Eurex Clearing AG

Comment Paper on the Basel Committee on Banking Supervision consultative document “Capitalisation of bank exposures to central counterparties”

Agenda

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A. Introductory remarks

Eurex Clearing is a globally leading central counterparty clearinghouse (CCP) and the largest clearinghouse in Europe. Eurex Clearing is a subsidiary of Deutsche Börse Group providing central clearing services for cash and derivatives markets both for listed as well as certain over-the-counter (OTC) financial instruments. Eurex Clearing actively contributes to market safety and integrity with state-of-the-art market infrastructure in clearing services as well as with industry leading risk management services for the derivatives industry. Customers benefit from a high-quality, cost-efficient and comprehensive trading and clearing value chain.

Eurex Clearing AG is a company incorporated in Germany and licensed as a credit institution under supervision of the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) pursuant to the Banking Act (Gesetz für das Kreditwesen). The Financial Services Authority (FSA) has granted Eurex Clearing status as a Recognised Overseas Clearing House (ROCH) in the United Kingdom.

Eurex Clearing appreciates the opportunity to comment on the Basel Committee on Banking Supervision's second consultation paper on the capitalisation of bank exposures to central counterparties (further referred to as the document), published in November 2011. After comprehensively commenting the first consultation paper, published in December 2010 we welcome the adjustments made in the latest document.

Before elaborating on detailed aspects of the current proposal Eurex Clearing would like to outline some general observations with the taken approach.

B. General observations

Eurex Clearing understands the document as a move forward in order to ensure the safety and integrity of financial markets and generally welcomes and support the goal of the proposal.

We appreciate the adjustment of parameters to better address the multilateral netting benefits arising from a CCP, i.e. the increase of factor rho controlling the amount of netting from 0.6 to 0.7, the introduction of a delta weighting for options, as well as the construction of the capital weighting factor c_1 as a decreasing function of the overall default fund contributions.

However, Eurex Clearing is concerned that the proposed rules are still overly conservative leading to overstated capital requirements for bank exposures to CCPs by overstating the risk inherent in CCP business. As a result the document in its entirety does not sufficiently reflect the prudent and safe risk management services and default procedure of CCPs.

During financial markets turmoil CCPs convinced through their performance. The insolvency of Lehman Brothers in 2008 and as a more recent example the default of MF Global could be properly and efficiently managed through CCPs. Hence, the risk framework and the default management procedures in place proved as perfectly fitted to ensure integrity and safety to the financial system. Both defaults caused no losses for

Eurex Clearings surviving clearing members nor did require a draw on default fund contributions even of the defaulting clearing member.

If the above described stabilizing nature of central counterparty clearing is not appropriately reflected in the regulation, the current capital requirements will not provide an incentive to use CCPs.

In that respect we would welcome the Basel Committee to consider further Quantitative Impact Studies to better judge the effect of the new proposals before introducing the proposed measures. In addition, a publication of data outlining the rationale for the chosen parameters from a regulators perspective would further strengthen the proposed framework.

Finally, we would like to draw attention to one aspect that has not (yet) been covered by the consultation paper due to its focus on exposures to central counterparties. While we are fully aware of the remit of the Basel Committee including its borderlines as sketched in paragraph 13 of the present document, it should be observed that the present document is silent on the treatment of the positions incurred by the central counterparty, which might happen to be a bank itself (a possibility explicitly mentioned in paragraph 28) and therefore subject to Basel II/III (-type) solvency requirements.

A simple analogy to or extension of the capitalization rules for exposures to central counterparties or even bilateral exposures would be clearly inappropriate in our view, which can easily be seen from the fact that a CCP only bears clearing member default-related losses (abstracting from default fund contributions of the CCP) from derivatives after the default fund, including potential replenishment, has been completely exhausted. The unique risk characteristics faced by a CCP that is itself a bank require careful consideration in view of an appropriate solvency regime, but also extend to other areas of quantitative prudential standards like liquidity standards or leverage ratio. The practical relevance of these issues is not limited to cases where the CCP happens to be a bank itself, but already surfaces once the central counterparty is part of a group subject to quantitative prudential standards at consolidated level.

C. Detailed comments on the consultation paper

A. General Terms: Definition of "central counterparty"

The definition of central counterparty (addition to Annex 4, Section I, A. General Terms) includes a provision according to which a CCP is a financial institution for purposes of the capital framework. We wonder about the rationale for the inclusion of such additional provision.

