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EACH response to the BCBS consultative document entitled "Supervisory framework for measuring and controlling large exposures"

The European Association of CCP Clearing Houses ("EACH") welcomes the opportunity to respond to the BCBS Consultative Document on the supervisory framework for measuring and controlling large exposures ("the Consultative Document").

The first part of the EACH comment on the Consultative Document is directed at Section IV, sub-section D, which relates to exposures to central counterparties. EACH supports the second option proposed in the Consultative Document, in paragraph 125. This option proposes that: "No Pillar 1 hard limit would apply to a bank's Q-CCP exposures" and that "Banks would still be required to report all large exposures to Q-CCPs to their supervisors".

In the second part EACH proposes to include an additional part in the Consultative document in respect of the large exposure limit for a CCP with a banking license.

Please see EACH's comments on both issues set out below.

An overarching concern is that the method used to calculate the exposures must be properly reflective of the risk. We refer to the well-known issues already identified by EACH concerning the original proposal to use of the Current Exposure method to calculate exposures to CCPs' default funds when applied to derivatives, which grossly overstate the risk of cleared positions. Such a method should not be used to calculate Large Exposures

Section IV, sub-section D, Exposures to Central Counterparties

EACH agrees with the advantages set out in paragraph 125 of the Consultative Document relating to the second option, namely:

- It does not conflict with the G20 recommendation that all standardised products should be cleared through CCPs
- It reduces the impact on the structure of the CCP industry
- It avoids practical issues relating to the diversification of exposures across multiple CCPs.

Conversely, we question the benefits claimed of hard limits on exposures to Q-CCPs (Option 1). In particular, we believe that the diversification of exposures across multiple CCPs would not necessarily help to ensure the stability of financial markets. For any given product set, the management of a large exposure is likely to be substantially less effective if this exposure is distributed across multiple independent CCPs than if it is held at a single CCP where an overview can be taken of the risk of the total exposure. Furthermore, in the event of the failure of a CCP participant, the management of the default is likely to be substantially more effective if the total exposure in that product is centred on one CCP, rather than independently by multiple independent CCPs. Given that CCPs are most vulnerable to participants with large exposures, the effective management of such potential defaults have profound impacts for the integrity of the financial system.

More generally, the management of all exposures by Q-CCPs is governed by the principles set out in the CPSS-IOSCO Principles for FMIs ("the PFMIs"). In particular, the PFMIs specifically require Q-CCPs to collateralise all exposures with high quality collateral, and to mark-to-market regularly. In addition, the PFMIs specifically address the treatment of large exposures and concentration risks, and set out appropriate standards for PFMIs, including the following:

a) 'A CCP should …. consider and address position concentrations' (Principle 6).
b) 'An FMI should also consider other relevant and material risks, such as market ….concentration' (Principle 3).
c) 'A CCP should monitor the existence of large exposures to its participants and, where appropriate, their customers' (Principle 4).
d) 'A CCP should perform this analysis of stress testing more frequently ……. when the size or concentration of positions held by a CCP's participants increases significantly' (Principle 4).
e) 'An FMI should also set and enforce appropriately conservative haircuts and concentration limits' (Principle 5).
f) 'An FMI should perform stress testing more frequently …. when the size or concentration of positions held by its participants increases significantly (Principle 7).
g) 'An FMI should …. have access to information on concentrations of risk arising from tiered participation arrangements that may affect the FMI, allowing it to identify indirect participants responsible for a significant proportion of the FMI's transactions or whose transaction volumes or values are large relative to those of the direct participants through which they access the FMI. An FMI should identify and monitor such risk concentrations' (Principle 19).

Given the standards in the PFMIs relating to indirect clients, it is appropriate for a client with a clearing member to treat this exposure as one with the Q-CCP under the large exposure framework. We therefore support the conclusion of paragraph 128 of the consultative document.

Finally, in relation to paragraph 129, which addresses the question of CCP interconnectedness of CCPs, we believe that CCPs should not be considered as interconnected provided they operate independently. In particular, assessment of such independence should take into account corporate, legal and operational independence, as well as margin and default fund interconnectedness.

Large exposure limit for a CCP with a banking license

EACH sees a number of serious problems arising from the large exposure limit for CCPs with a banking status.

- **Possible contradictions with the new regulations of CCPs**

New European regulation enhances the oversight of CCPs and guarantees high quality design of a CCP's risk management system establishing the risk management standards in respect of collateral requirements, effective margin system, sufficient financial resources, default funds system, clearly defined default rules and procedures.

