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

Capital treatment of bank exposures to central counterparties and the non-internal model method

Dear Sir/Madam,

ASX Group (ASX) would like to thank the Basel Committee on Banking Supervision (BCBS) for the opportunity to respond to Consultative Documents *Capital treatment of bank exposures to central counterparties* (June 2013) and *The non-internal model method for capitalising counterparty credit risk exposures* (rev. 25 July 2013).

In responding to your consultations, ASX fully recognises and supports the drive to place CCP clearing at the centre of the G20 objectives and we believe it is important that market participants are encouraged to use CCPs in order to promote financial stability. Indeed, CCPs are by their nature very risk averse institutions with proven, robust risk mitigation mechanisms as highlighted by their successful handling of the periods of financial instability (including 2008-2009).

ASX broadly supports the BCBS approach and recognises the need for capital risk weightings for different types of bank exposures to CCPs, especially exposures to CCP default funds. We are also keen to ensure that the methodology accurately reflects:

- the low risk inherent in bank exposures to CCPs relative to other types of banking counterparties;
- differing CCP default fund structures; and
- the need to encourage the use of CCPs by banks.

The following section highlights proposed amendments to the methodology. Three are particularly important in ASX's opinion:

- The removal of the DFcover* calculation from the approach;
- Further amendments and/or flexibility to properly account for multi-tranche default funds; and
- BCBS should not make the proposed changes to the trade exposure calculation.

ASX would welcome the opportunity to work closely with BCBS in finalising these proposals.

Suggested Changes to the Proposal

The DFcover* approach should be removed from the calculation.

ASX considers that the Non-internal Model Method (NIMM) calculation is a significant improvement on the Current Exposure Method and we broadly support this methodology as a way of calculating bank exposures to CCPs. The NIMM approach also aligns with the existing bank based methodologies used to calculate other non-CCP exposures.

ASX believes that the NIMM/K_{CCP} calculation is more risk reflective than the CPSS-IOSCO stress testing approach as it:

1. *Includes an implicit probability of the default event*

   ASX supports the use of K_{CCP} as it includes an implicit probability of default assumption through the 20 per cent risk weight in the Exposure at Default calculation. The CPSS-IOSCO stress testing approach, however, does not include any probability of default parameter. As a result the bank capital requirements under the CPSS-IOSCO stress testing approach will be inflated well above their risk reflective level.

2. *Better provides for consistent application across CCPs*

   Another key benefit of the K_{CCP} calculation is that it will ensure consistency in the calculation of capital requirements across CCPs, avoiding the need to align the capital requirements for CCPs with different CPSS-IOSCO cover requirements.

Over the longer term ASX could support the re-introduction of the CPSS-IOSCO stress testing approach once CCP stress testing can be harmonised across jurisdictions. This support, however, would also be contingent on the BCBS being able to incorporate a reasonable probability of default estimate into the capital requirements calculation and an appropriate way of aligning CCP capital requirements for firms using different CPSS-IOSCO cover tests.

The NIMM/K_{CCP} calculation should recognise a CCP's ability to offset client account default losses with remaining house account assets.

Although comfortable with the general NIMM approach, ASX believes that the NIMM calculation should be amended to reflect the fact that CCP rulebooks often ensure that any house profits must be offset against client losses in the event of a Clearing Member default while client profits cannot be used to support any house losses. Where such arrangements are in the place the BCBS methodology should allow CCPs to reduce the magnitude of any client position by any offsetting house position for the purposes of calculating K_{CCP}. This would ensure that CCPs with this client protection benefit (along with their bank Clearing Members) from a potential increase in hedging under the K_{CCP} calculation.

Subject to the removal of the DFcover* approach from the calculation, ASX prefers the use of the Tranches approach to determining risk weightings.

Providing that the BCBS is able to remove the CPSS-IOSCO stress testing approach from the capital requirements calculation, ASX would support the use of the Tranches approach for calculating bank capital requirements. The Tranches approach appears to more appropriately recognise CCP resources compared with the Ratio approach.

If the BCBS are unable to remove the CPSS-IOSCO stress testing methodology, then ASX would be unable to support either the Tranches or Ratio approaches as both approaches would grossly overestimate bank capital requirements for exposures to CCP default funds. This overestimation is driven by the unrealistic 1,250 per cent

risk weight incorporated into both approaches. If the BCBS are unwilling to remove the CPSS-IOSCO stress testing methodology, then ASX considers that this risk weight should be significantly reduced under both approaches.

Further flexibility is required in order to appropriately reflect more complex CCP default fund structures.

ASX is very concerned that the BCBS proposals do not cater for more complex multi-tranche CCP default funds, such as that used by ASX Clear (Futures) – See Attachment B. We are keen that the BCBS should avoid disincentivising such structures as they benefit the financial markets by reducing cross-market contagion risk and providing greater capital efficiency. Moreover, ASX believes that the use of such structures is likely to increase over time as CCPs innovate in order to clear a greater variety of products/tiers within existing CCP arrangements and additional risk mitigation techniques emerge such as auctions and associated juniorisation methodologies.

