

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
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Dear Secretariat

Response to BCBS 206

LCH.Clearnet welcomes the opportunity to put forward its views in respect of the Basel Committee's proposed text, as set out in the Committee's consultative document on the Capitalisation of bank exposures to central counterparties (BCBS206). Separately, we have contributed to, and support the responses to the proposal from EACB and ISDA.

To summarise the views contained in this letter, we consider that fundamental changes are required to the proposal in order to avoid consequences that contradict the original G20 objectives and run counter to the consultative report issued by CPSS-IOSCO on Principles for financial market infrastructures (March 2011).

We agree the need for stronger incentives to expand the scope of central clearing within the overall financial system and to reinforce its effectiveness as a risk management tool; witness LCH.Clearnet's successful management of the Lehman Brothers' default without recourse to either its own capital or the collateral of the non-defaulting members. More recently, the successful resolution by LCH.Clearnet of MF Global's bankruptcy underlines the robustness of our risk management policies, models and methodologies.

LCH.Clearnet agrees with the proposal's guiding principles of implementing a risk-sensitive approach and ensuring a high level of risk management standards for CCPs. However, we believe that the current proposal fails to deliver on the core objectives of encouraging the use of, and expanding the scope of central clearing:

- The proposals inaccurately base the calculation for the risk of derivatives on their notional values – which in the case of interest rate swaps misstates their risk exposure by a factor of 10 to 15.
- Centralized risk management and multilateral netting of a CCP lies at the heart of G20 commitments to enhance central clearing; however a CCP's multilateral netting is capped in the proposals at a level which bears no relation to the enforceability of such netting.
- Due to the lack of a risk-sensitive approach, the proposal creates a large additional capital burden for central clearing – according to our estimates this sum could be in excess of €20bn for the interest rate swap market alone.
- Feedback provided by some of our clearing members suggests that incentives for central clearing within the existing regulated markets are severely damaged by the current proposal and this could encourage moves to less well regulated jurisdictions.

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- We are concerned that existing clearing members could even be driven to terminate their clearing memberships and might seek to clear via a third-party rather than directly through a CCP. At the same time, the proposal brings a disincentive for banks to offer clearing services, which will reduce accessibility to central clearing.

Our central concern is that the use of the Current Exposure Method (CEM) is not adequate for quantifying risk, particularly for Interest Rate Swaps, in a multilateral setting as it results in inflated values for the required capital. Furthermore, it is in contradiction to the required use by CCPs of advanced models as prescribed by CPSS-IOSCO.

We therefore recommend starting work immediately on alternative risk-sensitive approaches to the calculation, such as the Internal Model Method or the Standardised Method. As an interim solution, we suggest adjusting the parameters of CEM and capping the results at a plausible level to ensure that the regulatory objectives of promoting central clearing are supported – to the benefit not only of CCPs and their clearing members but also to the wider economy.

In the appendix to this letter we provide more detailed feedback. We hope that our comments are helpful in further advancing the debate on this regulatory proposal and are more than happy to further contribute to the discussion. Please feel free to get in touch with us for any questions relating to this letter.

Yours sincerely



Jacques Aigrain
Chairman



 **Ian Axe**
Chief Executive Officer

Appendix – Detailed comments

Drawbacks of proposed Hypothetical Capital calculation

We believe that the current proposal fails to adequately address concerns which we raised in earlier drafts, namely three aspects of the calculation of hypothetical capital:

- Inadequacy of the Current Exposure Method (CEM)
- Inconsistency of treatment and prohibition of other methodologies, as allowed or required by CPSS-IOSCO and other regulatory requirements
- Aggregate capital requirement calculation

Use of CEM

We have outlined our particular concerns with the use of CEM in previous interactions with the BCBS. The method has several major drawbacks which make it particularly inadequate for calculating any relevant OTC derivative clearing flow, particularly interest rate swaps (IRS):

- CEM uses a metric based predominantly on notional exposures, which makes it particularly inappropriate for measuring the true economic risks of IRS. Neither tenor nor the 'size of the spread' between the fixed and floating legs of a swap transaction, which are the fundamental risk drivers, are taken into account. As a result, two transactions with the same notional but with fundamentally different characteristics and risks will attract the same capital charge.
- The add-on percentages in CEM are based upon the assumption that exposures are maintained over a time horizon of several months or years. This assumption does not hold true for those OTC derivatives cleared by CCPs, where margins are settled daily and risk continuously managed. The time-based add-on percentage is therefore not reflective of the risk of cleared OTC derivatives.
- CEM does not take account of risk offsets arising from a portfolio of transactions and does not fully reflect the benefits of multilateral clearing – the primary reason for using a CCP to clear centrally, rather than bilaterally.

Consistency with other regulatory requirements

- The recommendations developed by CPSS-IOSCO require CCPs to use internal models which reflect all risk factors when calculating margin requirements. Not using these models to calculate hypothetical capital itself creates additional capital requirements by comparing the results of two different methodologies to measure the same underlying risks. It is important to understand, therefore, that a substantial part of these capital requirements does not reflect the true underlying risk, but, rather the technical difference between the CEM approach for calculating hypothetical capital and a CCP's internal models for margining.
- The regulatory draft allows for the use of CEM, the Standardised Method (SM) or the Internal Model Method (IMM) when calculating the required capital for trade exposures towards a CCP, but prevents the use of SM or IMM for calculating hypothetical capital.

