Deutsche Bank

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Mr. Peter Dittus
Secretary General

Basel Committee on Banking Supervision
Bank for International Settlements

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Dear Mr Dittus,

DB Response to Basel Committee Consultation on capital treatment of bank exposures to central counterparties

Deutsche Bank (DB) recognises the paramount importance of central counterparties (CCPs) for systemic stability and supports the approach endorsed by the G20 to increase incentives for central clearing. We therefore welcome the opportunity to comment on the most recent consultation paper from the Basel Committee (BCBS) on the treatment of banks' exposures to CCPs.

Given the systemic importance CCPs will have in the reformed clearing landscape, it is pivotal, indeed, to minimise the probability of a CCP's insolvency. A CCP's insolvency could be caused by events related or unrelated to participant defaults. It is therefore crucial that CCPs have strong risk management processes and policies in place in order to proactively identify and effectively mitigate *all* types of risk that pose a potential threat to the CCP's solvency. In addition, we agree that in line with CPSS and IOSCO Principles for Financial Markets Infrastructures (PFMIs) CCPs should be required to develop robust recovery plans, which allow them to effectively deal with situations where risks of an unanticipated size or nature materialise in order to prevent its insolvency.

Our response focuses only on threats to CCPs' solvency as a result of participant defaults. Since a CCP's primary function is to mitigate counterparty risk, it must have a high level of financial resources at its disposal in order to cover losses from *potential* participant defaults. To be considered a Qualified CCP (QCCP) under the PFMIs, the CCP's financial resources must meet the Cover* standard, i.e. the CCP must be able to withstand either a) the default of the largest participant (Cover1) or, in the case of systemically important CCPs, b) the simultaneous default of the two largest participants (Cover2) under extreme, but plausible market conditions. While we fully agree with this requirement, we fundamentally disagree with the notion that CCPs and their members should be required to collectively back entirely the financial resources required under the Cover* standard with loss absorbing capital.

This requirement would imply that the financial system needs to be able to withstand the materialisation of extreme tail risks in all CCPs simultaneously. The probability that a single QCCP experiences a scenario envisaged by the Cover2 PFMI standard is already very low. The probability that all QCCPs experience a Cover2 event in a single year is many orders of magnitude smaller; in fact, it is so unlikely that it is inconceivable.

In summary, we are concerned that the proposed standards on CCPs' capitalisation go far beyond the objective of ensuring an adequate level of capital and would act as disincentive to central clearing. The requirements as proposed would make centrally cleared OTC derivatives unnecessarily expensive and lead to *lower* risk management standards on the one hand and an *increase* of systemic risk on the other. Capital requirements should encourage *pre*-funded default funds rather than unfunded commitments and need to be risk sensitive and consistent across trade, collateral and default fund exposures.

In our response, we elaborate more on the above mentioned aspects and then respond to your specific questions. We look forward to a continued dialogue with the joint working group of the Basel and IOSCO Committees on this important issue.

Yours sincerely,

Andrew Procter
Global Head of Compliance, Government and Regulatory Affairs

General comments:

Cover* is not a risk measure, therefore not adequate for calculating capital requirements

According to the first objective specified in paragraph 14, the Committee's intention in proposing these standards is to "ensure that bank's exposures to CCPs are *adequately* capitalised" and to ensure a "*resilient* financial system". In our view the proposed standards would exceed what is necessary to achieve this objective. The reason is that while Cover2 is a good measure of extreme tail risk to which a CCP *may* become exposed, the idea that participants should be required to fully capitalise this exposure measure with loss absorbing capital is excessive. The probability of any non-defaulting member losing any fraction of its default fund contribution in a single CCP in any given year is low, certainly less than 1. The probability of losing all of it in a single CCP is even smaller, and the probability of losing all default fund contributions in all CCPs in the same year, is inconceivable. It is therefore reasonable to conclude that only a fraction of the financial resources which CCPs must have *at their disposal* under the PFMI standards needs to be backed by loss absorbing capital in order to ensure a very resilient financial system.

We are convinced that the hypothetical capital construct is conceptually the right approach to:

- Measure the counterparty risk to which a CCP is exposed; and
- Determine the amount of loss absorbing capital that the CCP and its members collectively should be required to reserve.

