Eurex Clearing AG

Comment Paper on the Basel Committee on Banking Supervision consultative document "Capital treatment of bank exposures to central counterparties"

Agenda

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A. Introductory remarks

Eurex Clearing is a globally leading central counterparty clearinghouse (CCP) and the largest clearinghouse in Europe. Eurex Clearing is a subsidiary of Deutsche Börse Group providing central clearing services for cash and derivatives markets both for listed as well as certain over-the-counter (OTC) financial instruments. Eurex Clearing actively contributes to market safety and integrity with state-of-the-art market infrastructure in clearing services as well as with industry leading risk management services for the derivatives industry. Customers benefit from a high-quality, cost-efficient and comprehensive trading and clearing value chain.

Eurex Clearing is a company incorporated in Germany and licensed as a credit institution under supervision of the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) pursuant to the Banking Act (Gesetz für das Kreditwesen). Furthermore, Eurex Clearing is a Recognised Overseas Clearing House (ROCH) in the United Kingdom and supervised by the Bank of England (BoE). On 01.08.2013 Eurex Clearing has submitted an application for re-authorization as central counterparty under the Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (EMIR) to its national competent authority BaFin.

Eurex Clearing appreciates the opportunity to comment on the Basel Committee on Banking Supervision's new consultation paper on the capital treatment of bank exposures to central counterparties (further referred to as the consultation), published in June 2013, after comprehensively commenting the first consultation papers published in November 2011 and December 2010 respectively.

Before elaborating on detailed aspects of the current proposal Eurex Clearing would like to outline some general observations with the taken approach.

B. General observations

Eurex Clearing understands the consultation as a move forward in order to ensure the safety and integrity of financial markets and generally welcomes and supports the goal of the proposal.

In the consultation two models are introduced to determine banks capital requirements for default fund exposures with qualifying CCPs (QCCP). For both models the relevant parameter to calculate these requirements is the reference level of default fund (RLDF), which is defined as maximum of DF^{Cover*}[1] and the CCPs hypothetical capital (K_{CCP}), computed with the Non-Internal Model Method (NIMM)[2].

We appreciate the replacement of the Current Exposure Method (CEM) by the more risk sensitive NIMM to determine derivatives exposures. The NIMM results in more appropriate exposure figures than the CEM by considering product characteristics through product specific effective notionals instead of gross notionals, by accounting for over-collateralization and by allowing appropriate netting efficiencies for well structured portfolios.

We like to emphasis that the cost of clearing are not only driven by the methods proposed in this consultation but also through other regulatory initiatives e.g. the liquidity ratio. It has to be ascertained that the cost of clearing through QCCPs will result in significantly lower capital requirements compared to bilateral clearing or clearing through

[1] CCP's calculation of the minimum prefunded member default fund amount required by the CCP to cover the default of the largest or largest two members, which shall reflect the CPSS-IOSCO minimum standard Cover 1 or Cover 2 requirement;
[2] Consultation Paper: The non-internal model method for capitalizing counterparty credit risk exposures (BCBS 254)

non-QCCPs in order to reach the goals of the G20.

In this respect Eurex Clearing is concerned that the proposed rules, especially with regards to the DF^{Cover*} as a potential input for the proposed methodologies[3], are overly conservative leading to overstated capital requirements for bank exposures to CCPs. DF^{Cover*} is a funded tail loss which was estimated based on a combination of most severe hypothetical and historical stress scenarios, conditioned on the default of the largest or the largest two Clearing Members and represents a risk mitigating measure within the risk mutualization mechanism of a CCP. The mutualization mechanism of a CCP distributes losses in extreme but plausible events among its members and is not an indicator of the risk inherent in CCPs business.

Furthermore the DF^{Cover*} is proposed as an input factor without taking into account the probability of Clearing Members defaulting nor the probability that this resource has to be drawn. The absence of such weighting implies that the amount represented by DF^{Cover*} will be drawn with certainty in any given year.

In contrast the hypothetical capital is a risk and already capital weighted expected exposure at default measure developed to determine a bank's risk which needs to be adequately capitalized.

Thus both measures are aiming different purposes and are not comparable since only the hypothetical capital is risk and capital weighted.

Internal analysis have shown that K_{CCP} (NIMM) will not exceed DF^{Cover*}, which makes DF^{Cover*} the relevant input factor. As a result the document in its entirety does neither sufficiently reflect the prudent and safe risk management services and default procedure of CCPs nor the strengthened impact of the regulatory initiatives such as the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and the European Market Infrastructure Regulation ("EMIR") on these services.