The treatment of CCP's large exposure limit should be harmonized with the new European CCP regulation. For example, European regulation for central counterparties (Article 35 of EU Regulation No 153/2013 - ESMA) states that a CCP should dedicate at least 25% of its capital to cover a potential default. Furthermore, according to the Article 42 (paragraph 3) of EMIR Regulation (EU Regulation No 648/2012), the CCP has to maintain a default fund enabling the CCP to withstand at least the default of the clearing member with the largest exposure or of the second and third largest clearing members, if the sum of their exposures is larger.

By limiting the exposure to one clearing member to 25% of the CCP's capital the regulation raises questions on the economic value of the CCP default waterfall, the very process of collecting default fund as well as applying other risk mitigation techniques which are not mentioned in the Consultative document.

- **Possible conflict with the G20 recommendation that all standardized products should be cleared via CCPs**

Setting a hard large exposure limit to CCPs' exposures on clearing members, creates a conflict with the intention to clear all standardized products via CCPs as it seriously limits the trades/positions a CCP can accept to clear from one clearing member (or clearing members belonging to the same financial group). CCPs are passive in this process in the sense that they accept (or not) trades submitted to them by the clearing members. Therefore they cannot diversify their exposures to clearing members to satisfy the large exposure limit. Any limits a CCP would have to set on clearing members would restrict its ability to accept and net the exposure to clearing members. On the other hand clearing members would have to diversify their operations between different CCPs.

This would lead to a more fragmented structure of the CCP sector which, as rightly set out in paragraph 125 of the Consultative Document, could lead to an increase of risk in the financial system.

In addition, the Consultative document forces banks to use the comprehensive approach for collateralized transactions, which will oblige CCPs with a banking license to employ the supervisory haircuts, while internally modelled haircuts cannot be used.

In case CCP are credit institutions we propose following treatment: Trade exposures (including initial margin) shall be exempted for large exposure and solvency purposes as they are covered by the lines of defense being the netted positions, the margins received, the default fund contribution of clearing members and own contributions to the default fund by the CCP. The default fund contribution to the default fund by the CCP consists of equity, consequently it should be deducted from the regulatory equity. Other exposures shall be treated as exposures towards credit institutions, for all qualifying CCPs.

The hybrid approach (comprehensive approach) as proposed by the BCBS for the treatment of collateral would have a significant impact on repo-markets cleared by CCPs with a banking licence. Paragraph 72 of the Consultative Document requires that the original collateralised exposure is substituted by the exposure to the issuer of the collateral. For a CCP this would imply that the collateral amounts of all repo-trades concluded with all clearing members would have to be considered as an exposure to the issuer of the collateral. This amount could almost equal the total open position of the market cleared via the CCP. Therefore, no CCP with a banking license will be able to comply with any level of large exposure limit in respect of this collateral.

In our view the combination of the hybrid approach for collateral and the large exposures framework (calculating potential losses of a bank resulting from a default of one counterparty) does not work for CCPs. Summing the exposures to the issuer of collateral, even if posted by different clearing members implies the simultaneous default of all these clearing members. We want to highlight here that concentration and wrong-way-risks are already regulated in EMIR.

EACH proposes that the issues highlighted above are addressed by creating an exemption from the large exposures framework for CCPs with a banking licence.

Alternatively, an exemption could be provided for the hard limit, applying only a soft limit at a level which is sufficiently high to take into account the issues raised above.

In case no (partial) exemption would be included in the regulation then EACH proposes to at least address the issue regarding collateral by excluding the sum of collateral from the large exposure value, setting a requirement to control and report the exposure on collateral; or to apply a certain risk weighting when calculating the exposure on collateral; or to apply a soft limit to these exposures with the higher level.

EACH urges the Secretariat of the Basel Committee on Banking Supervision to carefully assess the above mentioned observations and implications and offers a meeting, in which these points can be further discussed.

Should you require further information, please do not hesitate to contact the undersigned.

Yours sincerely,

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About EACH

European central counterparty clearing houses (henceforth CCPs) formed EACH in 1991. EACH's participants are senior executives specialising in clearing and risk management from European CCPs, both EU and non-EU. Increasingly, clearing activities are not restricted exclusively to exchange-traded business. EACH has an interest in ensuring that the evolving discussions on clearing and settlement in Europe and globally, are fully informed by the expertise and opinions of those responsible for providing central counterparty clearing services.

EACH has 23 members:

AthexClear S.A.

CC&G (Cassa di Compensazione e Garanzia S.p.A.)

CCP Austria

CME Clearing Europe

CSD and CH of Serbia

ECC (European Commodity Clearing AG)

EMCF (European Multilateral Clearing Facility)

Eurex Clearing AG

EuroCCP (European Central Counterparty Ltd)

ICE Clear Europe

IRGiT S.A. (Warsaw Commodity Clearing House)

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Oslo Clearing ASA

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This document does not bind in any manner either the association or its members.

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