The hypothetical capital approach starts with calculating an exposure measure for each CCP participant and recognises a) the loss mitigating effects of collateral held by the CCP from each participant, and b) the *probability* of each participant actually defaulting. The Cover2 approach also recognises the loss mitigating effect of collateral, but assumes the joint materialisation of (i) extreme tail scenarios materialising and (ii) the two largest CCP members jointly defaulting with probability 1. The combination of assuming that these three low probability events occur jointly makes the materialisation of the scenario a very remote possibility. If there was only one CCP in the world, asking that members and CCP collectively hold sufficient loss absorbing capital to withstand such an event would not be unreasonable. In a world with multiple CCPs, requiring that the system provides sufficient loss bearing capital to withstand such extreme events occurring *simultaneously in all CCPs* is inappropriate.

We are not opposed to the Cover* requirement as the determinant of how much financial resources each CCP should have at its disposal, but for the purpose of calculating capital requirements it is crucial to implement a risk sensitive measure in order to avoid unintended consequences.

Implementing Cover* as a basis for capital requirements would not promote central clearing

We believe the proposed capital requirements would fail to meet the second objective "to promote central clearing of OTC derivatives", because excessive capital requirements would make centrally cleared OTC derivatives more expensive than necessary to ensure a resilient financial system. Our concerns relate to both the risk-based capital framework and the treatment of centrally cleared derivatives under the leverage ratio framework. They equally apply to clearing members which clear only their own derivatives positions as well as to

clearing members providing access to CCPs for third parties. OTC derivatives markets could face severe capacity constraints if the total capital requirements imposed on the banking system were inappropriately calibrated.

In our view, a financial system with central clearing can achieve higher systemic stability, i.e. will be more resilient to contagion risk, with less loss absorbing capital and/or collateral compared to a bilateral regime. Therefore, it is not necessary to provide specific incentives to promote central clearing. As long as capital requirements are being calculated through an appropriately calibrated, risk sensitive approach, centrally cleared transactions can be facilitated at an overall efficient cost while ensuring a high level of safety for the system.

Arguably, central clearing of OTC derivatives needs not be promoted in jurisdictions where it will soon become a mandatory requirement for those OTC derivatives classes which are sufficiently standardised and liquid. Once certain products are subject to mandatory clearing, participants that already have access to a CCP's services will have economic incentives to also clear other products, even if clearing of those products is not mandatory. For example, in the US the clearing of OTC interest rate swaps in four major currencies is mandatory. In addition, direct and indirect participants clear interest rate swaps in other currencies as well, to the extent they are made available by the CCPs and the counterparty is able to clear using the same CCP. We are concerned that the economic incentives that lead market participants to clear products centrally on a voluntary basis may be reduced if the cost of central clearing became too high as a result of excessive capital requirements.

Implementing Cover* as a basis for capital requirements may lead to lower risk management standards and higher levels of systemic risk

If the capital requirements were implemented as proposed, i.e. with the maximum of hypothetical capital requirement and Cover* standard as the reference level "RLDF", it would make the use of OTC derivatives unnecessarily expensive, both in an absolute sense but also relative to other products, including non-cleared derivatives. We believe that all risks should be adequately capitalised in the financial system such that the price of all products reflects their true relative costs. If one set of products were unduly burdened with excessive capital requirements the likely consequences could be that:

1. The price of this product set will be too high, relative to the economically efficient level;
2. Its use by market participants will be too low; and
3. Market participants may develop strategies that try to reduce the inefficiency.

It is possible that CCPs and their members might be incentivised to lower the severity of the stress tests for determining the Cover* requirement, which may result in CCPs having insufficient financial resources when needed. If CCPs and clearing members have to hold loss absorbing capital against the tail risk measure represented by the Cover2 requirement, the incentives would be to make the tail risk measure less onerous. This would not be in the interest of the CCPs or their participants and would imply less systemic stability as each CCP would have a higher probability of experiencing an event that exhausts its financial resources.

