POSITION PAPER

WSBI-ESBG response to the BCBS consultation "Capitalisation of bank exposures to central counterparties"

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The World Savings Banks Institute (WSBI) and the European Savings Banks Group (ESBG) welcome the opportunity to provide a response to the Basel Committee on Banking Supervision (BCBS)'consultative document on the "Capitalisation of bank exposures to central counterparties (CCPs)" in context of the new Basel III rules.

General Remarks:

- WSBI-ESBG is in favour of a tougher regulation for OTC derivatives and to channel every standard OTC trades through CCPs. Nevertheless, WSBI/ESBG considers that the capital requirements envisaged in the current proposal will be excessive and will most likely discourage the clearing members from providing these services to the clients, which will most likely cause an increase in the cost of these services. This point is particularly relevant for all those small and medium size credit institutions that will need the services of clearing members and especially in derivatives OTC standard since as of 2013 it will be mandatory to clear these instruments through CCPs.
- In general WSBI-ESBG agrees with the idea that banks maintain sufficient capital exposures to central counterparties (CCPs). Thus we appreciate the efforts of the BCBS, as well those taken in various individual jurisdictions, for example, the European Union to improve derivative regulation and create more incentives to encourage central counterparty clearing, as decided on at the G-20 level.
- WSBI-ESBG would, however, like to draw attention to the fact that various jurisdictions have already undertaken own initiatives concerning central counterparties along the lines of the G-20 objectives. For example, in the European Union, the European Commission tabled its proposal in September 2010 for a 'Regulation on OTC derivatives, central counterparties and trade repositories[1], which purports to ensure that by the end of 2012, all standardised derivatives contracts will be centrally cleared. In WSBI-ESBG's view, the EU initiative in particular already fulfils the objectives of the G-20 to a considerable extent. Thus the BCBS should recognise such developments when deriving the final Basel III capital adequacy rules text.

- WSBI-ESBG has doubts as to whether decisions or determinations which are made by the CCP itself should indirectly be incentivised by banking regulation, as banks may ultimately only have a very limited influence on CCPs' decisions regarding their own capital and organisation. Rather, sufficient capital adequacy of CCPs should be achieved through direct qualitative and quantitative capital requirements and the prudential supervision of CCPs.

[1] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52010PC0484:EN:NOT

- WSBI-ESBG welcomes the Basel Committee's intention to conduct an impact study on the effect of these specific changes on bank capitalisation. However, we need to raise awareness that the real impact of such changes can only be assessed with great difficultly, as in various jurisdictions the current status-quo in this area is bound to change as a result of ongoing regulatory developments at the level of the jurisdiction. For instance in the EU, there is no clarity yet on the future rules for CCPs and clearing of OTC derivatives – yet they are likely to have an effect on current CCPs' structures and, especially, on their default funds. Thus the truly materialising impact of the proposal (particularly with regard to default fund capital requirements) is, for the time being, very hard to predict.

Specific comments:

- **Concerning the definition of a CCP (consultative paper p. 3 para. a and Annex A, para. 113, 114, 117 and 118):**

In Annex A of the consultative paper, a CCP is defined as being a licensed CCP provided that the CCP is *'based and prudentially supervised in a jurisdiction where the supervisor substantially enforces the CPSS/IOSCO Principles for Financial Market Infrastructures on an ongoing basis'*.

In WSBI-ESBG's view, given the aforementioned initiatives that have already been taken in this regard at the level of individual jurisdictions (such as the EU), the definition of what qualifies as a licensed CCP should allow for necessary flexibility in relation to the circumstances in an individual jurisdiction, as well as to ensure international consistency. In the European Union, for example, the new European Markets and Securities Authority (ESMA)[2] will play a role in the authorisation and supervision of CCPs. Against this background, CPSS, IOSCO, national and supranational regulators should work closely together – in the EU, credit institutions should be able to trust, that a CCP, which is authorised and supervised according to the forthcoming regulation, also adheres to the CPSS/IOSCO standards.

