European Association of CCP Clearing Houses

November 25, 2011

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

Capitalisation of exposures to Central Counterparties

Dear Sir or Madam,

EACH, the European Association of Central Counterparty Clearing Houses, welcomes the opportunity to put forward its views in respect of the Basel Committee's Consultation on the proposed Capitalisation of bank exposures to Central Counterparties, which follows the previous consultation in December 2010. On that occasion, EACH also submitted its contributions to the Committee.

Before responding to the changes made by the Basel Committee to the December 2010 proposal, EACH would like to turn the attention of the Basel Committee to further issues, which should be clarified and/or ensured in the Consultation.

EACH shares the Committee's view that a safe capitalisation of risks is of great importance to the financial system. We appreciate that the intention of this proposal is to reinforce the existing incentive for institutions to use CCPs for OTC derivatives. However, the proposed revisions would require a Clearing Member to set aside increased capital for a client trade executed through a CCP in comparison to a client trade completed on a purely bilateral basis as in both circumstances the client trades must be capitalised as bilateral trades and additionally the Clearing Member must capitalise the back to back position at the CCP at a 2% weighting.

Furthermore EACH understands that, in extreme situations, CCPs can fail. However the following characteristics of a CCP demonstrate that the event of a CCP default is extremely remote and a CCP is an extremely safe and sound entity especially compared with financial institutions which take market positions in order to generate revenue.

CCPs are single purpose entities which interpose themselves between buyers and sellers guaranteeing that both parties fulfil their obligations. CCPs maintain a balanced position at all times and do not run market risk, except in the event of the default of one of their members. As well as being fully collateralised to cover that risk, they are subject to dedicated supervision.

Taking this into account, we have to express some concerns regarding certain points of the proposed approach where some unwanted incentives may be introduced by the new regime.

We ask that the Committee provide more detailed and comprehensive guidance on the individual capital calculation methods including sample calculations for each asset class. Global and international regulators and supervisors must ensure that calculations in respect of all CCPs and the determination of capital requirements for all entities are comparable.

Finally it should be ensured that in all cases bilateral trade exposures receive significantly higher capital charges compared with exposures to CCPs. It is unclear whether the proposed regime, applying the current Exposure Method, does this when compared with the Internal Model Method used for bilateral OTC exposures. As a consequence it is not clear for us whether the intended capital requirements would still provide an incentive to use CCPs.

Use of CEM:

With respect to the valuing of the exposure of Clearing Members' positions at CCPs it is allowed to use the Internal Model Method to value the exposure for the purpose of calculating trade exposure capital adequacy but for the purpose of valuing the exposure of the same positions for Default Fund capital adequacy then the CEM must be used. This results in the perverse situation where the same position has a completely different exposure valuation for no identifiable reason.

The CEM is the standard method used under the current Basel II regime to calculate risk exposures of bilateral transactions. This calculation utilises a simplified approach to risk weighting, netting and collateral haircut calculation.

Taking this into account, it is perplexing to attempt to apply this method to Default Fund exposures in light of the large positions outstanding with many different central counterparties.

The CEM method has several considerable drawbacks which makes it inappropriate for the calculation of CCP exposures:

- The method considers nominal amounts in its exposure calculation on which generic percentages across asset classes are applied rather than looking at the risk specifics of a portfolio.

- The add-on percentages are based upon a time horizon of several months or years. These assumptions do not hold for CCPs as, contrary to the case of bilateral transactions, CCPs calculate and settle margins on a daily basis and often on an intraday basis reducing the current exposures to zero. In addition, effective default management procedures are in place. It should be noted that many CCPs settle to market – where the traded contract is expunged and replaced with a new contract at the settlement price - rather than mark to market where the original traded price is retained and the exposure to date is collateralised. It must be recognised that settlement to market contracts fall within the definition of Annex 4 paragraph 92(i) note 2.