During financial market turmoil's CCPs convinced through their performance. The insolvency of Lehman Brothers in 2008 and as a more recent example the default of MF Global could be properly and efficiently managed through CCPs. Hence, the risk framework and the default management procedures in place proved as perfectly fitted to ensure integrity and safety to the financial system. Both defaults caused no losses for Eurex Clearing's surviving Clearing Members nor did they require a draw on default fund contributions even of the defaulting Clearing Member. This reflects the very low probability that an amount as DF^{Cover*} will have to be drawn.

The resilient and effective risk management mechanisms which have been in place during those crises are even further strengthened by regulatory initiatives such as the Dodd-Frank Act and EMIR. As a consequence this should be translated into appropriate and adequate capitalization requirements for bank exposures to QCCPs, reflecting the effectiveness of these regulatory initiatives.

If DF^{Cover*} would be the relevant input factor, the above described stabilizing nature of central counterparty clearing and the effectiveness of regulatory initiatives were not appropriately reflected in the regulation and the resulting capital requirements would not provide an incentive to use CCPs.

In that respect we recommend to remove the DF^{Cover*} as an input to determine capital requirements on bank exposures to QCCPs in order to base those requirements on a more meaningful measure for capitalization purposes like the hypothetical capital calculated with the NIMM and to prevent overly conservative capital requirements contradicting the overall goal of the G20.

[3] Internal analysis have shown that K_{CCP}(NIMM) will not exceed DF^{Cover*}, which makes DF^{Cover*} the relevant input factor

C. Answers to the questions

Question 1

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

Answer:
Given adequately defined input parameters we think that both models can result in appropriate capitalization figures. The Tranche Approach might be the preferable methodology, since it aims to provide a transparent reasoning for a certain capital charge by comparing a CCPs risk position with CCPs available resources to mutualize this risk among its members represented by the default fund, defining three scenarios depending on the relation between the risk position and the default fund.

Our opinion is based on the assumption that the 16% chosen to determine c_1 represent an error which will be corrected to 1.6% in order to be consistent with the interim rules. A capital ratio of 16% implies a risk weight of 200%. In the interim rules the risk weight for default fund contributions exceeding the hypothetical capital ranged between 2% and 20%. Furthermore, in paragraph 38 it is stated that the mentioned 16% represent a risk weight. We therefore ask the Committee for clarification of this point.

As already highlighted before, we are of the opinion that DF^{Cover*} is not an adequately defined input parameter, translating into overly conservative capitalisation ratios contradicting the goal of the G20 to move as many OTC derivatives as possible to CCPs. We will further elaborate on the appropriateness of the chosen input parameters in our answer to question 2.

Question 2 (1)

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?

Answer:
We recommend to remove the DF^{Cover*} as an input parameter to determine capital requirements on bank exposures to QCCPs in order to base those requirements on a more meaningful measure for capitalization purposes like the hypothetical capital and to prevent overly conservative capital requirements contradicting the overall goal of the G20.

Our major concerns are that DF^{Cover*} is not an appropriate measure on which capital requirements should be based on, since it is a prefunded estimated tail loss calibrated under severe hypothetical and historical stress scenarios, conditioned on the default of the largest or the largest two Clearing Members and thus represents a risk mitigating component within a CCPs risk mutualisation mechanism which distributes losses in extreme but plausible events among its members and is not an indicator of the risk inherent in CCPs business.

Furthermore, the consultation proposes to apply DF^{Cover*} neither assigning a risk weight related to the Clearing Members which have contributed to the fund nor a weighting reflecting the probability that the amount represented by DF^{Cover*} has to be drawn. No weighting implies a risk weight of 1250% meaning that DF^{Cover*} will have to be drawn with

certainty within any given year. Given the strong performance of CCPs in past crisis and the common credit quality of Clearing Members, this is not a valid assumption.

Both facts together show that DF^{cover*} is an inappropriate factor for the aimed purpose, translating into overly conservative capital requirements.

Additionally it is not clear when a CCP will have to apply an amount sufficient to cover the default of the largest or the largest two members as DF^{Cover*}. It is not obvious whether this decision is governed by the regulatory requirements established in the jurisdiction where a CCP is located or whether a CCP is allowed to use a cover one model based on the CPSS IOSCO principles for the calculation even though the regulatory requirements established in its home jurisdiction require the application of a cover two model to size the default fund. It is possible that in some jurisdictions CCPs are required to use a cover two model whereas CCPs with the same risk profile in other jurisdictions are required to use a cover one model. That would make capital requirements among CCPs incomparable, leading to an advantage for CCPs which are located in jurisdictions with less stringent requirements which would be a counter intuitive result.

To prevent such uncertainties we propose to use the hypothetical capital calculated with NIMM to base capital requirements on a, for this purpose, logical and comparable measure.