In our view, it would be preferable to define an objective, rules-based standard for calculating capital requirements that does not rely on subjective assessments or arbitrary assumptions. The Cover* method does not provide an objective standard, because there could be significant differences in defining "extreme, but plausible" market scenarios. The different levels in assuming either a Cover1 or a Cover2 standard are very material from a risk

perspective, and both the number of members and their respective default probability could differ greatly between CCPs. In order to avoid inappropriate incentives as described above, the RLDF level that serves as a benchmark for evaluating the strength of a CCP's available financial resources should be defined by a risk sensitive measure that limits the scope for regulatory arbitrage.

Capital requirements should not penalise larger default funds, should be risk sensitive and consistent across trade, collateral and default fund exposures

The insolvency of a CCP implies that the transactions of all participants would be terminated and that participants may incur costs in the process of replacing those positions. We agree with the Committee's view that the probability of a CCP's insolvency is lower the more loss absorbing resources the CCP has at its disposal. Consequently, the risk weights for participants' trade and collateral exposures should be lower where higher financial resources are available to the CCP. The capital framework for banks' exposures to a CCP - across trade exposures, collateral exposures and default fund exposures - should start from the premise that the overall counterparty exposure faced by a CCP does not depend on how losses are distributed between defaulting and non-defaulting participants:

1. Higher Initial Margin requirements shift the risk towards defaulters and therefore lower the residual risk for all non-defaulters;
2. Higher Default Fund contributions further reduce the tail risk for non-defaulting participants' trade and collateral exposure;
3. Clearing Members collectively assume the difference between (1) and (2) through underwriting the risk borne by the default fund.

We believe that the principle expressed in (3) is fundamentally encapsulated in the hypothetical capital construct. CCPs should be allowed to develop internal risk models, approved by a regulator, to measure the tail risks to which they are exposed as accurately as possible. If this option is not available, we consider NIMM as a significant improvement over CEM in terms of risk measurement. However, as further explained in our response to the Committee's consultation on NIMM, we think that work is required in order to make improvements to NIMM.

In our response to questions 1, 4, 5, and 6 we provide a proposal for how the framework would achieve consistency across trade, collateral and default fund exposures.

Capital requirements should encourage pre-funded default fund contributions over unfunded commitments

We support the objective that the capital framework should encourage prefunded default fund contributions rather than unfunded commitments, as the CCP may need the financial resources in the default fund quickly and to ensure that the CCP is not exposed to the risk that members may be unable or unwilling to honor their commitments to fund additional contributions when needed.

However, on balance, we do not believe that the proposed capital framework will actually achieve this objective:

1. The formula laid out in paragraph 60 for incorporating unfunded commitments in the capital requirements under the ratio approach is *indifferent* between pre-funded contributions and unfunded commitments.
2. Taking any unfunded contributions into account appears to increase the capital requirements for clearing members by diluting the impact of the CCP's contribution to the default fund (unless the CCP was committed to make additional contributions in proportion to non-defaulting members).

The tranches approach, by contrast, can easily be adjusted to reflect the impact of unfunded commitments on the hypothetical capital: A possible way to incentivise pre-funded rather than unfunded contributions would be to allow for *full* deduction of pre-funded contribution in the RLDF, i.e. KCCP measure, but to only recognise a *partial* risk-reducing effect for un-funded commitments.

Under the Committee's current proposals, the only incentive for pre-funded contributions arises from the treatment of unfunded default fund contributions in the determination of the risk weight for trade exposures in the formula in paragraph 63. The proposed calibration of alpha = 0.5 is certainly conservative. However, a second – or alternative – incentive in favor of pre-funded contributions could be built into the framework by only recognising alpha times the committed contributions in the RLDF calculation.

The treatment proposed in paragraph 58, that unfunded commitments should be assumed to be three times the funded commitment in those cases where a maximum commitment cannot be determined appears very punitive, unless the risk reducing effect of unfunded commitments is taken into account both in the KCCP calculation and in the determination of the risk weight for trade and collateral exposures.

Similarly, we note that the Committee proposes an increase in the risk weight on trade exposures to QCCPs, i.e. CCPs that have financial resources at their disposal equal to Cover*, from 2% to 5%. We have always maintained that 2% is already too high and we are unable to understand how the Committee concluded that 2% would be too low.

