Nederlandse Vereniging van Banken

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Basel Committee on Banking Supervision
Via email: baselcommittee@bis.org

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Subject: NVB reaction to BCBS 253 on the capital treatment of bank exposures to central counterparties

Dear Sir, Madam,

On behalf of the Dutch Banking Association[1] (NVB) I would like to thank you for giving us the opportunity to react to BCBS 253 on the capital treatment of bank exposures to central counterparties.

As this consultation is a follow up on a paper issued in 2010, one of the main changes is the incorporation of the NIMM concept, which was introduced in the intermediate period. The NVB welcomes the creation of NIMM, as this measure is more risk sensitive than the CEM approach it is designed to replace. Although NIMM will produce more risk sensitive results, this CP will still generate significant capital requirements for trades with CCPs, due to the inclusion of the Cover 1 or 2. At this point in time, the differences in terms of the impact of both formulas is difficult to evaluate. However, a simple assessment shows that the capital per clearing member in a standard case where the default fund funded by the CCP is small, will be at least 50% of the default fund contribution. This is very conservative and much higher than the outcome of Method 2 from the previous consultative document. The current proposal, if left unchanged, could discourage central clearing, which is clearly not intended.

In the annex, you will find the responses to the various questions. Should you have any questions or remarks, please feel free to contact me at your convenience.

Kind regards,

Onno Steins
Advisor Prudential Regulation

[1] The Dutch Banking Association (NVB) is the representative voice of the Dutch banking community with over 90 member firms, large and small, domestic and international, carrying out business in the Dutch market and overseas. The NVB strives towards a strong, healthy and internationally competitive banking industry in the Netherlands, whilst working towards wider single market aims in Europe.

Annex – Answers to the specific questions

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

A: We have no strong preference. Usually the own default fund contribution of the CCP is small. In that case the methods are very similar.

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?

A: We understand that the objective of the proposal is to ensure that bank's exposures to CCPs are adequately capitalised, while also incentives are preserved for central clearing. We expect that the proposal regarding the capitalisation of the default fund exposure results in a very conservative capital requirement. This is mainly caused by setting the reference level of the default fund equal to the maximum of the default fund requirement related to CPSS-IOSCO's cover 1 or 2 and the hypothetical capital. The hypothetical capital will be less over-conservative as result of replacing the CEM by the NIMM[2]. But the cover 1 or 2 requirement is similar to the way CCPs determine their default fund. For example in case of LCH-Swapclear, the default fund should cover the scenario that the two largest members default. As usually (e.g. in case of LCH-Swapclear) the own default fund contribution of the CCP is small, cover 1 and cover 2 will respectively result in a capital requirement of almost 50% and 100% of the default fund. This will result in significantly higher capital requirements compared to the previous proposal (taking into account the alternative method 2). Also note that the methodology to calculate hypothetical capital will be consistent between CCPs, however this is not the case for cover 1 or 2, as this depends on the stress scenarios developed by the CCP. Therefore including the cover 1 or 2 in the proposal will result in inconsistency between different CCPs. Finally the cover 1 or 2 levels do not take into account the probability of default of the members of the CCP, therefore the resulting capital is not in line with the risk based capital framework. We recommend to set the reference level of the default fund equal to the hypothetical capital instead. This, together with a further fine-tuning of the NIMM, should result in a proper capital requirement for default fund exposures.

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?

A: As mentioned in our answer to question 2, the capital charges for the default fund are expected to be very conservative. An alternative method (i.e. method 2 in the previous proposal) would be required to avoid any over-conservative outcomes of the main method.

[2] As currently proposed we view the NIMM as a substantial improvement to the CEM. However, especially for long maturity IR swaps, the methodology results in very high add-ons that seem too conservative. This is mainly caused by approximating the duration by the maturity.

Furthermore, a 1250% risk weight assumes that all CCPs will default at the same time. We advocate to make the applied risk weights dependent on the number and concentration of default fund contribution exposures within a bank or - alternatively – to reduce the 1250%. The conservatism of the 1250% is also demonstrated in the industry response issued by ISDA /IFF by the use of a IRC type model.

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

A: We support the existing proposal of applying a low risk weight for CCPs to keep the incentive to centrally clear products. We do not support the inclusion of the NIMM/cover ratio in the weight of the trade exposures as proposed. These weights should not be used to incentivise banks to put more money in default funds but related to the risk of losses. As the industry response of ISDA/IFF shows the probability of large losses on default funds are rather low. The risk of losses on trade exposures therefore becomes very remote. If CCPs are capitalised up to the levels as implied by NIMM, the risk weight should not surpass 2%.

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?

A: See our answer to question 4; we support a 2% RW for trade exposures as well as for non-insolvency remote initial margin. It would however be logical that - if initial margin has a senior status to other exposures - this is reflected in lower risk weights.

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?

A: The formula to calculate capital for default fund exposures already takes into account multiple defaults and its probability via the NIMM. Therefore this formula capitalises the risk of members having to top up the default funds.