German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Association of German Banks | P.O. Box 040307 | 10062 Berlin | Germany

Via e-mail: baselcommittee@bis.org

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

Dominik Adler
Division Manager
Telephone: +49 30 1663-2110
Fax: +49 30 1663-2199
E-mail: dominik.adler@bdb.de

Ref. DK: BASEL
Ref. BdB: C 17
Reviser: Ae/Ha

25 November 2011

Capitalisation of bank exposures to central counterparties
here: Comments of the German Banking Industry

Dear Sir, Madam,

Thank you for giving us the opportunity to comment on the second consultative document on *Capitalisation of bank exposures to central counterparties*.

As this document contains no fundamental changes compared with the previous one, we shall confine ourselves in the following to a number of specific remarks:

Grace period

We welcome it that if a qualifying CCP loses its status there will be a grace period of three months before bilateral capitalisation rules apply. This prevents any adverse reactions in an unexpected case due to erratic increases in capital requirements.

Waiver of large netting sets

The waiver (subject to the conditions set out in paragraph 110) of an increased margin period of risk of 20 business days for trading activities where the number of trades exceeds 5,000 at any point during a quarter is highly sensible in our view. This provision would be at odds with the intended incentive to use CCPs.

Indirect access

We should appreciate further details of when the assumption that the transfer of all transactions of a party with indirect access is "highly unlikely" would be deemed to be fulfilled. We also assume that the clearing members which may take over the transactions in question would not be required to capitalise these potential exposures in advance. This would seriously undermine their willingness to take over the transactions to be transferred and make risk management virtually impossible.

Coordinator:
Association of German Banks
Burgstraße 28 | 10178 Berlin | Germany
Telephone: +49 30 1663-0
Telefax: +49 30 1663-1399
www.die-deutsche-kreditwirtschaft.de

The introduction of an additional risk weight of 4% (paragraph 113) where a bank with indirect access is protected against the default of its clearing member and the default of other clients of this clearing member (but not against the simultaneous default of the clearing member and other client(s)) would ensure finer differentiation between treatment as a bankruptcy-remote exposure and as a bilateral trade. This could create an additional incentive to use CCPs.

However, it would have to be made clear that bankruptcy-remote safekeeping is necessary only at CCP level and not at clearing member level, since the client is adequately protected by the porting requirement and the requirements for orderly transaction booking.

Should bankruptcy-remote safekeeping nevertheless be additionally required at clearing member level, this should not apply at any rate to variation margin, but only to initial margin. A requirement for bankruptcy-remote safekeeping at this level would make the standard practice of transferring full ownership of collateral, which serves among other things to ensure market liquidity, impossible. On top of this, existing formalities would practically rule out the bankruptcy-remote transfer of collateral for use as variation margin in many jurisdictions, as such formalities are, in the case of variation margin, irreconcilable with the required reposting or refunding of collateral at short notice, i.e. on a daily or intraday basis where necessary. Furthermore, the services of a third-party custodian would have to be used for cash collateral and many types of securities collateral, splitting risk positions and thus making them more complex. Finally, additional protection of variation margin is unnecessary because of netting.

If a client concludes a derivative transaction via a clearing member, both the client and the clearing member must treat the transaction conducted between them like a bilateral derivative transaction. This is the case even if the actual transaction has been cleared through a CCP. Where OTC derivatives are concerned, this results in a capital requirement, in the form of a CVA charge, for both the client and the clearing member. The client may avoid the CVA charge if the strict conditions for application of the preferential risk weights of 2%/4% are fulfilled. The clearing member has no means of avoiding a CVA charge arising from the client position.

It can therefore be assumed that clearing members will pass on their capital-related costs arising from client transactions (default fund, plus CVA charge) to clients. This will lead to a marked increase in the cost of transactions, which cannot be intended economically, as the bulk of derivate transactions conducted by clients serve to hedge risk positions. In addition, from the client's perspective, centrally cleared OTC derivatives (unless the preferential risk weights can be applied) are discriminated against compared to bilateral OTC derivatives. Clearing members namely face an additional burden not only through the CVA charge but also through the capital-related default fund costs. Such a cost difference creates an incentive to avoid central clearing. At the same time, it makes clearing members less willing to handle derivative transactions for clients. We fear that clients will as a result have trouble hedging risk positions by means of derivative transactions in some cases. For this reason, we are in favour of exempting centrally cleared clearing member-client derivative transactions from the CVA charge.