In summary, we recognise it is difficult to provide a framework that avoids unnecessary complexity and is simple to communicate, explain, justify and to apply. However, in our view modifications are needed in order not to fall short of the key objectives, notably:

- To promote central clearing of OTC derivatives;
- While ensuring a resilient financial system;
- Providing incentives for default fund contributions to be pre-funded; and
- Measuring risk in a holistic and consistent way.

We have suggested simple modifications to the proposals which would, in our view, achieve a better balance between the objectives, while avoiding unnecessary complexity.

Please note that our responses to the Committee's consultation questions are based on the following assumptions, for which we request clarification from the Committee:

1) The equation for determining K_CM(i) in para 27 uses a risk weight of 1250% whereas the equation for K_CM(i) in para 60 uses a risk weight "RW". RW is defined as 20% in box A on p. 5. It is necessary to clarify the value of RW in para 60; we

understand it would be the same as RW in para 63 and would be jointly calibrated together with alpha. As argued in our response to question 1 we believe it should be 5% or lower.

2) The capital ratio in the c1 function defined in paragraph 37 is 16%, which would correspond to a risk weight of 200% assuming an 8% capital requirement. This was 1.6% in the interim rules and our expectation is that this was unintended and a typographical error. Nonetheless, as argued in our response to question 1 we believe the capital ratio should actually be 0.4% for reasons of consistency.

Responses to the consultation questions:

Q1: Which of these two proposed methodological approaches best satisfies the objectives which the capital treatment seeks to achieve and why?

Even though the risk of loss on default fund contributions for non-defaulting clearing members is very small, it is nonetheless true that the risk of losing the first Euro of clearing fund contribution is lower than the last Euro. Consequently, a Euro contributed to the default fund by a CCP that is junior to non-defaulting members' contributions reduces the risk of loss on non-defaulting members' contributions by more than a Euro contributed by the CCP that will be used on a pari passu basis. Neither the ratio nor tranches approach fully reflect the different level of riskiness in various layers of the default fund, but the tranches approach relatively better reflects it. In the remainder of our response to this question we will argue that a series of reasonable modifications to the proposed ratio approach will actually result in the tranches approach. Therefore, a modified tranches approach is the appropriate method in our view.

Under the ratio approach, each clearing member's capital requirement, K_CM(i), is equal to the clearing member's default fund contribution, DF_CM(i) times a factor that should reflect the "riskiness" of the contribution. Firstly, the CCP's contributions to the default fund should be deducted from the reference level RLDF in order to reflect the fact that clearing members are not exposed to the risk backed by the CCP's own capital. As a first approximation the riskiness of clearing members' default fund contributions would then be reflected by the ratio:

Max{(RLDF – DF_CCP)/ DF_CM; 0},

where the Max() function ensures that clearing members' capital requirements are floored at zero. The second factor DF_Cover*/(DF_CCP, junior + DF_Cover*) should be discarded, a) because the CCP's own contributions have already been deducted from RLDF, and b) because the factor is based on DF_Cover*, which in our view is not a meaningful risk measure. With these adjustments, the total capital requirement for all clearing members collectively would equal K_CM = Max{RLDF – DF_CCP; 0}.

This capital requirement would still be a function of DF_CM, since RLDF itself should be a function of DF_CM(i): In the Cover* definition, the (pre-funded) default fund contributions of the one or two largest members would be deducted, but the default fund contributions of all other members neglected. Under the KCCP method, the (pre-funded) default fund contributions of each member should reduce the CCP's exposure measure to the respective member. Thus, the revised ratio approach neglects the additional risk borne by clearing members collectively through the provision of larger default fund resources.

In order to account for this additional risk, another term should be introduced that reflects the increasing remoteness of the risk to which default fund contributions beyond the RLDF level are exposed, i.e. some decreasing function should be introduced. Elsewhere in the consultation paper, a risk weight of 5% is assigned to trade exposures to QCCPs that have a fully funded default fund equal to the RLDF requirement. The risk weight scales up and down in proportion to the ratio RLDF/DF_PREF, and is capped at 20% and floored at 2%. We suggest that the probability of incurring losses on default fund contributions beyond the RLDF requirement is no higher than the risk of incurring losses on trade exposures. In order to be consistent with the treatment of trade exposures, we suggest that the additional capital charge on default fund contributions beyond the RLDF level should be:

8% * 5% * RLDF/DF_PREF = 0.4% * RLDF/DF_PREF.