ASX would be pleased to assist the BCBS in refining the methodology but, conscious of likely time limitations and the potential complexity of the solution, recommends that the BCBS should in the first instance provide CCP regulators with a degree of discretion in implementing the BCBS requirements in order to ensure that the risk protections contained in complex default fund structures are reflected in bank capital requirements.

ASX believes that two main changes are required to cater for multi-tier default funds:

1. *Recognition of all paid in CCP Resources*

   ASX supports the BCBS position that the default fund exposure methodology should recognise all paid-in Clearing Member default funds which occur in the default waterfall, regardless of the number of tranches. However, ASX's concern stems from circumstances where additional tranches of CCP capital are included in the default resources. These too should be recognised in calculating bank capital requirements. In order to accurately calculate default fund exposures, ASX considers that full recognition should be granted for any CCP paid in contributions which suffer losses before any Clearing Member paid-in tranche.

   All paid-in CCP default fund contributions should be recognised under the proposed trade exposure calculations. In the event of a Clearing Member default all CCP resources will be exhausted before any loss is experienced on trade exposures.

2. *Differential risk weightings for each tranche of Clearing Member contributions to the default fund*

   Another concern is that the current BCBS proposal treats all paid-in Clearing Member tranches in the default waterfall as effectively having the same probability of default. ASX believes that the BCBS should ensure that more senior paid-in Clearing Member tranches receive lower risk weightings relative to more junior paid-in Clearing Member tranches.

BCBS should not make the proposed changes to the trade exposure calculation.

ASX believes it is important that a level playing field exists between the risk weightings of bank Clearing Members and bank clients of Clearing Members. We also consider that BCBS should encourage banks to become Clearing Members as a way of enhancing overall systemic stability.

ASX understands that the new BCBS trade exposure proposals will not apply to bank clients of Clearing Members. This would create a disincentive for banks to become Clearing Members as their risk weightings, but not those of bank clients, could rise from 2% to 20%. ASX therefore considers that the new trade exposure proposals are not appropriate as the existing two per cent risk weighting for both bank Clearing Members and bank clients of Clearing Members are already sufficiently prudent.

Further consideration should be given to standardising the CCPs reporting requirements and confidentiality arrangements.

The new BCBS proposals will place additional requirements on CCPs to calculate and provide data to bank Clearing Members. Experience during the QIS has shown that bank requests for data are varied and ASX would appreciate if the BCBS could propose some reporting requirements that ensure consistency and ease the administrative burden on CCPs. ASX would appreciate if all QIS related information can be made available to all CCPs.

Furthermore, ASX remains concerned that the BCBS proposals could result in commercially sensitive information being shared with Clearing Members and competitor CCPs. ASX believes that the BCBS should impose significant safeguards for information sharing and transmission.

Issues requiring further clarity

DFcover requirements*

The Consultative Document does not outline how the requirements for CCPs using cover 1 and cover 2 will be aligned although ASX understands that the BCBS "will seek to achieve a capital treatment that establishes an appropriately level playing field between QCCPs in different jurisdictions." ASX strongly believes that further clarity is necessary and given its importance, any BCBS proposal should be subject to further consultation.

The BCBS proposals refer to a cover 1 and cover 2 requirement while the CPSS-IOSCO PFMIs refer to a cover 1 plus affiliates and cover 2 plus affiliates. It is unclear which test CCPs should use for calculating bank exposures to CCPs.

Frequency and Time Periods of the Calculation

ASX CCPs calculate daily credit risk stress tests in line with CPSS-IOSCO requirements. The results from the CPSS-IOSCO *Principles for Financial Market Infrastructures (PFMI)* credit risk stress testing often vary considerably based on general market activity and the size of open positions held by specific Clearing Members. This feature of financial markets will ensure that the DF^{cover*} value is likely to fluctuate considerably on a daily basis along with Clearing Member capital requirements.

ASX understands that CCPs will need to calculate default fund exposures on a quarterly basis at a minimum. It is unclear if CCPs should estimate the PFMI requirement based on the date the calculation is made or alternatively use some form of averaging over the previous three month period.

Per Default Assumptions

Many contingent Clearing Member default funds are structured on a per default basis – such as the contingent ASX Clear Emergency Assessment power. ASX has previously outlined this issue to the BCBS and we still consider that, where a contingent default fund is based on a per default basis, the size of the Clearing Member default fund for BCBS calculations should explicitly be limited to the maximum possible value under the default of the single largest Clearing Member. ASX has previously commissioned independent analysis for Australian Prudential and Regulatory Authority (APRA) to demonstrate the adequacy of such an assumption.

Posted Initial Margin

ASX supports the broad BCBS approach on posted initial margin. However, the BCBS consultation is unclear as to the applicable posted initial margin risk weight if initial margin is not held in a bankruptcy remote manner and

variation margin haircutting does not occur before initial margin haircutting. ASX believes that setting this risk weight at two per cent would be sufficiently prudent.

ASX would like to thank the BCBS for the opportunity to comment on these consultation documents. We would be happy to discuss any of these issues with BCBS staff and would like to arrange a meeting with the BCBS to further explore our concerns with the proposed methodology and collaborate on the production of an enhanced solution. If you have any comments or questions, please contact Joshua Everson at joshua.everson@asx.com.au or phone: +612 9227 0233.