Aggregate capital requirement calculation

In the regulatory proposal, the aggregate exposure, net of clearing member specific collateral and members' default fund contributions, is compared with a CCP's own funds and the pre-funded default fund contributions of non-defaulting members. The portion of hypothetical capital not covered by a CCP's own funds receives a risk weight of 1,250%, a similar percentage as applied to exposures of the very highest

risk such as the equity tranches of securitisations. Default fund contributions carry much lower risk than such exposures and should attract a lower risk weight. We suggest that the maximum applicable risk weight should not exceed that used for equity exposures, namely 400%.

Furthermore, the use of the exposure scalar μ of 1.2 applied to the hypothetical capital not covered by the sum of a CCP's own funds and the pre-funded default fund contributions is implausible; it implies that a clearing member can lose more than it has paid into the default fund. Given that a bank's capital is supposed to buffer losses, it follows logically that the maximum capital requirement for any given asset is the total loss of this exposure¹.

The current proposal fails to deliver a risk-sensitive approach due to the combination of these factors and leads to a result which is neither intuitive nor reflects the underlying risks.

Based on our latest estimates, each LCH.Clearnet clearing member will be forced to hold capital of a multiple of paid-in default fund contribution, implying a risk weight which is way in excess of the highest risk weights used elsewhere in the Basel framework. At a time of severe capital tension in the banking sector, it is counterproductive to add a further material capital obligation for central clearing – some €20bn for IRS alone.

Recommendations

The proposal should not exclude the use of an IMM approach for determining hypothetical capital. In order to address regulatory concerns about the comparability of models between CCPs and their objectiveness, we propose that the banking regulator, in coordination with the relevant regulatory bodies for the respective CCP, defines a set of required characteristics for these internal models, which can then be validated by the CCP regulators. We underline that CPSS-IOSCO clearly mandates the use of what is in, in effect, IMM for margining.

As an alternative, we recommend permitting the use of SM, which has not been explored sufficiently in the debate to date. As well as offering the attractive characteristics of CEM – transparency and simplicity – SM is clearly superior to CEM in relying primarily on risk factors rather than notional exposures. Our initial analysis shows that SM delivers results which are far better aligned with the actual risk than those generated by using CEM.

With either IMM or SM, we acknowledge that such a modification to the regulatory approach will require additional time and that this is not in line with the desired timeline. We recommend that work on alternative models based on IMM or SM starts immediately. While this work progresses, we recommend an interim solution with the following two elements:

- *Element 1:* Within the current CEM approach, modify the NGR weight (ρ) to 1.0.
- *Element 2:* Cap the maximum C-factor to reflect the fact that whilst clearing members may replenish their default fund contribution once beyond their committed contribution, they are unlikely to do so more than twice. Following this reasoning, the maximum amount that a clearing member could lose will amount to three times their default fund contribution which would translate into a maximum C-factor of 300%.

¹ Including current exposure plus any future exposures for which a bank is legally liable, e.g. resulting from derivative positions.

Other comments concerning the proposed rules text

Clearing member capitalisation of client trades

In our view, the proposed rules for client clearing imply that clients who are using clearing services indirectly by routing the deals through a clearing member will receive better treatment than clearing members themselves – this translates into a disincentive to become a clearing member and could even drive existing members to terminate their status as a clearing member and decide to clear using a third party in order to avoid the enormous capital requirements.

In addition, the current proposal provides banks with a disincentive from offering central clearing of client trades, in contradiction to the stated G20 objectives. Under the proposal, in addition to treating cleared and uncleared trades as exposures, clearing members will need to hold additional capital for cleared client trades:

- **Direct Increase (~trade exposure increase):** The clearing member's trade exposure against the CCP will rise by the value of the exposure of the client trade; and
- **Indirect Increase (~default fund exposure):** Routing additional (notional) volume towards the CCP will further increase the hypothetical capital of the CCP and the capital required by the individual clearing member.

As central clearing becomes mandatory for certain products, banks may choose to discontinue client clearing rather than incurring increased trade and default fund exposure to the CCP. In times of higher overall capital requirements and slow economic growth, we are concerned that client clearing could move from the current well-capitalised and regulated banks to less well regulated players with lower capital.

Recommendation

We recommend amending the proposed rules to maintain incentives for clearing members to offer client clearing. One possibility would be to exclude from the hypothetical capital calculation, a clearing member's position against its clients for centrally cleared transactions, or to assign a risk weight of 0%.

Areas for further clarification

We request further clarification on the following questions:

- **Definition of "bankruptcy remote".** The proposed rules intend that collateral posted by a clearing member to, and held in a way which is bankruptcy remote from, the CCP will benefit from a 0% risk weight. In the case of client clearing, collateral will need to be "bankruptcy remote" from both the clearing member and the CCP. However, beyond references to segregation in an account with a third party, the draft proposal gives no detail as to what types of arrangement will satisfy the definition of bankruptcy remote.
- **Continuity/portability of transactions.** The proposal seems to intend that the cleared transactions will continue in the event of the default of the clearing member and can be ported to another clearing member. We seek clarification of what type of arrangements will give the requisite level of assurance that continuity/porting will occur.
- **Client clearing models.** The proposal describes two types of arrangement for client clearing: where the clearing member (i) acts as "financial intermediary" for the client and (ii) guarantees the performance of its client. It is not clear how these map onto the terminology that is commonly used in the market and by CCPs of (i) direct principal and (ii) agency models.