

November 25, 2011

Secretariat of the Basel Committee on Banking Supervision  
Bank for International Settlements  
CH-4002 Basel  
Switzerland  
baselcommittee@bis.org

Dear Sir/Madam:

**Re: CBA<sup>1</sup> Comments on the Basel Committee's Consultative Document:  
*Capitalisation of bank exposures to central counterparties***

Thank you for the opportunity to comment on the Basel Committee's November 2011 Consultative Document: *Capitalisation of bank exposures to central counterparties*.

We appreciate the Basel Committee's continued efforts to develop guidance in this area. We are pleased that the Consultative Document is significantly clearer and addresses a number of our previous concerns with respect to the December 2010 consultative paper. Notably, and while we would like further change to permit greater recognition of netting benefits and reduced bank capital requirements held in respect of clearing member default fund contributions, we are pleased that the factor in the Current Exposure Method (CEM) which controls the amount of netting has been increased.

For your consideration, below is a summary of our key concerns with regards to the Consultative Document. Additional detailed discussion on specific paragraphs is included in the attached.

**Incentives for central clearing and for banks to act as clearing agent**

Under the proposals contained in the Consultative Document it is apparent that, if clearing member-to-client cleared trades continue to be charged as a bilateral OTC and subject to Credit Valuation Adjustment (CVA) exposures, cleared trades will attract higher capital requirements than un-cleared bilateral trades. This is because the trade between a client and a clearing member is subject to the same capital requirements as an identical bilateral OTC transaction, while the capital requirement for a trade between a clearing member and CCP and for the

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<sup>1</sup> The Canadian Bankers Association works on behalf of 52 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 267,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness.

clearing member's contribution to the CCP default fund are additive. Accordingly, the current proposals serve as a significant disincentive for clearing members to provide clearing services.

In this regard, greater clarity is required with respect to the capital requirements for cleared clearing member-to-client transactions. We believe that if banks clear for clients, the exposure should be lower than a bilateral exposure. Otherwise, there is no capital incentive for central clearing and for banks to act as a clearing agent.

### **Current exposure method**

The CEM was introduced as a simple approach for approximating the potential future exposure of OTC derivatives. It is a simple approach, intended for less sophisticated banks and small portfolios of derivatives. Clearing members house portfolios are typically very large, and often very well hedged. Thus, given that the CEM was not designed for this type of portfolio, we are concerned that the CEM will not produce a meaningful estimate of hypothetical capital for the purposes of the default fund exposure.

We are of the view that applying the CEM to centrally cleared derivatives to estimate the riskiness of CCP default fund contributions would significantly overstate hypothetical capital since it is not designed for the CCP environment where the risk is reduced through multilateral netting and loss mutualization.

We do not believe that the CEM can be simply recalibrated to provide a more risk sensitive approach. It is not an appropriate tool for calculating CCP hypothetical capital and as such, an approach which provides more accurate estimates for typical CCPs is preferred. We recommend the use of the Internal Model Method (IMM) be permitted since it is more risk sensitive and takes into account netting benefits.

### **Proposed timeline**

While the proposals contained in the Consultative Document are now slightly clearer and address some previously outstanding issues, we believe that significantly more consultation remains necessary to refine the proposals to avoid unintended consequences. Therefore, we strongly suggest that more time be provided to engage the industry in these efforts and to ensure that an appropriate Quantitative Impact Study can be completed.

We thank you for taking our comments into consideration and would be pleased to discuss these issues further at your convenience.

Sincerely,

A handwritten signature in black ink, appearing to be 'J. G. Smith', written in a cursive style.

## CBA comments on BIS Consultation Paper – Capitalisation of bank exposures to central counterparties

### CBA Members' Comments and Requests for Clarification

#### OVERALL COMMENTS

- The Basel Committee has recognized that while CPPs create benefits for OTC derivatives markets, they introduce concentration and operational risk. These risks need to be monitored and prudent regulation needs to be in place to mitigate those risks. We firmly believe that this regulation needs to be in place prior to requiring the market to adopt the CPP infrastructure.
- There is no evidence to suggest that the financial system will be safer if CCPs are appropriately capitalized. While the new rules tackle the capitalization of the CCP from a credit risk point, we question whether CCPs will have enough capital to support any operational risk (like a cyber attack for example). Conversely, banks are capitalized to cover multiple risks (such as credit, operational, market and business risk) which give a bigger capital buffer assuming all risks correlate to 1.
- There is no evidence to suggest that the CCP's model for securities financing transactions (SFT's) will be economically viable if banks need to hold 3% of tier 1 capital (on the basis of leverage ratio rules).

#### SCOPE

- **Exposures to Qualifying CCPs – bilateral uncleared exposures**

We note that the consultative document speaks to the treatment of trade exposures (paragraph 110), posted collateral (paragraph 115) and default fund exposures (paragraph 116). Banks may however also provide CCPs with liquidity facilities or enter into bilateral OTC or SFT transactions with the CCP as part of a default management framework. We are of the view that these bilateral uncleared exposures should be risk weighted equivalently to trade exposures where they are not loss absorptive, *i.e.*, not available for the mutualisation of losses due to a clearing member default.

#### TRADE RELATED EXPOSURES

- **Paragraph 19: Trade related exposures (p.4)**

The trade exposure definition includes current and potential future exposure to a CCP, as well as initial and variation margin. We recommend that, where legally enforceable, variation margin already delivered should offset against the value of the position that it has been delivered against.