Question 2 (2)

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?

Answer:

The replacement of the CEM with the NIMM is an improvement for the determination of the hypothetical capital. However, the NIMM is a model developed for banks and therefore not able to fully capture the setup of CCPs. We want to highlight the two major shortcomings of the NIMM for CCP purposes.

Firstly, the NIMM is calibrated on a margin period of risk (MPOR) of 5 days. This is not consistent with other regulatory initiatives e.g. EMIR, where a MPOR of two days for exchange traded derivatives is required. To ensure consistency among regulatory requirements and to further propagate the prudent and safe set up of CCPs risk management systems, we recommend to allow the application of a MPOR of two days in the NIMM for CCP purposes for all centrally cleared derivatives.

Secondly, the NIMM is only applicable to determine derivatives exposures. To determine Repo as well as securities lending exposures for hypothetical capital purposes, CCPs are required to use the comprehensive method. To determine a CCPs hypothetical capital the derivatives, repo and securities lending exposures have to be summed up. This approach does not allow to take any cross product netting effects between derivatives, repos and securities lending transactions into account when calculating a CCPs hypothetical capital. Given that many CCPs offer cross product netting opportunities as risk mitigating measures as well as to increase capital efficiencies for their Clearing Members, the currently proposed approach may result into overly conservative capital requirements.

It should be reminded that CCPs already use internally developed margin models which were approved by their national competent authorities to not only determine the exposure

towards their Clearing Members but to also requiring initial margin in exactly the same height, calibrated on a minimum confidence level of 99%. It is not obvious why a few banks are allowed to use internally developed models to determine their exposure values and CCPs are prohibited to use their already approved and implemented internal models for hypothetical capital purposes.

Question 3

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?

Answer:
The proposed risk weight of 1250% is disproportionate high, contradicting the objectives set out in Section II.C of the consultation. We recommend changing the risk weight to better reflect the credit quality of the Clearing Member institutes which have contributed to the default fund. This would result in risk weights ranging between 20% and 100% as in bilateral transactions or even lower instead of applying a risk weight of 1250%.

A risk weight of 1250% would not only de-incentivize central clearing through disproportionate high capital requirements, but bears the danger to adversely affect a CCPs incentive to size clearing funds or the default waterfall in general translating into a destabilization of the financial market especially during market turmoil's.

Such a high risk weight could create the incentives for CCPs to increase their initial margin requirement. This would reduce the amount of default fund contribution necessary to cover the default of the largest or the largest two members translating into a reduced default fund requirement. Since the default fund is designed to mutualize losses in extreme but plausible tail events such an adjustment would further translate into a reduction of risk mitigating resources available during those extreme events. Also contractually committed contributions to the default fund are typically related to the pre-funded contributions. As a result estimated tail losses could not be effectively distributed among Clearing Members increasing the default probability of CCPs and thus increasing contagion risk in extreme but plausible market situations.

Question 4

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

Answer:
CCPs convinced through their performance in severe market turmoil's. Since the latest financial crisis regulatory initiatives e.g. EMIR were developed to even further strengthen CCPs risk management systems. Given these developments it is not obvious why the risk weight for QCCPs fulfilling these even more stringent requirements are increased to a worst case 20%. Even the risk weight fixed at 2% is demonstrably conservative given the CCPs track record.

Hence we propose to at least remain with the fixed risk weight of 2%, or using this risk weight as a cap, allowing risk weights for trade exposures with CCPs to be even lower than 2%, reflecting an appropriate risk measure for such exposures. We want to

emphasize that in the formula used to determine an appropriate risk weight DF^{Cover*} should also be replaced by the hypothetical capital (K_{CCP}(NIMM)), as already recommended for the capitalization of default fund contributions.

We want to further stress that according to the applied formulae a risk weight above 5% would only be possible for CCPs not fulfilling regulatory requirements and which therefore should be classified as Non-QCCPs. Thus, the proposal lacks clarification why a 20% risk weight is proposed to be applied to QCCPs when this risk weight could per definition only be applied to Non-QCCPs. For clarity and consistency, we therefore recommend deleting the 20% risk weight as it would be only applicable to Non-QCCPs which are not covered in this consultation.

In case the Basel Committee will, against our recommendation, keep the proposed risk weights ranging between 2% and 20% for trade exposures with QCCPs, we kindly ask the Committee to provide additional guidance for the treatment of client exposures to CCPs established in the interim rules, paragraph 113 to 116. A simple transfer of the proposed range of risk weights in this consultation to client exposures would not allow to differentiate between different segregation levels available (i.e. Omnibus Net, Omnibus Gross and Individual segregation) and thus not differentiate between different levels of protection.