If we define this expression as the function “c1”, the capital calculation according to our modified ratio approach is:

K_CM(i) = DF_CM(i) *Max{(RLDF – DF_CCP;0)/DF_CM} + c1*Max{(DF_PREF – RLDF; 0)/DF_CM},

where DF_CM only counts prefunded member contributions. As it turns out, this is mathematically equivalent to the tranches approach, except that the equation is written in a more compact form.

The only difference between our modified ratio approach and the proposed tranches approach is the definition of the function c1, which in the consultation paper has a capital weight of 1.6%, whereas we believe it should be 0.4% in order to maintain consistency with the treatment of trade exposures.

Q2: What are the pros and cons of using the greater of the minimum Cover* level required by the CPSS-IOSCO PFMIs or the hypothetical level of default resources calculated using NIMM as a model for calculating the relative risk of clearing members contribution to QCCP default funds? Should the Committee consider any adjustments to NIMM to improve its measurement of derivative exposures in the context of CCPs? Would it be better to use only one of these measures, or are there other suitable alternatives?

As explained in the introduction, Cover* is an exposure measure whereas K(CCP) is a risk measure that takes both potential exposures and default probabilities into account. For the purpose of determining capital requirements that ensure a specific level of systemic stability, a risk measure that takes estimated default probabilities into account is clearly preferred. Therefore, the concept of Cover* should be removed from every aspect of the capital requirements calculation.

We are convinced that CCPs should be encouraged to measure the tail risks to which they are exposed as accurately as possible. For this reason, CCPs should be allowed to develop internal risk models and obtain regulatory approval to use them in their KCCP calculation. The necessary simplicity of any non internal model approach implies a loss of risk sensitivity and accuracy in our view.

The proposed NIMM provides a reasonable standard as an exposure measure that meets the Committee’s requirement that it should be “simple to communicate, explain, justify, and apply” Nonetheless, we believe the NIMM suffers from a fundamental inconsistency in that it first calculates an exposure value which is calibrated to “stressed market conditions”, assumes

haircuts for non-cash collateral which are consistent with stressed market conditions, but then does not recognise the full risk-mitigating benefit of the collateral value held by the CCP. This is due to the parametric specification of the multiplier function, in particular the floor. The justification for this treatment provided in the consultation paper BCBS254 is that the NIMM exposure could otherwise become zero (or negative).

However, this would only be the case where the collateral held is more than sufficient to cover the level of risk assumed in the exposure calculation. As currently proposed, the NIMM will always show a residual amount of "uncollateralised tail risk" equal to 5% of the calculated exposure amount, irrespective how much collateral is held by the CCP. However, this artificial "uncollateralised tail risk" may not be an accurate measure of the actual tail risk to which the CCP is exposed.

For systemically important CCPs the Committee may want to consider whether it would be appropriate to calculate stressed NIMM exposures that would result in greater transparency of the actual tail risks faced by systemically important CCPs.

Q3: What risk weights / capital charges would best achieve, or appropriately balance, the objectives set out in Section II.C? In particular, how would possibly lower values ensure that clearing members are capable of absorbing losses in times of stress without the drawing down of the default funds threatening the viability of the non-defaulting members who have contributed to them? How would the proposed 1250% risk weight affect incentives to use central counterparty clearing?

The general comment section of our response addresses the objectives specified in II.C. As further explained in our responses to questions 1 and 2, we are convinced that the tranches approach based on an RLDF requirement equal to an appropriately calibrated K(CCP) measure is fully consistent with ensuring a highly resilient financial system. Clearing members' ability to absorb losses through their default fund exposures only requires a capital base that is far lower than the Cover2 requirement. As explained in the general comments section, we are convinced that a risk weight of 1250% on Max(KCCP, Cover*) would strongly disincentivise central clearing. In our view, default fund exposures to QCCPs that collect initial margin at the 99% confidence level (or even higher!) from all participants are no more risky than a typical AA or strong single-A rated exposure. Therefore, we estimate that the capital requirements should correspond to a 20-50% risk weight applied to Cover*.

