European Banking Federation

EBF Ref.: D2107B-2011
Brussels, 28 November 2011

Set up in 1960, the European Banking Federation is the voice of the European banking sector (European Union & European Free Trade Association countries). The EBF represents the interests of some 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions.
The EBF is committed to supporting EU policies to promote the single market in financial services in general and in banking activities in particular. It advocates free and fair competition in the EU and world markets and supports the banks' efforts to increase their efficiency and competitiveness.

EBF response to Basel Committee consultative document on capitalisation of bank exposures to central counterparties

GENERAL COMMENTS

The EBF acknowledges that the stability of the financial system is a top priority in the international policy making agenda and understands that market infrastructures in general and central counterparties in particular are central to ensuring the stability pursued.

The EBF has contributed to the last consultations on the subject matter in which international and European policy makers gathered the views of the industry. Firstly, the BCBS consultation run in February 2011, to which the EBF responded via the International Banking Federation (IBFed). Secondly, the European Commission consultation on counterparty credit risk in March 2011 which included a section on capitalisation of bank exposures to central counterparties.

Whilst the EBF is appreciative of the few changes made to the BCBS December 2010 proposal in the BCBS consultative document, by and large EBF members think that the most relevant concerns from the industry’s point of view have not been taken on board in the new document.

Firstly, the main issue where a solution should be sought is the fact that, despite the stated intention of the paper, the rules fall short of providing sufficient incentives for banks to increase their use of central counterparties. This policy will only succeed by providing clear and tangible incentives to clearing members. There is also the potential risk that clients will develop new products to circumnavigate the need for clearing which will defeat the object and also potentially increase risk.

European Banking Federation (a.i.s.b.l.)
10 Rue Montoyer B-1000 Brussels
T: 32 (0)2 508 37 11
EBI register - ID number 4722660838-23
http://www.ebf-fbe.eu

Secondly, the capitalisation of default fund contributions is based on a non risk-sensitive and too conservative method for the calculation of the CCPs own hypothetical capital. The capital requirement for the default fund is, in our opinion, overstated. As a consequence, it will be considerably cheaper to clear a portfolio as a clearing client than to clear it as a clearing member, unless the costs for default fund contribution and capital requirements are passed on to clients. The result might be that no bank will choose to be clearing member leaving the role of clearing to entities with weaker risk management standards and lighter supervisory oversight.

Finally, the general approach to address the macro-systemic risk posed by central counterparties through the micro-prudential supervision of banks does not seem an efficient and comprehensive way to tackle the root problem. CCPs systemic risk should be better addressed through regulation of CCPs, risk management standards and controls, robust CCP capital standards and emergency access to central banks' liquidity. On the contrary, the proposed regulation might be heading in other direction by imposing on CCPs a one for all crude CEM method rather than fostering them to develop advanced risk sensitive models. Furthermore, the two Quantitative Impact Assessments (QIS) performed demonstrate that clearing in non qualifying CCPs lead in some cases to a reduced capital charge compared to clearing in qualifying CCPs.

SPECIFIC COMMENTS

- The hypothetical capital using the Current Exposure Method (CEM) has not been changed. CEM is not risk sensitive and this method will produce excessive capital requirements for CCPs with large, well hedged portfolios. Regulators should allow CCPs to use the Internal Model method to calculate the exposure for hypothetical capital. An observation period would be very beneficial for refining the methodologies based on how they work in practice.

- For cleared transactions, the clearing member (CM) has to capitalise the leg between CM and the client (including CVA variation charge), the leg between the CM and the CCP (regardless the fact that this leg for a client transaction should be free of capital requirement if the CM can provide legal opinions that show that a CCP default would pose no risk for the CM clearing client transactions), and potentially a third leg if the CM is also executing broker.

- There will be no extended margin period of risk for large netting sets in IMM for trade exposures, however industry's suggestion to use a shorter time period for CEM in the hypothetical capital has not been taken on board. In general, margin period of risk for cleared products should be shorter, as positions can be closed out quickly in case the margin is not paid.

- When computing capital for trade exposures <u>to</u> qualifying central counterparties (QCCP), banks should be allowed to use as maturity similar margin period of risk than for IMM when other models as CEM are being used, in order to recognise the limited amount to be lost if a CCP defaults. It is going to be required that all QCCP (according to "Principles for financial market infrastructures. Consultative report March 2011. OICV-IOSCO", Principle 6: Margin) mark, at least daily, participants' positions to

market and collect variation margin to limit the built-up of current exposures. So we consider that this mitigating effect should be taken into account to calculate trade exposure to QCCPs, independently of the model used.

- Banks can use the internal model method for trade exposure. One variant in the rules, the IMM shortcut method would work particularly well for CCP exposures. However this shortcut method does not allow offset of initial margin (IM) with future price movements during the margin period of risk - exactly what IM is designed to cover. This should be changed to make the shortcut method usable for CCP exposures. The IMM short-cut method simulates the price movement over the margin period of risk for collateralised transactions, using VaR. Especially as many banks have to build models for exchange traded derivatives now, this shortcut method would be very helpful in increasing coverage. But as initial margin cannot cover the future price movement in the shortcut method, it does not make sense to use this method for cleared transactions.

- The capital requirement for the default fund is, in our opinion, overstated. But also the operational aspects of the calculation of default fund contributions could be improved in terms of transparency, all the more given the increased importance attached to the use of central counterparties. Though not specifically requested in this consultation, it is an important piece in the overall functioning of the proposed framework.

- These rules apply only to banks, i.e. at present not to US Future Commission Merchants (FCM). Unless US regulators clarify that they will apply these CCP capital rules to FCMs, these entities will be under a completely different capital regime. This can create an unlevel playing field for European banks and lead to unintended consequences. Whilst we appreciate that Basel rules apply to banks only, the Basel committee needs to be mindful that their regulation might lead to distortions in the market, and potentially more risk overall. A higher level of international coordination should be made a priority in order avoid an unlevel playing field and avoid regulatory arbitrage.

  The timeline seems extremely tight considering that the BCBS should assess the impact of its proposals while CCPs and banks need to prepare themselves for their implementation. Given that widespread mandatory central clearing and the capital framework will be new for the market and regulators, we suggest that an observation period similar to leverage and liquidity is introduced. This observation period would be in line with the Pittsburgh G20 conclusions, since the 2012 deadline applies to mandatory CCP clearing, but not to capital requirements regarding exposures to CCPs. Such an observation period would allow firms to build models for their exchange traded derivatives, the CCPs to build models for the hypothetical capital and for regulators to assess and approve these models. Also potential unintended consequences resulting from inconsistent implementation could be observed and mitigated.

Note: In addition to the above considerations, the EBF generally shares the concerns expressed in the communications of ISDA and the Institute of International Finance (IIF) to the Basel Committee on 19 September 2011 as regards the capitalisation of exposures to CCPs.

http://www2.isda.org/attachment/MzUyNg==/Letter%20to%20Basel%20Committee%20CCP%20pdf%20-%20Adobe%20Acrobat%20Pro%20(3).pdf.

- - - 0 0 0 - - -