We would like to suggest deleting this sentence because we think it is not well aligned with the approach adopted towards financial institutions in the Basel II/III capital framework. The Basel II/III capital framework does not contain an exhaustive detailed catalogue of financial activity undertaking types which (together with a second 'catalogue' of relevant dependency relationships towards another entity like majority ownership or control of the latter entity) fully determines whether a particular entity needs to be included in the scope of regulatory consolidation in general and group-level solvency requirements in particular. Paragraph 24 and footnote 7 of the Basel II Comprehensive Version document merely contain a list of examples of financial activities that are widely regarded as being sufficiently related to the activity of a bank or

securities firm to allow for meaningfully imposing the requirement to include such entities in the scope of regulatory consolidation. Providing a precise definition of such entities is therefore within the responsibility of national supervisory authorities or rule-making bodies. This is also expressly acknowledged in the "Basel III Definition of Capital FAQs" (see answer to question #13). Against this background, we propose to delete the above-mentioned sentence in the definition of central counterparty to achieve consistency with the general approach of Basel II/III.

If the newly added provision is meant for consolidation of a CCP this will be creating exactly the situation as we have already outlined above at the end of section B. We consider a solution to the consolidation aspect as only possible after the issues outlined above at the end of section B have been solved.

Annex 4, Section II:

As the treatment for cash products is out of scope in the current proposal, we wonder why the current treatment as defined in Annex 4, Section II Paragraph 6 is not retained in this respect. We therefore propose to include this explicitly by inserting the following after the second sentence of paragraph 6(i):

"An exposure value of zero is attributed to spot transactions, including respective collateral posted, that the bank has outstanding with a qualified central counterparty. The settlement of cash transactions remains subject to the treatment described in Annex 3."

Paragraph 109:

We propose to clarify that the treatment under paragraph 110 following is not related to cash / spot transactions; this should be clearly labelled in paragraph 109 (as outlined under Annex 4, section I).

Paragraph 112: Requirements for the privileged treatment of client exposures towards a clearing member

The set of requirements that must be met in order to achieve privileged treatment of client exposures towards a clearing member can broadly be characterized as consisting of a 'segregation requirement' and a 'continuity requirement'. In a more detailed analysis, the latter 'continuity requirement' (paragraph 112, lit. b)) in our interpretation does not appear to require continuity of trades (accomplished by replacing the defaulted CM intermediary through either a non-defaulted CM intermediary or the CCP itself) as an end in itself but as a sufficient condition to ensure full preservation of economic value (potentially) embodied in the set of derivatives outstanding from the client's perspective. In our view, the fact that a close out of the client at market value is established as an equally acceptable way of complying with the 'continuity requirement' (paragraph 112, lit. b), second sentence) corroborates our above interpretation. Whereas we support the conceptual considerations underlying the requirements, the newly introduced term of "highly likely" (paragraph 112, lit. b), first sentence) adds vagueness to the degree of certainty required for a qualifying client protection scheme, which we think is counterproductive. A preferable solution would consist of an exhaustive list of admissible arrangements to satisfy the 'continuity requirement' and would not invoke a

notion of probability. This could be accomplished by modifying paragraph 112, lit. b), as follows:

"Relevant laws, regulation, rules, contractual, or administrative arrangements provide that, upon default or insolvency of the clearing member, either

- the offsetting transactions with the clearing member continue to be indirectly transacted through the CCP, where client positions and collateral are transferred at market value, or
- the client's transactions with the clearing member migrate to be directly transacted by the CCP, where client positions and collateral are transferred at market value, or
- the client's positions (and collateral, where applicable) are closed out at market value."

Paragraph 113

Paragraph 113 states that "where a client is not protected from losses in the case that the clearing member and another client of the clearing member jointly default (…) a risk weight of 4% will apply to the client's exposure to the clearing member."

We would appreciate a clear definition on the applicability of paragraph 113. Lacking a clear definition Eurex Clearing interprets the newly introduced 4% risk weight as a factor applicable to solutions offering only partial bankruptcy remoteness (As a step between client's positions being fully bankruptcy remote (2% risk weight) and client's positions being not bankruptcy remote (treatment as bilateral transactions, risk weight of at least 20%)). Bankruptcy remote as defined for all entities except the CCP.