## CBA Members' Comments and Requests for Clarification

### CAPITALISATION OF TRADE EXPOSURES

#### ▪ Paragraph 110: Concentration risk

We note that concentration risk is not addressed in the consultative document. While the consultative document summary notes that extended margin period of risk will not apply for large netting sets, and paragraph 11 of Annex A states that higher margin period of risk will only apply for illiquid trades or disputed trades, neither specifically mention how to treat concentrated positions (we expect CM's will have positions that are concentrated with CCP's and would expect that a higher margin period of risk would not apply, however it is not clear).

Further, we note that there is no floor with respect to the margin period of risk. It is critical that the proposals set out in the consultative document be implemented symmetrically to avoid an unlevel playing field for capital market businesses. Setting a floor in connection with the margin period of risk will assist symmetric implementation.

### CAPITALISATION OF DEFAULT FUND EXPOSURES

#### Calculation of the "hypothetical capital"

#### ▪ Paragraph 116: Hypothetical capital (p. 4 & 15)

The description of hypothetical capital ( $K_{CCP}$ ) calculation in paragraph 24 states: "...collateral posted to the CCP (initial or variation margin) as well of the default fund contribution from each member are treated as risk mitigants which reduce the exposure that the CCP has to each CM."

However, the specification of the  $K_{CCP}$  in paragraph 116 does not represent the variation margin held by the CCP against its exposure to a clearing member to reduce the  $K_{CCP}$  arising in respect of the exposure to that clearing member. We further note that, specifically:

- $EBRM_i$  is defined as the exposure value to clearing member "i" before risk mitigation, which appears to disallow recognition of Variation Margin as an exposure mitigant in  $EBRM_i$ ; and
- $VM_i$  is defined as variation margin that a clearing member is entitled to receive but has not yet received or variation margin that the CCP is entitled to receive but has not yet received.

Neither of the definitions of  $EBRM_i$  and  $VM_i$  include Variation Margin that the CCP actually holds (and is entitled to continue to hold) as collateral against MTM exposure under  $EBRM_i$ . Therefore, we believe that the definition of  $EBRM_i$  and/or  $VM_i$  should be amended to include Variation Margin that the CCP holds as collateral. Conversely where Variation Margin is a payment that contractually extinguishes a liability rather than a pledge of collateral, e.g., futures contract, the Positive Replacement Cost input to EBRM should be calculated net all Variation Margin payments that have been made.

Furthermore, the inclusion of variation margin payable to the CCP in the calculation of the CCP's exposure to each CM creates a double-count of credit risk. Variation margin is due to the CCP if there is a positive MTM (from the CCP's perspective) on a trade – that is, on a trade where the CM owes the CCP. Given that the trade exposure is already captured in EBRM, it is a double-count to include it again as variation margin.

## CBA Members' Comments and Requests for Clarification

### TREATMENT OF POSTED COLLATERAL

- **Paragraph 115: Treatment of Posted Collateral (p.14)**

Paragraph 115 requires recognizing counterparty credit risk on collateral posted with a CCP when that collateral is not bankruptcy remote. Could the Basel Committee please clarify how will capital be calculated for such counterparty credit risk?

Further, could the Basel Committee clarify whether it is a requirement to capitalize against counterparty credit risk on posted collateral that is not bankruptcy remote when that collateral is variation margin? Since variation margin posted to a CCP covers MtM owed to the CCP, we recommend that the MtM liability offset any counterparty credit risk and no counterparty credit risk capital should be required on variation margin.

### CAPITALISATION OF DEFAULT FUND EXPOSURES

#### Allocation of aggregate capital requirements to individual clearing members

- **Paragraph 116(ii): Default fund exposures – calculation (p. 16)**

Paragraph 116(ii) applies a capital charge to Clearing Members for unfunded Default Fund contributions where  $DF'$  exceeds  $K_{CCP}$ , regardless of whether Clearing Members' unfunded liability to contribute additional resources to the CCP is capped. While this is intended to discourage the undercapitalization of CCPs, it also discourages Clearing Members from limiting their unfunded tail risk obligations to a failing CCP, potentially increasing tail risk to the Clearing Members in a CCP failure.

- **Paragraph 116(ii): Default fund exposures – default risk (p.16)**

In the allocation of the aggregate capital requirements among individual clearing members, no consideration is given to the fact that clearing members do not carry the same risk of default and should therefore not share the aggregate capital in proportion to their  $DF$  contributions. Clearing members that have a higher risk of default risk losing all or a greater portion of their own contribution than other clearing members. Hence, we suggest a risk-sensitive approach to allocating the aggregate capital in the form of an additional factor to the formula in Annex A, paragraph 116(ii).

- **Paragraph 116(ii) & 117: Default fund exposures – location and frequency of default fund calculation (p.16)**

Paragraphs 116 and 117 leave the location of default fund calculation open and require either the CCP, bank, or supervisory body to perform the calculation of the required inputs to the default fund, such as  $K_{CCP}$ ,  $DF_{CM}$  and  $DF_{CCP}$ . Since the CCP has complete information for calculation of all required inputs (in particular  $DF_{CM}$ ), it would be preferable to have the calculation performed by the CCP, subject to sufficient transparency to the clearing members and supervisory body (including sufficient information to enable banks to satisfy obligations in paragraphs 107 and 108 with respect to Pillar 2 Basel II minimum capital requirements and senior management/committee reporting requirements respectively). Finally, monthly calculation of the default fund calculations would be preferable as fiscal quarters may not end on the same months for all involved institutions.

**CBA Members' Comments and Requests for Clarification**

**INDIRECT ACCESS RELATED ISSUES**

- **Calculation of default fund exposures**

Could the Basel Committee please clarify how default fund exposures of a bank are to be computed in the case of indirect access to a QCCP. When should a bank apply the double default risk weight of 4% instead of 2%?