Calculation of hypothetical capital and capitalisation requirements

The CCP's hypothetical capital K_{CCP} is to be calculated using the mark-to-market method in accordance with Annex 4, Section VII. The relevant add-on factors for the potential future exposure set out in tabular form in paragraph 92 (i) of Annex 4 are calibrated to residual maturities of non-cleared OTC derivatives of several months to several years. The add-on factors do not, in particular, take into account the daily

variation margining (mark-to-market) for futures contracts, as a result of which the residual maturity is set from a credit risk perspective at one day. The add-on factors thus strongly overstate risk. In addition, the existing netting agreements are taken into account too imprecisely, without reflecting the actual economic effect of risk reduction. Because of the weaknesses outlined, we believe that the mark-to-market method of calculating the exposures held by a CCP whose counterparty credit risk stems almost exclusively from derivative positions is inadequate. We therefore propose allowing CCPs to additionally use the Internal Model Method (IMM). In our view, CCPs should be able to use the IMM and already do so today to some extent. CCPs which use risk-sensitive models should therefore not be forced to use the cruder CEM, as otherwise the incentive to develop suitable models would be undermined. One option would be parallel determination of the CEM and internal models for a transitional period and subsequently deciding on the basis of the experience made what alternatives would be feasible to meet the obligation that then comes into effect.

We continue to take the view that treating default fund contributions less favourably at regulatory level than an equity exposure (of more than 10%) by a bank in another bank is unfair. The proposed risk weights of 1250% and 1250% × μ respectively are not sufficiently risk-sensitive in our view, so that we strongly oppose them. In this context, we also noted in the 30 June 2011 impact study that, when looking at the market leader, the capital requirements for default fund exposures greatly exceeded the aggregate capital requirements for funded default fund and unfunded default fund exposures. The study showed that the capital requirements for exposures to a qualifying CCP may significantly exceed those for exposures to a non-qualifying CCP. This possible discrimination against a qualifying CCP compared to a non-qualifying CCP is, in our view, not what the envisaged regulation intended. Capitalisation of default fund exposures to a qualifying CCP should therefore be limited to the aggregate capital requirements for funded default fund and unfunded default fund exposures.

As we see it, the proposed extremely high capital requirements for qualifying CCP default fund exposures if the CCP's own financial resources are less than its hypothetical capital are designed to ensure that CCPs are adequately capitalised. The attempt to regulate CCPs indirectly via the capital requirements for banks is wrong in our opinion for regulatory policy reasons. That goes particularly in view of the fact that the scope banks have for influencing the organisation and capitalisation of CCPs is limited, as they will be legally obligated in future under corresponding regulatory provisions to use CCPs for certain transactions, and no discretion will thus be allowed (see, for example, EMIR). This means that they will also have no way of indirectly exerting pressure on CCPs, however. Adequate capitalisation and a high level of system stability should be achieved via carefully designed qualitative and quantitative requirements for CCPs and monitoring of compliance with these by regulators, and not only indirectly via CCP users. There is a general consensus that most of the capital that has to be deposited to reduce risk should actually be set aside by the party whose job is ultimately to remove risk from the market, namely the CCP. However, depending on a CCP's capitalisation, number of CMs and volume of cleared transactions, this capital requirement is being shifted to an ever greater degree to the participating banks or CMs and indirectly, via higher charges, to clearing brokers' clients as well; curiously, a lack of internal funds is thus being offset by external funds.

The Basel Committee proposals ignore in our view the fact that CCP credit counterparty risk exposures to all its clearing members must be fully collateralised on a daily basis. Exposures are collateralised by means of a margin system (initial margin, variation margin, intra-day margin calls). Clearing houses generally calculate margin using scenario-based, carefully calibrated value-at-risk approximations (usually with a confidence level of 99% - 99.7%), taking into account netting agreements. This method

adequately captures the (market) risk of a position and thus of the actual potential future exposure. In addition, some clearing members validate the initial and variation margin called for by clearing houses on a daily basis using their own internal market risk models and could also present the results of such validation on request.

Default fund contributions from other clearing members would only have to be used if (i) a clearing member becomes insolvent and (ii) the exposure held by it depreciates in value at the same time to such an extent that both the collateral posted by it (initial and variation margin) and its default fund contribution (possibly plus some of the CCP's own resources) would no longer be sufficient to cover the depreciation in value of its exposure in full. Thanks to the method used to calculate initial margin and default fund contributions, such a case is extremely unlikely.

Even after the failure of Lehman Brothers, following which SwapClear had to wind up a portfolio with a nominal value of USD 9 trillion, default fund resources were not touched. The margin put up by Lehman Brothers at trade level was sufficient for this purpose.

The redistribution of the total capital requirements among the individual clearing members described in paragraph 116 (page 18) is to be based on the prefunded default funds. Consequently, a member which only contributes unfunded default funds would not be assigned any capital requirement. In our view, calculation of the capital requirements taking into account unfunded default funds and redistribution based on the total default fund contributions would be more risk-sensitive.

We also disagree with the method for distributing the capital requirements to individual clearing members (K_{CMi}). While we are not opposed to a granularity criteria in general, the total of all K_{CMi} across all i should not be higher than K^*_{CM}. Along with the planned application of the CEM for the hypothetical capital, this would lead to a further systematic overstatement of risk.

Should you have any questions or require any further information, please do not hesitate to contact us.

Yours sincerely,
on behalf of the German Banking Industry Committee,
Association of German Banks

Dominik Adler

Dirk Jäger
Managing Director

Dominik Adler
Division Manager