While we understand the rationale for the introduction of such a factor we are concerned about the unintended consequences the chosen size of the factor might have.

The currently safest model is where a client has full segregation of its positions and collaterals and an unconditional portability of those. This bankruptcy remote solution qualifies to receive a 2% risk weight.

Applying a relatively low risk weight of 4% for only partially bankruptcy remote solutions will not provide incentives for CCPs to develop full bankruptcy remote solutions. In addition, the chosen risk weight does not properly reflect the risk of losses.

In order to better reflect the risk inherent to such partially bankruptcy remote solutions and to incentivize CCPs in developing fully bankruptcy remote solutions we propose to increase the risk weight to a level which is significantly larger than 2%, but smaller than for bilateral trades.

Paragraph 116 step (i): Rho for centrally cleared OTC derivatives

The document requires CCPs to use the CEM for the calculation of the hypothetical capital in order to provide a simple tool to determine capital requirements resulting from clearing members default fund contribution.

The CEM is a highly conservative method, not reflecting the safeness and multilateral netting opportunities a CCP offers. Eurex Clearing therefore welcomes the adjustment of Rho from 0.6 to 0.7 and the introduction of the delta weighting for options. However,

a rho of 0.7 still does not appropriately reflect the low business risk associated through the multilateral netting as well as the sound risk management which CCPs have in place and which proved to be highly efficient especially in stressed markets.

To better reflect the stabilizing effect of CCPs more appropriately and therefore creating a capital incentive for market participants to clear through central counterparties, Eurex Clearing proposes to further increase the value of rho.

Paragraph 116 step (ii): Non-cash items as potential components of the default fund

We would like to suggest additional clarifications of the rules text with regard to the issue of non-cash items as potential components of the default fund. Most importantly, we would appreciate an explicit statement in the rules text that securities posted by a clearing member with a CCP for purposes of fulfilling the clearing member's obligation to contribute to the default fund can be counted as "prefunded default fund contributions from … clearing members" (as captured by the variable DF'_{CM}) within the meaning of paragraph 116. Such clarification would be consistent with the instructions provided by supervisors during the CCP Quantitative Impact Studies. We anticipate that supervisors might want to restrict such permission by introducing asset eligibility requirements and/or the requirement to apply appropriate haircuts to the market values of the respective securities. Besides, the treatment of (third-party) guarantees is not entirely clear to us. Within the definition of the notion of "default funds" in the part to be added to Annex 4, Section I, A. General Terms, "unfunded contributions towards, or underwriting of, the CCP's mutualised loss sharing arrangements" are mentioned as potential elements constituting a default fund. On the other hand, third-party guarantees do not appear to qualify as "prefunded default fund contributions" within the meaning of paragraph 116. As a consequence, they would not enter into the variable DF'_{CM}. Contemplating the case of a third-party bank guarantee provided on behalf of a particular clearing member towards the CCP as a means of fulfilling the clearing member's default fund contribution obligation, we wonder whether the third-party bank would be required to recognise a risk position for the guarantee (to be treated according to the risk weighting logic of paragraph 116) within its solvency calculation despite the fact that its conditionally owed payment would not count towards the risk bearing potential DF' of the CCP.

Furthermore, EMIR and CPSS / IOSCO foresee that third-party guarantees can be used as collateral under strict requirements. To make the framework consistent with those standards, it should be explicitly stated that third-party guarantees satisfying the conditions of CPSS / IOSCO and/or EMIR should be counted as pre-funded default fund contributions and as collateral in the sense of paragraph 115.

We would appreciate some further guidance on the prescribed treatment.

Paragraph 116 step (ii), factor c_2

Eurex Clearing proposes to decrease the risk weight underlying the factor c_2.

Whereas Eurex Clearing appreciate the Committee's general idea to establish a risk - sensitive way of treating default fund exposures (where a CCP's margining framework and strength of lines of defence indirectly influence the risk weights of the default fund

exposures), we regard a c_2 of 100% which implies a risk weight of 1250% as highly, if not overly conservative.

