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Mr. Bill Coen
Acting Secretary General
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Dear Mr. Coen

DB Response to Basel Committee Consultation on capitalisation of bank exposures to central counterparties (CCPs)

Deutsche Bank (DB) welcomes the opportunity to comment on the most recent consultation paper from the Basel Committee (BCBS) on the treatment of bank exposures to CCPs.

DB has worked closely with the International Swaps and Derivatives Association (ISDA), the Institute of International Finance (IIF) and the Global Financial Markets Association (GFMA) on this issue, and is fully supportive of the Joint Associations' response as well as the letters sent to the Basel Committee and to the Risk Modelling and Methodology Group (RMMG) in September of this year outlining industry's serious concerns about these proposals.

We are particularly concerned about the continued reliance on the Current Exposure Method (CEM) for the calculation of CCP's hypothetical capital. As outlined by the industry on a number of occasions, the CEM is fundamentally inappropriate for measuring the risk of a clearing house towards its members and cannot be fixed through minor modifications.

In addition, the capital requirements relating to the client clearing business raise a number of issues. The lack of clarity in definitions and prescriptions will result in different capital treatments for the same risks and/or double counting of risks between client and clearing brokers. The rules as currently proposed do not reflect the legal constructs of the clearing business and will act as a significant disincentive for banks to clear OTC derivatives on behalf of other market participants as outlined below.

Given the seriousness of industry's concerns, we strongly urge the Basel Committee to find an interim solution to reduce the capital requirement significantly. The final set of requirements should depend upon the outcome of an observation period carried after the implementation of the derivatives reforms mandated by the G20 have been fully implemented and the implications of the proposed CCP capitalisation framework – including the unintended consequences repeatedly highlighted by the industry - can be appropriately assessed.

We look forward to continued dialogue with the Basel Committee on this important issue.

Yours sincerely

Andrew Procter
Global Head of Government & Regulatory Affairs
Deutsche Bank AG

Calculation of hypothetical capital

Requiring hypothetical capital to be calculated against the risk faced by a CCP towards its members is a conceptually sound principle. However, we do not accept that the CEM is an appropriate methodology for measuring that risk.

We acknowledge that recognition of the internal models of CCPs for regulatory purposes is not possible at the current time given the need for supervisory review and oversight. However, CCP's ability to apply for, and receive, regulatory approval for the use of internal models to calculate hypothetical capital should not be excluded from the BCBS standards. In addition, it is not clear why CCPs are not given the choice to use the Standardised Method for calculating hypothetical capital. It is an accepted methodology for banks under the Basel framework and does not rely on internal models.

Until such a time as internal models are recognised, there are a number of obvious adjustments that could be made to the CEM methodology for CCPs to better align the capital requirement with the low risk profile of the clearing business. The proposed reduction in the "beta factor" from 0.4 to 0.3 is estimated to result in a reduction of capital requirements by 23%. While the beta factor is a blunt tool that could be used for calibrating banks' capital requirements for CCP exposures to almost any desired level, we re-iterate that the future state of the OTC derivative market is not only unknown, but fundamentally un-knowable. For this reason, and because of the fundamental flaws of CEM in measuring CCP hypothetical capital, we would propose using the beta factor to achieve a result more comensurate with capturing only the new trades to which mandatory clearing will apply after January 2013, and not old trades executed before 2013.

Capital requirements relating to the client clearing business

Today, derivative clearing for customers primarily exists for exchange traded futures and option contracts. As the results of the recent Quantitative Impact Study (QIS) of the BCBS demonstrate, the quantitative implications of the proposed CCP capitalisation framework for listed futures and options are manageable, despite the fundamental shortcomings of the underlying methodology. However, the results for CCPs active in the clearing of OTC derivatives between dealers clearly demonstrate the economically irrational capital requirements which were predicted by the industry in its September letter to the RMMG.