- The positions held at the CCP by the clearing members are de-netted for a large part by the CEM, while these positions are subject to strong legal netting agreements.

- Finally the KCCP calculation (assumed capital of a CCP required to cover its risk) adds up all (weighted) CEM exposure calculations, while the current role of a CCP is to cover the default of the member or members having the largest exposure. The Default Fund of a CCP should cover these risks as to perform its systemic function and therefore KCCP should also be based upon the same assumption.

In light of the above arguments the proposed calculation provides a significant over-estimation of the risk inside CCPs and it is therefore not fit for purpose. Its fundamental weaknesses mean that default fund contributions will inevitably be given a high capital weighting, irrespective of other adjustments. Moreover impact studies performed have shown large outcomes of exposure calculations for some CCPs. This cannot be the right outcome.

Possible solutions:

Therefore, EACH identifies two alternative approaches, which it considers to be vastly superior to the currently proposed CEM approach. In order of sophistication and therefore of the outcome, these are:

- An approach based CCPs' internal models supported by back testing results.

- As an interim solution, improvement of the current methodology to better take into account the specific risk characteristic of CCP exposures.

Although the first alternative approach is by far to be preferred, EACH acknowledges that it requires regulators, market participants and CCPs to work together to develop and agree the appropriate models and parameters required for this approach.

Therefore, if this would be considered not to be feasible on the short term, the second alternative proposes minimal adjustments to the CEM to mitigate some of the most important shortcomings of the models and alleviate some of the improper capital burden for market participants and could be adopted as an interim solution. In addition to the overestimation of risk through the CEM methodology, the weighting of the risk exposures in the Default Fund (in as far as they cover a part of K_{CCP}) is set at 1250%. The combination of both elements results in an excessive capital charge given the risk profile of a CCP default fund.

The approach that the Basel Committee is currently advocating incentivises CCPs to increase margin requirements and reduces default fund exposures. This would not only result in a decrease of market efficiency (more collateral required to cover the same level of risk, drain on liquidity) but it also decreases the capacity of the CCP to absorb tail risks. Finally, it may create a incentive which makes clearing members less risk sensitive towards the CCP and therefore less inclined to contribute to the on-going high quality of the CCP's risk management (e.g. via the Risk Committee or Default Management Committee) which is essential for the CCP.

In general EACH strongly supports the goals of the Basel Committee underlying this proposal. Nonetheless, continuation with the current proposal would entail a large and unnecessary burden on banks clearing through a CCP while not achieving its intended goal of a risk based approach nor would it promote risk adverse behaviour by clearing members.

EACH proposal:

EACH proposes an alternative risk based approach, making appropriate use of CCPs' existing models, which would solve many deficiencies and can be applied in a relatively short period of time. EACH would welcome the possibility to work together with regulators and market participants to further develop these proposals, which it considers essential and which would have tangible benefits for the financial system as a whole due to the more accurate assessment of risk and appropriate allocation of capital to cover that risk. In so doing, it would also contribute to the financial stability objective of the Basel Committee. Such an option would be immensely preferable to use of CEM which we do not favour.

Alternatively if the alternative proposal could not be considered for practical reasons, EACH proposes at least the following changes to the CEM method on an interim basis:

- A change to the CEM netting formulae to $A_{Net} = NGR*A_{Gross}$ to recognize CCP netting.

- The notional position used in the formulae should be weighted for its relevant duration and the current value deliverable should be recognized.

Independently of the applied exposures measurement, EACH recommends changing the risk weighting applied to the default fund contribution in order to recognize the low risk exposure of default fund exposures. Such a recommendation becomes particularly crucial when the CEM method (even with the proposed changes) is maintained.