- **Central Counterparties – treatment of exposures of banks which are not themselves clearing members, but which are clients of clearing member (p. 6, para. 9.i and Annex A, para. 112):**

Para 112 a) and b) lays out under which conditions the 2% risk weight for trade exposures applies to clients of clearing members, where the clearing member operates as an intermediary vis-à-vis a qualifying CCP. In this context, WSBI-ESBG would like to reiterate the role played by a direct regulation of CCPs. This being said, WSBI-ESBG takes the view that the first set of conditions laid out in (a) are sufficient to achieve an effective reduction of default risk. However, the conditions outlined in (b) are found to be highly unpractical in reality, as they would entail the ex-ante contractual commitment of additional clearing members to take over the exposures of another (i.e.

[2] http://register.consilium.europa.eu/pdf/en/10/pe00/pe00042.en10.pdf

the 'original') clearing members, in the case of default or insolvency at an uncertain point in the future. Such contracts would be very difficult to determine in reality, and WSBI-ESBG would propose either deleting b) entirely, or if this is not possible, to soften the wording to alternatively read:

112 b) '~~Relevant laws, regulation rules and contractual arrangements ensure that~~ the clients' contracts with the defaulted or insolvent clearing member ~~will~~ **can** *be taken over by another clearing member, and thereby continue to be indirectly transacted through the CCP, should the clearing member default or become insolvent".*

- **<u>Trade Exposures (p. 6, para. 9.c and Annex A, para. 114/119)</u>:**

WSBI-ESBG agrees that the low capital charges for exposures to qualified CCPs should be limited to posted collateral, market-to market exposures and potential future exposures.

Concerning the specific capital requirement suggested for trade exposures towards qualified CCPs, WSBI-ESBG finds that the BCBS should provide greater conceptual clarity as regards the kind of risk this capital requirement is to cover, i.e. credit risk or operational risk. In fact, credit risk should already be addressed by collateral and the capital charge on the default fund contributions. If it is directed at operational risk, however, there is the risk of double counting given that, unless the AMA method is applied, there is already a specific operational risk charge based on income from different business areas.

- **<u>Qualifying default fund exposures (p. 4 para. 9g and Annex A, para. 117):</u>**

In relation to the calculation of qualifying default fund exposures, the Basel Committee has called for specific comments on other practicable methods for calculating such exposure or hypothetical capital. In this respect, WSBI-ESBG considers that, alongside the 'waterfall method' prescribed, a possibility could be to adopt a standardised method, i.e. a unique risk weight based on the risk inherent in contributions to default funds.

As regards the waterfall method, WSBI-ESBG would like to point out that this approach relies on input into banks' calculations of capital requirements of exposures towards CCP, which banks need to receive from CCPs, supervisors or some other counterparty (e.g. trade repositories). Thus in this way banks have to depend on input from a "third party", which may easily cause additional time pressure in context of banks' delivery of the overall CAD calculations. A related question is at which frequency the necessary third party information will be provided to banks.

All in all, we believe that the relevant supervisor has a role to play to ensure that a 'qualified' CCPs' default fund should always be at least equal to its hypothetical capital.

- **<u>Central Counterparties - discretion of bank supervisors (Annex 4 new section of central counterparties IX paragraph 106 and 107 (p. 11)</u>**

Paragraph 106 (…) a bank supervisor has the ultimate discretion to determine whether banks subject to its supervision should hold more than the minimum capital requirements arising from dealing with a QCCP

Paragraph 107 (…) a bank retains the responsibility to ensure that it maintains adequate capital for exposures to such a CCP…

Paragraph 107 (Annex A) states that regardless of the view of a CCP supervisor, a bank supervisor has the ultimate discretion to determine whether banks subject to its supervision should hold more than the minimum capital requirements arising from dealing with a CCP. WSBI-ESBG does not agree with this approach given the risk of distortions to the international level playing field. We also take the position that in this context the ultimate discretion of the national supervisor, (we add) individual bank or QCCPs supervisor at national level is not essential as the regulation will have been agreed upon at the international level. We insist on the need to only have one supervisory organism at the European level, which should also be entitled to decide whether a CCP is qualified or not.

- **<u>Annex A: Regulatory capital rules text on the capitalisation of exposures to central counterparties (p. 9)</u>**

Central counterparty: (…) CCP is a **financial institution**, but in our view, it should never be a credit institution because of conflict of interest that it could generate between the business of the CCP and of the credit institution (i.e., incentives to use the margins to make them profitable, or to cover needs of liquidity…).