Legislation that mandates central clearing of OTC derivatives for most market participants, not only banks, will soon become effective in many jurisdictions. However, the QIS did not take account of the future state of the market when the majority of today's bilaterally settled OTC derivatives move to a centrally cleared model. The resulting increase in capital requirements is unpredictable for three reasons:

- The detailed rules for the capitalisation of client clearing business are not clear from the BCBS consultation paper;
- The legal framework for client clearing of OTC derivatives is still under review or in development in major jurisdictions; and
- Many CCPs are in the process of revising their risk, margin, and default fund methodologies in order to comply with the (yet to be finalised) CPSS/IOSCO principles which, according to the BCBS proposal, will determine whether banks need to apply the capital treatment for "Qualifying" or "Non-qualifying" CCPs.

The difficulty in anticipating the final shape of the market is likely to influence the behaviour of market participants, thereby adding further uncertainty in the evolution of the new market structure.

If this situation persists, banks may not be willing to perform clearing services for other market participants in significant size. In order to comply with future clearing requirements the vast majority of today's market participants will have to find one or more CCP members willing to clear their trades. As we have stressed previously, excessive capital requirements for banks will inevitably result in excessive costs of clearing for all market participants. Given the unpredictable quantitative implications of the proposed capital framework many of today's market participants will be prevented from trading derivatives altogether, because they will not be able to afford the cost of becoming a CCP member and will struggle to find a CCP member willing to clear their trades.

This further underpins the need for the BCBS to find an interim solution and to review the CCP capitalisation framework when the participants in the OTC derivatives market – including banks and CCPs – have adjusted their activities to the new mandatory central clearing model. We propose an extended observation period during which additional impact studies could be performed and market participants and regulators could work together towards a more refined capitalisation framework that is fit for purpose.

Other detailed comments (Based on Annex A of the Consultation Paper)

Exposures to qualifying CCPs versus exposures to non-qualifying CCPs (para 118 and 119 on N-QCCP): Given that the capital requirement of a Clearing Member facing a non-qualifying CCP takes into account that member's liabilities towards the CCP must be limited, including unfunded liabilities, we believe that a scenario could arise where the framework would incentivise the use of non-qualifying CCPs. This is fundamentally counterintuitive. It would create potential for arbitrage opportunities and would be contrary to the risk management objectives of the CPSS-IOSCO standards. Banks should not be required to hold capital in excess of their maximum exposure (including contractual exposures). This unintended consequence underlines the need for banking supervisors and CCP regulators to agree on an appropriate mechanism for capitalisation of those exposures.

Capitalisation requirements for clearing clients and Clearing Members: Paragraph 110 says that "where a bank acts as a Clearing Member of a CCP, either for its own purposes or as a financial intermediary between a client and a CCP, a 2% risk weight applies to the clearing bank's exposure to the CCP… The 2% risk weight also applies where a Clearing Member guarantees that the client will not suffer any loss ... in the event that the CCP defaults".

In a typical clearing relationship the Clearing Member does not guarantee the CCP's performance to the client. Therefore, it is unclear why the 2% risk weight may apply when the Clearing Member acts only as an intermediary between the client and the CCP, and the risk that the CCP may default is borne only by the client.

Paragraph 112 stipulates that "where a bank is a client of a Clearing Member, and enters into a transaction with the Clearing Member acting as a financial intermediary .. the client's exposure to the Clearing Member may receive the treatment in paragraph 110… "

The intention seems to be that, if certain conditions are met, banks as clients of Clearing Members should apply the same capital treatment as if they were a Clearing Member themselves. However, the rules appear to result in double counting as both the client and the Clearing Member are required to hold capital against the same risk, i.e. the risk that the CCP defaults, which is in reality borne only by the client.

We recognise that the legal frameworks governing the rights and obligations of Clearing Members and clearing clients are currently under review or in development in many jurisdictions. We would therefore like the BCBS to confirm that the fundamental principle that banks only have to hold capital against risks to which they are actually exposed will also apply in the context of the client clearing business.