Qualifying CCPs:

EACH furthermore recognises that the proposed treatment depends on the CCP to which a bank has exposure being designated as a "Qualifying CCP" – "qualifying" being defined inter alia as being "compliant with CPSS-IOSCO standards". Under the existing CPSS-IOSCO Recommendations, CCPs are assessed on whether they observe, broadly observe, partly observe or do not observe each Recommendation. To our knowledge, there are different procedures implemented in the different jurisdictions to assess a CCP's compliance with each Recommendation. Further, EACH asks the Basel Committee to specify which level of observation of the CPSS-IOSCO standards would enable a CCP to be designated as "qualifying".

EACH is also concerned that there might be differences between CPSS-IOSCO Principles and norms on CCPs introduced by EMIR and this may pose an additional regulatory burden and consequent costs on European CCPs and possibly create even a possibility for regulatory arbitrage in favour of non-European CCPs. EACH is participating actively in both CPSS-IOSCO and EMIR discussions in order to avoid EU CCPs being subject to differing global standards, which are for example:

- Differences between CPSS-IOSCO and EMIR on the size of the default fund for credit and liquidity risk.

- Differences between CPSS-IOSCO and EMIR on the acceptance of collateral.

- Differences between CPSS-IOSCO and EMIR on the governance especially the Risk Committee of FMIs.

- Differences between CPSS-IOSCO and EMIR on the appropriate arrangements for the segregation of participant assets and portability of customer assets.

An ideal structure would be to ensure a more harmonised implementation timeframe and use as a norm a standard assessment by CPSS-IOSCO (which ideally should not differ significantly from the standards that will be set up by ESMA within the framework of EMIR) of whether supervisors' rules are compliant with the CPSS-IOSCO Principles and, if so, any CCP authorised by that supervisor is therefore deemed "qualifying" and not be challenged by a regulator in another jurisdiction where that CCP may also be carrying on business.

Accordingly EACH fully supports the approach hinted at in the third paragraph of page 6, whereby a CCP authorised under EMIR is ipso facto CPSS-IOSCO compliant; this would avoid the burden of double regulation, but the possibility of regulatory arbitrage in favour of non-EU CCPs would still remain open. We believe it would be extremely beneficial to have this principle explicitly stated, so to avoid unnecessary burdens such as double assessments, etc.

<u>Treatment of collateral:</u>

Although EACH welcomes the 0% capital weighting proposed for collateral that is held at a custodian in a bankruptcy remote manner, we nevertheless would make the following points:

- If the Committee's focus is on counterparty credit risk, then it should permit alternative methods by which that risk can be mitigated and not only prescribe one manner of risk mitigation (i.e. placement of collateral with a bankruptcy remote custodian)

- There are a number of legal uncertainties associated with the use of bankruptcy remote custodians not taken into account.

While EACH agrees that there should be fair treatment of banks regardless of the type of access to CCPs, we must note that that in Europe CCPs apply membership requirements that are objective and exclusively risk-based. Entities – including banks – which do not fulfil such requirements will necessarily access CCPs exclusively as Clients of Clearing Members.

In this regard – as risk managers – we strongly advocate fair treatment rather than equal treatment, regardless of the type of access.

Below please find EACH's comment to the changes made by the Basel Committee to the December 2010 proposal.

Capitalisation of default fund exposures:

Changes to the December 2010 proposal	EACH Comment
To address the concern that the CEM underestimates the multilateral netting benefits arising from a CCP, the factor in the CEM which controls the amount of netting (rho) is increased from 0.6 to 0.7.	We have noted that the Basel Committee has made a changes to the formulae by having a lower multiplication factor for gross positions (from 0.4 to 0.3) and to allow more off-sets (0.6 to 0.7). These changes are welcomed but we would urge the Basel Committee to better recognize the benefits for CCP netting. It appears that in the current CEM calculation, the amount of gross positions is driving the outcomes of the calculation while these are not a relevant factor due to strong multilateral netting applied by CCPs. Our proposal is to change the formula for calculating the add-on for potential future exposure to better recognize the impact of netting (rather than 70% weighting as currently proposed) § The current formula is: $A_{Net} = 0.3*A_{Gross} + 0.7*NGR*A_{Gross}$ § We propose the formula should be: $A_{Net} = NGR*A_{Gross}$ § This adjustment will better recognize netting but will still base the exposure on notional values.
Changes to the December 2010 proposal	**EACH Comment**
Where a CCP cannot calculate the Net-to-Gross Ratio (NGR) used in the CEM due to the need to change its systems and data collection methods, a default NGR value of 30% will be permitted until March 2013.	EACH has no further comments to this change made by the Basel Committee.

