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Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland
Sent by email to: baselcommittee@bis.org

25th November 2011

Re: Capitalisation of bank exposures to central counterparties

Dear Chairman Ingves

Rivast Consulting is pleased to respond to the Committee's consultative document *Capitalisation of bank exposures to central counterparties* ('BCBS 206'). We share the Committee's goal of enhancing the bank regulatory framework, and support the Committee's efforts to develop regulatory capital rules for bank exposures to CCPs. The current practice of assigning a zero risk weight to CCP exposures is indefensible, and hence reform is to be welcomed. In the following we outline some specific thoughts on the Committee's proposal.

Introduction

The committee faces two key questions in addressing direct* bank exposures to central counterparties:

- How risky is a trade exposure to a CCP?
- How risky is a clearing member's default fund contribution to a CCP?

We address each of these separately below.

In what follows, we assume a typical definition of the terms 'initial margin' ('IM'), 'variation margin' ('VM'), etc. However we would urge the Committee to define these terms precisely. This is especially the case for terms such as 'bankruptcy remote' where clarity is required on precisely which segregation models meet the Committee's requirements.

1. Trade Exposures

The Committee proposes to assign a 2% risk weight to trade exposures to CCPs meeting certainly standards, notably compliance with CPSS IOSCO principles (as revised). While CPSS IOSCO compliance is likely to lead to safer CCPs, we do not view it as sufficient to justify the highly beneficial 2% risk weight, and urge the committee to consider requiring two additional criteria.

* The issue of the capital treatment of cleared client exposure has been discussed in various prior responses to the Committee so we do not comment on it again here.

These are:

- That the CCP is resolvable; and
- That the CCP has adequate financial resources.

Resolution

As Paul Tucker recently said[†]:

> *There is a big gap in the regimes for CCPs – what happens if they go bust? I can tell you the simple answer: mayhem. As bad as, conceivably worse than, the failure of large and complex banks.*

This issue, then, is sufficiently vital that the existence of a robust resolution mechanism should be a precondition for a CCP to be granted the 2% risk weight. In particular, resolvability means that it is much more likely that cleared contracts will be able to continue through a CCP stress event, an important systemic risk mitigant.

Financial resources

The CPSS IOSCO guidelines do not contain a precise quantitative description of what it would mean for a CCP to have adequate financial resources. Clearly it is important to be sure that a CCP is adequately resourced before granting it a preferential risk weight. Fortunately however the Basel Accords provide a template for the definition of 'well resourced CCP'. The following should also be required before a CCP is granted a preferential risk weight:

- That the CCP has enough equity capital to support its operational risk[‡];
- That the CCP in addition has sufficient resources to fund its activities through resolution; and
- That the CCP in addition has sufficient resources to support its counterparty credit risk.

This would suggest that the Committee should define what a CCP's equity capital is, what its financial resources excluding equity capital used for operational risk and resolution are, and that it should set the requirements

Equity capital > Operational risk requirement ('ORR') + Resolution capital requirement ('RCR')

Financial resources – (ORR + RCR) > Counterparty credit risk requirement

[†] Central counterparties: the agenda. Speech given by Paul Tucker, Deputy Governor Financial Stability, Bank of England, at the European Commission Conference on European Post Trading Landscape: The Road Ahead, Brussels, 24 October 2011. Available at www.bankofengland.co.uk/publications/speeches/2011/speech524.pdf

[‡] Typically *only* CCP equity can support operational risk as other elements of the CCP's waterfall are reserved for counterparty credit risk.

where all of these terms are precisely defined. We discuss the counterparty credit risk requirement in the next section.

2. Default fund exposures

The riskiness of a clearing member's default fund contribution clearly depends on the resources junior to it in the CCP's risk waterfall. We therefore applaud the Committee's concept of defining the required capital for counterparty credit risk ('K_{CCP}') and defining the capital treatment of a default fund contribution based on the relationship between this tranche, CCP equity available to support credit risk ('DF_{CCP}'), and K_{CCP}. However there are serious difficulties with the details of the Committee's proposal, and one element of significant imprudence.

The definition of K_{CCP}

The Committee proposes:

$$K_{CCP} = \sum_i \max(EBRM_i - VM_i - IM_i - DF_i; 0) \cdot RW \cdot Capital\ ratio$$

There are two problems with the proposed definition:

- Default fund cannot be used *both* to reduce exposure *and* as capital against residual credit exposure after exposure has been reduced. Therefore the term '$-DF_i$' should be removed from the definition of K_{CCP} in order to avoid imprudence.
- The definition of $EBRM_i$ is highly risk insensitive due to the use of the CEM in its definition[§]. While we accept that CCPs are currently limited by their inability to calculate $EBRM_i$ using Basel-compliant IMM models, the CEM is a very poor substitute.

Instead we suggest that each clearing member *separately* calculates their own estimate of K_{CCP} for their own portfolio using whatever methods are permitted by their national supervisor. The calculation would be

$$K_{CCP} = \max(EBRM - VM - IM; 0) \cdot RW \cdot Capital\ ratio$$

This would be simpler, more risk sensitive, and more prudent than the Committee's proposal. Clearing members would then compare their default fund contribution with K_{CCP} and DF_{CM} as in the Committee's proposal. Notably this approach would not require the arbitrary assumption of a default scenario (such as the two clearing members defaulting assumed in paragraph (iii) on page 18).

[§] See ISDA Research Note, *A Note on the Impossibility of Correctly Calibrating the Current Exposure Method for Large OTC Derivatives Portfolios*, June 2011. This, and other studies, clearly demonstrate that the CEM is particularly ill-suited to the calculation of *EBRM* for large, well diversified portfolios such as those typical of clearing members at systemically important CCPs.

Clarifying remarks

It is perhaps worth pointing out two aspects of this setting, and we would encourage the Committee either to include this guidance in any revised version of BCBS 206 or to clarify why it is not appropriate.

i. Many if not all CCPs will arrange *IM* so that it is bigger than (*EBRM* – *VM*). In other words, initial margin will cover how far the portfolio can plausibly move between the last margin call and close out. Thus for many portfolios K_{CCP} will be zero. If the Committee views it as desirable that CCP initial margin is calculated so that this is the case, then that should be clearly stated.

ii. Financial resources are required *separately* to mitigate loss given default; to support any residual counterparty credit risk after mitigation; and to absorb losses. These elements are therefore additive, and only financial resources in excess of $\sum_i EBRM_i$ can absorb losses.

    Specifically, if a CCP has $\sum_i (EBRM_i - VM_i - IM_i - DF_i) - DF_{CCP} = 0$, then the CCP cannot absorb any losses from counterparty default[**] without becoming badly resourced. Again, clarity on this point would be welcome.

We believe that the concept of a 'well resourced CCP' would lead to increased market confidence in clearing. It would therefore reduce the risk of a systemic failure of one or more CCPs. Thus we encourage the Committee to develop this concept based on the ideas already set out in BCBS 206.

If you have any comments or questions regarding this response, or require further information, please contact David Murphy (david@rivast.com).

Yours sincerely

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[**] Specifically, it cannot absorb losses beyond the defaulter's *IM*, *VM* and *DF*. This point is vitally important as clearing members are likely to leave such a CCP much more easily than one that is better resourced. In other words, CCPs that are close to being badly resourced in this sense are prone to runs.