Yours sincerely

Alan Bardwell
Chief Risk Officer

Attachment A - About ASX Group

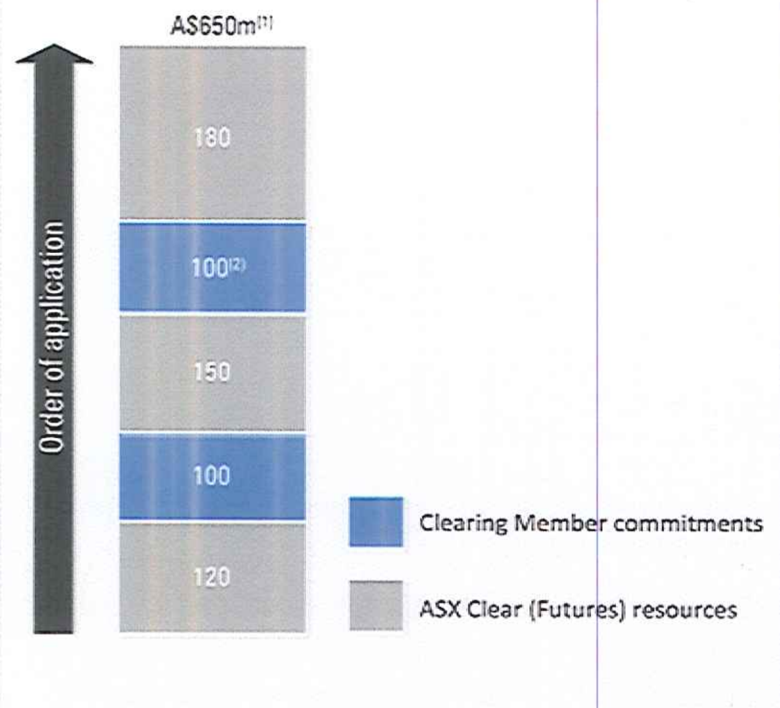
The ASX Group is a provider of multi asset class exchange services. It operates Australia's main equities and derivatives exchange markets and the post-trade processing services in which transactions executed on Australian markets are cleared and settled.

ASX currently operates two CCPs – ASX Clear and ASX Clear (Futures). ASX Clear provides CCP services for a range of financial products traded on the Australian markets, including cash equities, pooled investment products, warrants, certain interest rate products and equity and commodity-related derivatives.

ASX Clear (Futures) provides CCP services for derivatives traded on the ASX24 market, including futures and options on interest rate, equity, energy and commodity products. ASX Clear (Futures) also clears OTC derivatives contracts and Australian Government bonds. ASX launched the OTC Interest Rate Derivatives Clearing Service on 1 July 2013 and is initially targeting dealer activity. The initial Australian dollar OTC derivatives products currently covered include Fixed vs Floating BBSW Interest Rate swaps, Overnight Index swaps and Basis swaps. ASX intends to extend this service to offer client clearing for Australian customers in Q2 2014.

ASX's CCPs are licensed entities regulated by Australia's corporate regulator and central bank. ASX CCPs must comply with the obligations arising from their clearing and settlement facility licences, granted by the Australian Government, including those arising from the Financial Stability Standard for Central Counterparties determined by Australia's central bank, the Reserve Bank of Australia (RBA). This standard was updated in December 2012 primarily to implement the new global CCP standards outlined in the CPSS-IOSCO *PFMIs*.

Attachment B – ASX Clear (Futures) Default Waterfall



In the event of a Clearing Member default, ASX Clear (Futures) would first utilise defaulting Clearing Member initial and additional margins. If these resources were insufficient to cover any defaulting Clearing Member losses then ASX Clear (Futures) would apply the following order of application in order to cover any losses:

- $120 million of paid in CCP resources.
- $100 million of paid-in Futures Clearing Member resources.
- $150 million of paid in CCP resources.
- $100 million[2] of paid-in OTC derivatives Clearing Member resources.
- $180 million of paid in CCP resources.

ASX believes that the following enhancements should be made to the BCBS methodology:

1) Full recognition should be granted to the ASX Clear (Futures) $150 million tranche as this tranche will be exhausted before any loss is experienced by the second $100 million Clearing Member tranche.

2) The second Clearing Member tranche will only suffer loss after $370 million of default fund resources are exhausted. The first Clearing Member tranche will be subject to loss after $120 million of default resources are exhausted. Under the current BCBS methodology both tranches would be subject to the same capital treatment. ASX believes that it is prudent for the second Clearing Member tranche to be subject to a much lower risk weight given the significantly lower probability of loss compared with the first Clearing Member tranche.

(1) Expected maximum ASX Clear (Futures) default resources following admittance of all OTC Clearing Members to the ASX OTC Derivatives clearing service.

(2)This tranche currently consists of $25m of paid-in Clearing Member commitments. This value is expected to increase to $100m as more Clearing Members are admitted to the ASX OTC Derivatives clearing service.