Q4: The Committee invites comments on this potential risk sensitive approach to capitalising trade exposures to CCPs.

According to the formula in paragraph 46, participants in a QCCP that have a pre-funded default fund equal to the Cover* requirement need to assign a risk weight of 5% to their trade exposures. The risk weight is capped at 20% for QCCPs that have a funded default fund that only equals a quarter of Cover* and floored at 2% for QCCPs that have a funded default fund larger than or equal to 2.5 times Cover*.

Firstly, we believe that a 5% risk weight on trade exposures to QCCPs which meet the Cover* requirement is too high, certainly in the case of CCPs that meet the Cover2 standard. The risk weight for trade exposures to QCCPs was 2% under the interim rules. We believe this is already conservative considering the remote probability that a QCCP that meets the Cover2 standard exhausts its resources.

Secondly we think that asking for prefunded financial resources equal to 2.5 times Cover* in order to reach a 2% risk weight on trade exposures is too high.

Q5: Do you consider it appropriate to treat initial margin, where a QCCP has legally enforceable rules that make initial margin a senior claim to variation margin in the event of losses in excess of default resources, differently from other trade exposures by retaining a fixed 2% risk weight on initial margin posted in a non-insolvency remote manner?

The International Swaps and Derivatives Association (ISDA) in its recent White Paper "CCP Loss Allocation at the End of the Waterfall" recommended a particular sequence of recovery measures that CCPs should implement through their recovery plans. According to these recommendations, which are primarily targeted at CCPs clearing derivatives, all residual risk would fall on Trade Exposures, either through the application of Variation Margin Gains Haircutting (VMGH) or through Partial or Full Termination. The recommendations are deliberately designed to avoid initial margin collateral being put at risk throughout the recovery process. We believe that it would be appropriate to assign a risk weight of 0% to initial margin collateral held by a CCP that has implemented recovery plans which do not foresee the use of initial margin, irrespective of whether the initial margin collateral is held in a manner that is isolated from the CCP's insolvency.

We also believe that a 2% risk weight would be appropriate in cases where the CCP's recovery plan places initial margin in a senior position to variation margin haircuts on trade exposures, even if the recovery plan is not legally enforceable (by CCP participants). CCPs may not want their recovery plans to be "legally enforceable" and the recent CPSS-IOSCO consultation on CCP recovery plans recommend that CCPs should maintain flexibility with respect to the choice and the order in which a number of possible recovery tools could be applied, including haircuts on initial margin. For this reason we fear that CCPs may be reluctant to commit to legally enforceable rules which would compromise their flexibility, even if the CCP did not have the intention to use haircuts on initial margin throughout the recovery process.

As argued in the answer to question 4, we think that a 2% risk weight on Trade Exposures to CCPs that meet the PFMI standards for QCCPs is already conservative. In any case, the risk weight applied to initial margin should not be higher than 2%, if the CCP is a QCCP.

Q6: Do the proposed approaches to capture commitments to top up default funds in the capital treatment of exposures to QCCPs satisfy the objectives which the capital treatment seeks to achieve? Are there ways in which the proposed capital treatment of commitments could be improved? Is the proposed α value of 0.5 appropriate?

As discussed in the general comments section and in our response to Question 1, the capital framework should not penalise larger default funds and should be consistent across trade, collateral and default fund exposures. The framework should recognise that higher initial margin *and* higher default fund commitments from clearing members reduce the residual tail risk for all non-defaulting participants in a CCP. Arguably, unfunded commitments have a lower risk reducing effect. Therefore, only a fraction of "alpha" times the notional default fund commitments should be allowed to reduce both KCCP *and* the risk weight on trade exposures.

Whether alpha = 0.5 is appropriate can only be determined empirically in our view. However, it needs to be ensured that the risk reducing effect of both funded and unfunded default fund contributions is recognised in a consistent manner, i.e. the risk weight RW used in equation 63 should be the same as in equation 60, and correspond to the definition of the capital weight c1 in equation 37.