifying CCP although the default fund would have priority under the regulatory requirements specified in the document.

We believe that the provisions of the Standardised Approach for credit risk and the IRBA should be applied to default fund contributions to clearing houses that are not classified as qualifying CCPs.

Editorial remarks
In conclusion, we should like to draw attention to some presumably editorial shortcomings in the consultation document:

- Annex 4, Section II, paragraph 6 stipulates that the exposures specified therein are to be subject to paragraphs 106-120 of the new section on CCPs. The types of exposure in question are presumably trade exposures, although the term is never actually mentioned here. Paragraphs 106-120 also contain provisions on default fund exposures, however.

- Paragraph 106 of the new section on CCPs in Annex 4 merely refers in general to "*transactions by a bank with a CCP*". This term could also basically cover default fund exposures. The criteria set out are not applicable to default funds, however, so that further explanation is required here in our view in order to rule out any misunderstandings.
- Paragraph 119 refers to "*CCR EAD to a non-qualifying CCP*". Trade exposures are presumably in fact meant here. But, formally, this term also covers default fund exposures, though these are then mentioned separately in paragraph 120, as well as equity exposures.
- Paragraphs 119 and 120 both contain the same phrase "*or to those transactions to a qualifying CCP that do not meet the requirements in paragraph 106",* but with different legal consequences. On the one hand, the Standardised Approach and, on the other, a risk weight of 1250% is to be applied. Clarification would be advisable here.

We shall of course be pleased to answer any further questions you may have and additionally explain our concerns to you personally.

Yours sincerely,
on behalf of the Zentraler Kreditausschuss
Association of German Banks

Dirk Jäger Anja Schulz