Calculation of aggregate capital requirements:

Changes to the December 2010 proposal	EACH Comment
Where a substantial excess amount of DF_{cm} exists over the hypothetical capital requirement, the 1.6% capital requirement is reduced, subject to a floor of 0.16%, on a sliding scale by a applying a "decay factor" to reflect the diminishing risk associated with large amounts of DF_{cm}.	EACH welcomes this change made by the Basel Committee, as it demonstrates no extreme change.

Indirect access related issues:

Changes to the December 2010 proposal	EACH Comment
Revised segregation and continuity requirements are proposed so clients of clearing members can benefit from the CCP framework where it is considered that a client's trade with a clearing member is effectively a trade with the CCP.	The treatment of client exposures set out in paragraph 112 of the consultative report places an onerous and cumbersome responsibility on clients to ensure no possibility of loss in the event of insolvency of the clearing member or its clients, and the portability of positions and collateral. In particular each client must be in a position to deliver an 'independent, written and reasoned legal opinion' that concludes that there would be no effective legal challenge to the arrangements. This is an extremely high level of proof, out of proportion to the level of confidence required in any other aspect of clearing arrangements. We believe that such a high level of proof is inappropriate and extremely cumbersome, and the 'test' should instead be contingent on a CCPs adherence to CPSS-IOSCO principles.
Treatment of clearing member exposures to clients as bilateral trades (paragraph 111)	This proposal would place clearing members' trades for clients through a CCP at a disadvantage, from the point of view of capital weighting, compared to pure bilateral trading. This cannot be the intention of the Committee. EACH therefore disagrees with this proposal.

Changes to the December 2010 proposal	EACH Comment
The revised approach introduces an additional risk-weighting category for the case when a client is not protected from loss in the case of joint default of both the clearing member and other clients, but meets all other requirements for segregation and continuity of accounts. A risk weight of 4% is proposed for trade exposures in such cases.	EACH asks the Basel Committee for more clarity on the proposed change.

Should you require further information, please do not hesitate to contact the undersigned.

Yours sincerely,

Rory Cunningham
Chairman

Marcus Zickwolff
Secretary

About EACH

European central counterparty clearing houses (henceforth CCPs) formed EACH in 1991. EACH's participants are senior executives specialising in clearing and risk management from European CCPs, both EU and non-EU. Increasingly, clearing activities are not restricted exclusively to exchange-traded business. EACH has an interest in ensuring that the evolving discussions on clearing and settlement in Europe and globally, are fully informed by the expertise and opinions of those responsible for providing central counterparty clearing services.

EACH has 23 members:

CC&G (Cassa di Compensazione e Garanzia S.p.A.)

CCP Austria

CME Clearing Europe

CSD and CH of Serbia

ECC (European Commodity Clearing AG)

EMCF (European Multilateral Clearing Facility)

Eurex Clearing AG

EuroCCP (European Central Counterparty Ltd)

HELEX AS

ICE Clear Europe

IRGiT S.A. (Warsaw Commodity Clearing House)

KDPW_CCP S.A.

KELER CCP Ltd

LCH.Clearnet Ltd

LCH.Clearnet SA

MEFF

NASDAQOMX

National Clearing Centre (NCC)

NOS Clearing ASA

NYSE Liffe

OMIClear

Oslo Clearing ASA

SIX x-clear AG

This document does not bind in any manner either the association or its members.

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