Indirect Clearing Regime (para 112 and 113): We welcome the move away from requiring guaranteed portability in order to qualify for the 2% risk weight. However, paras 112 and 113 raise a number of questions around interpretation. The proposal creates a very high threshold for meeting the 2% risk weight. It is not clear what is meant in para 112(b) by "highly likely to continue to be indirectly transacted through the CCP, or by the CCP, should the Clearing Member default or become insolvent. " It is also unclear what the intended meaning of "transferred at market value" is or how this transfer would work in practice. It is not clear whether, for example, "any losses" would include fraud. It seems that the client clearing arrangement would need to provide that the client does not bear any losses on account of the insolvency of a Clearing Member or of any clients of that Clearing Member. If this is what is implied, then it is highly unlikely that any current client clearing arrangements would meet those criteria. It is also not clear whether the client can choose to have the positions auctioned off.

Treatment of posted collateral (para 115): Our interpretation of this paragraph is that both the Clearing Member and the client may have to hold capital against the risk of losing posted collateral in the event of a CCP failure, specifically "Where assets or collateral of a Clearing Member or client are posted with a CCP or a Clearing Member,..the bank posting such assets or collateral must also recognise the counterparty credit risk…"

In a typical client clearing relationship the client would post collateral to the Clearing Member and the Clearing Member would pass it on to the CCP. As explained above, it is not clear why a Clearing Member would have to hold capital against positions where the client bears the full risk and the Clearing Member is acting only as an intermediary.

Leverage ratio: The leverage ratio acts as a further disincentive to banks providing client clearing services. Under the current proposals each transaction executed and cleared by a client with the same bank could result in three positions being counted by the bank under the leverage ratio. If this punitive treatment were to be applied it would serve as a huge deterrent for banks to offer clearing services to their own clients, and an even greater disincentive for offering clearing to other market participants.

In addition, in the case of a Clearing Member defaulting, other Clearing Members would be restricted in their ability to take on the defaulted Member's client positions because of the risk that they would be constrained by the leverage ratio. Therefore, we believe that client clearing activities should be carved out of the leverage ratio.

Capitalisation of default fund exposures and frequency of calculation: In general banks estimate the expected RWAs associated with their business activities as part of their capital plan. This is not possible under the currently proposed CCP capitalisation framework, because the capital requirement for default fund contributions has the unique feature that the capital requirement for each member depends on the CCP's risk towards all of its members. Only the CCP has the necessary information required to calculate the RWA requirement for each member's contribution to the default fund. Both the risk weight and each Member's allocation within the default fund are subject to change. The RWA requirement for facing a CCP is beyond the control of an individual member, since it depends on the risk profile of the portfolios of all other members.

As a result, banks as Clearing Members are unable to predict and influence the regulatory capital implications of their CCP default fund exposures in advance. This feature, in particular, makes it very difficult for banks to give commitments to their own clients in terms of clearing their trades, let alone other market participants.

Given that Clearing Members are reliant on CCPs for the calculation of the RWAs on exposures to CCPs, CCPs should be required to perform the calculation in advance of each quarter rather than retrospectively. This will at least allow banks to plan their RWAs associated with activities other than clearing at the beginning of each quarter.

Paragraph 107 and 108 – Monitoring, stress testing and reporting requirements: We generally agree with the more rigorous processes required around stress testing and scenario analysis as outlined in para 107. It is also appropriate that this category of risk exposure be reported to senior management. However, we are concerned that under the current requirements, Clearing Members have no mechanism to provide input to a CCP if there are concerns over the adequacy of the CCP's calculations. We would suggest that Clearing Members should be able to approach the CCP's supervisor and alert its own supervisor where there is disagreement over models.

Treatment of exchange traded derivatives (para 6(ii)): This paragraph states that when the client-to-Clearing Member leg of an exchange traded derivatives transaction is conducted under a bilateral agreement, both the client and Clearing Member should capitalise the transaction as an OTC derivative. Greater clarity is needed on this point as the meaning of "bilateral agreement" is not clear in this context and it is also not clear how this would work in practice.