WSBI-ESBG defends that at every economic zone (such as the European Union or the United States) only one body, responsible for the supervision of the CCPs and the recognition of a QCCP (Qualified CCPs), should exist.

- **<u>Annex 4, Section I, A. General Terms</u>**

Initial margin (p.10): (…).In case a CCP uses initial margin to mutualise losses among the clearing members, it will be treated as a default fund exposure…

WSBI-ESBG considers that in order for a CM (Clearing Member) to be able to properly differentiate between both cases, it is necessary to force the CCPs to be much more transparent on the reporting on the form in which they obtain and the purpose of the IM (Initial Margin).

- **<u>Annex 4 Section II Scope of application 6(ii) (p.10)</u>**

6(ii) When the client-to-clearing member leg of an exchange traded derivatives transaction is conducted under a bilateral agreement, both the client and the clearing member are to capitalise that transaction as an OTC derivative.

In WSBI-ESBG's view this point is not clear enough and there should be clarified concept of bilateral agreement.

- **<u>Exposures to qualifying CCPs Trade exposures (p.11, 12 and 13)</u>**

(i) *Clearing member exposures to CCPs Paragraph 110.*

110. Where a bank acts as a clearing member of a CCP, either for its own purposes or as a financial intermediary between a client and a CCP, a risk weight of 2% must be applied to the clearing bank's trade exposure to the CCP in respect of OTC derivatives, exchange traded derivative transactions and SFTs. The 2% risk weight for trade exposures also applies where the clearing member guarantees that the client will not suffer any loss due to changes in the value of its transactions in the event that the CCP defaults.
And,

(ii) Clearing member exposures to clients Paragraph 111.

111. The clearing member will always capitalise its exposure (including potential CVA risk exposure) to clients as bilateral trades, irrespective of whether the clearing member guarantees the trade or acts as an intermediary between the client and the CCP.

WSBI/ESBG considers that the capital requirements envisaged in the current proposal will be excessive **<u>and will most likely discourage the CM from providing these services to the clients,</u>** which will most likely cause an increase in the cost of these services. The new framework contemplates a set of capital buffers for bank's exposures to CCPs that seems to be excessive for CMs, given that it will apply to both legs of the trade made through a CM, and to the former, we still need to add the **<u>capital charge</u>** for the default fund.

In fact, if the CM, in the client leg of the cleared trade, continues to be deemed a bilateral OTC trade and if we add the new CVA (Credit Value Adjustment) requirement that cleared trades will attract higher capital requirements than a bilateral trade. We are particularly worried by the extent that this CVA can have in the future for banks. This is because the trade leg between client and CM is subject to the same capital requirements as a bilateral OTC transaction, while the capital requirements for the trade leg between CM and CCP and the CM's contribution to the CCP default fund are additive.

Moreover, it does not seem coherent that the client's trades (from the client's perspective) with a CM, under certain suppositions of segregation and portability, enjoy a beneficial treatment in terms of capital requirements for exposures compared to the CM's exposure to the clients.

This point is particularly relevant for all those small and medium size credit institutions that will need the services of clearing members and especially in derivatives OTC standard, since as of 2013 it will be mandatory to clear these instruments through CCPs.

About WSBI-ESBG (World Savings Banks Institute – European Savings Banks Group)

WSBI-ESBG – The Global Voice of Savings and Retail Banking

WSBI (World Savings Banks Institute) is one of the largest international banking associations and the only global representative of savings and retail banking. Founded in 1924, it represents savings and retail banks and associations thereof in 90 countries of the world (Asia-Pacific, the Americas, Africa and Europe – via ESBG, the European Savings Banks Group). WSBI works closely with international financial institutions and donor agencies and facilitates the provision of access to financial sectors worldwide – be it in developing or developed regions. At the start of 2009, assets of member banks amounted to almost € 9,000 billion, non-bank loans to € 4,300 billion and non-bank deposits to 4,600 billion. Together the member banks conducted operations through 160,000 outlets.

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of over € 6.000 billion, non-bank deposits of € 3.100 billion and non-bank loans of € 3.300 billion (all figures on 1 January 2009). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

WSBI and ESBG members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. WSBI and ESBG member banks have reinvested responsibly in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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