The risk weight of 1250% does not sufficiently represent the difference between qualifying CCPs and non – qualifying CCPs. We are aware that the overall capitalization requirement for banks' default fund contributions to qualifying CCPs will be lower than 100% in most cases. However, to clearly distinguish between both types of CCPs we propose to apply strictly lower risk weights for exposures with qualifying CCPs. The risk-weight for a classical equity exposure of 400% at a maximum might serve as a benchmark.

Paragraph 116 step (ii): Derivation of the risk weight for default fund contributions, step (ii) - computation of K^*_{CM}

In our understanding, the size of K^*_{CM} is – for given calibration of the parameters c_1 and c_2 – determined on the basis of two dimensions: (a) the comparison between the size of the prefunded default fund contributions (DF_{CCP} and DF'_{CM}) and the hypothetical capital requirement (K_{CCP}), and (b) the order in which the prefunded default fund contributions by the CCP on one hand and the clearing members on the other hand are used according to the provisions governing loss allocation / mutualisation within the default fund. The dimension referred to as (a) above is fully transparent in the rules text as it underlies the formula defining K^*_{CM} based on a partition of three possible cases (page 16 of the rules text) and the following verbal description of equations (i) to (iii).

In our view, the dimension referred to as (b) above becomes less transparent. It appears to be partly built into the definition of DF_{CCP} (which requires first loss absorption by the CCP's prefunded default fund contributions) and to be treated, although in a purely qualitative way, in the verbal description of equation (ii) (top of page 18 of the rules text).

To increase the transparency of the rules text and to ensure an internationally harmonized implementation of the rules, we would rather strongly prefer a more explicit and formula-based treatment of both dimensions.

Whereas we understand that a wide variety of loss allocation rules within the default fund are imaginable so that it is virtually impossible to ex ante derive an exhaustive list of appropriate K^*_{CM} formulae, we think it is feasible to capture the baseline cases (which then can also serve as upper/lower bounds for treating more complex loss allocation rules). We therefore suggest amending the section of the rules text dealing with the computation of K^*_{CM} by a 3x3 matrix, the row dimension of which would correspond to the dimension referred to as (a) above (distinguishing between the cases (i) $DF' < K_{CCP}$, (ii) $DF_{CCP}^{new} < K_{CCP} \leq DF'$ and (iii) $K_{CCP} \leq DF_{CCP}^{new}$, where DF_{CCP}^{new} differs from the current definition of DF_{CCP} in the rules text by not requiring the first loss absorption criterion) and the column dimension of which would correspond to the three baseline orders of loss allocation (first loss position of the CCP default fund contribution vs. pro rata loss absorption of both CCP and clearing members' default fund contributions vs. first loss position of the clearing members' default fund contributions).

The existing formulae (page 16 of the rules text) would then enter into the respective cells of the "first loss position of the CCP default fund contribution" column, and the remaining cells of the matrix would need to be filled appropriately. In our view, such a tabular representation could enhance the clarity of the prescribed treatment.

Paragraph 116 step (iii): Derivation of the risk weight for default fund contributions - computation of K_{CMi}

In our view, the definition of the factor β (page 18 of the rules text) should be modified in a number of aspects (each of limited materiality) to achieve greater consistency with the overall framework. Firstly, we conjecture that the quantity $A_{Net, i}$ for derivatives entering into the computation of β should equal the respective quantity entering into the computation of $EBRM_i$ and should therefore reflect the adjusted size of 0.7 for the rho factor. Based on this assumption, we propose to replace the term "A_{Net} is defined in Annex IV paragraph 96(iv)" by the term "A_{Net} is defined in Annex 4, paragraph 96(iv), as amended in paragraph 116 [of the present document]". Secondly, we conjecture that the sole mentioning of "OTC derivatives" in the definition of the factor β (page 18 of the rules text) is not intended to artificially subdivide the set of risk positions underlying the computation of $EBRM_i$, as part of which "exchange traded derivatives" are explicitly mentioned (page 15 of the rules text, last section). We therefore propose to align the wording in the definition of the factor β. Thirdly, for SFTs the reference to paragraphs 147 to 153 appears to be too narrow as it does not include the extension of the formula of the comprehensive method for financial collateral applicable in the case of repo netting. We therefore propose to replace the reference "as defined in paragraphs 147 to 153" by "as defined in paragraphs 147 to 153 and 173 to 175".

We hope that you have found these comments useful and remain at your disposal for further discussion. If you have any questions please do not hesitate to contact:

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