In case the rules for trade exposures of clients to QCCPs established in the interim rules, paragraph 113 to 116 are not intended to be changed, we kindly ask the Committee to clarify which segregation model would qualify for which risk weight respectively provide more granular qualification requirements in order to reduce the interpretation spectrum. This would be appreciated since there is a large uncertainty within the market regarding this topic.

Question 5

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?

Answer:
As we have already argued in our response to Question 4 above, an increase of the risk weights for bank exposures to CCPs above 2% is counterintuitive given the background of CCPs observed performance in severe market situations and the even further increased requirements for CCPs established in the aftermath of the most recent financial crisis. As for trade exposures we propose to at least remain with the fixed risk weight of 2%, or using this risk weight as a cap, allowing a decrease below 2%.

We want to emphasise that in some jurisdictions it is not possible to hold cash collateral bankruptcy remote from CCPs. In such jurisdictions the interim rules as well as the proposed rules in this consultation create an incentive for Clearing Members to rather post securities as margin collateral than cash, since securities could be hold bankruptcy remote from CCPs, hence attracting no capital requirement. Even so criteria for eligible collateral have been increased by various regulatory initiatives over the world; this would reduce a CCPs available liquidity especially in an increasing interest rate environment.

Furthermore, we question the incorporation of variation margin haircutting as measure to reduce risk weights for posted initial margin, in the consultation. We understand that

variation margin haircutting as described in the consultation would be applied after the defaulter's pre-funded default resources (initial margin and default fund contribution) are drawn, but before any prefunded contributions of non-defaulting Clearing Members have been touched. It is not clear to us which influence such a mechanism is expected to have on the initial margin posted by non-defaulting members. I.e. in Europe, EMIR prohibits CCPs to use initial margin posted by non-defaulting members to cover losses resulting from the default of another Clearing Member.[4] Thus in Europe posted initial margins of non-defaulted Clearing Members are already protected by regulatory requirements. We want to highlight that initial margins posted by non-defaulting Clearing Members which can be used to cover losses resulting from the default of other members are rather exposed to the default risk of the other CCPs participants than to the CCPs default risk. Hence the risk weight for such initial margins should be increased to adequately reflect this.[5]

Finally, we want to clarify that a method like variation margin haircutting should not be applied before the reliable and successful risk mutualisation mechanism, represented by the default fund, has been applied. This would render an interference which would adversely impact a CCPs default waterfall. It might be worthwhile to have a tool like variation margin haircutting available during the replenishment of the default fund as a recovery option or as resolution option after all available resources have been exhausted. However, it has to be taken into account that variation margin haircutting is not a tool which could be used for every CCP in the same manner. The success of the tool depends strongly on the product mix of the CCP and could result in an unbalanced allocation of losses.

Question 6

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?

Answer:

Since we propose to use the Tranche Approach instead of the Ratio Approach, there would be no need to additionally include commitments since they are implicitly considered by construction. We would therefore recommend to refrain from explicitly modelling a charge for commitments into the Tranche Approach.

Since the drawing of any commitments is very unlikely we propose to neither add such commitments as increasing factor for the default fund exposure nor as a reducing factor for trade exposures.

We want to highlight that the current proposed approach would be punitive for CCPs for which the minimum risk weight of 2% for trade exposures would be already applicable before accounting for commitments. For members of such CCPs the consideration of commitments would increase the overall capital requirement for default fund contributions whereas the capital requirements for trade exposures with those CCPs were not reduced since they had already reached the floor of a 2% risk weight before commitments. In this consultation a CCP's safeness is measured by the ratio $RLDF/DF^{Pref}$. It is assumed that

[4] Article 45 (4) EMIR 'Default waterfall'
[5] Paragraph 55 and 56 read as there might be a possibility for CCPs to use initial margin of non-defaulted members. If this option is available in some jurisdictions, risk weights for exposures to those CCPs have to be increased to reflect the default probability of CCPs participants

the lower this ratio, the lower the risk. According to the proposed calculation methodologies only CCPs which have a very low ratio and thus are assumed to be very safe could receive a risk weight of 2% on trade exposures before commitments. Exactly these CCPs would be punished by the proposed method. If that is the purpose of the Basel Committee we question the intention of such a rule.

We therefore again recommend to use the 2% risk weight for trade exposures as a cap and allow commitments to reduce this risk weight below 2% in case the Ratio Approach will be, against our recommendation, the finally chosen method.

A α value of 0.5 would imply that only 50% of the committed contributions would be available which appears to be reasonable since at this stage some large Clearing Members may have defaulted leading to a reduction of available commitments.

We hope that you find these comments useful. If you have any questions please do not hesitate to contact:

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