



FEDERATION
BANCAIRE
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*Banking supervision
And Accounting issues Unit
The Director*

Paris, September 27th 2013

French Banking Federation comments on the Basel Committee's Consultative Document on Capital treatment of bank exposures to central counterparties (BCBS 253)

Dear Sir,

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

We appreciate the opportunity to comment on the consultative document relative to the capital treatment of banks exposures to CCP and support the Committee's objective to correct the shortcomings of the interim methods enclosed in the July 2012 publication (*Capital requirements for bank exposures to central counterparties*).

However we think these proposals are not consistent with the objectives sought by the G-20 to incentivize financial institutions to deal through a CCP.

More specifically we would like to express our deepest concern with respect to the introduction of the minimum prefunded default fund contributions required to cover the risk of the largest clearing member default or the two largest clearing members' default (DF^{Cover*}) as a basis to compute capital requirements for exposures to CCP, we are therefore in favor of the use of CCP hypothetical capital (K_{CCP}).


Mr. Wayne BYRES
General Secretary of the Basel Committee
on banking and supervision
Secretariat of the Joint Forum
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Then we do not see the rationale to capitalize the trade exposures as the risk they bear is part of the counterparty credit risk that has been already capitalized via the waterfall framework.

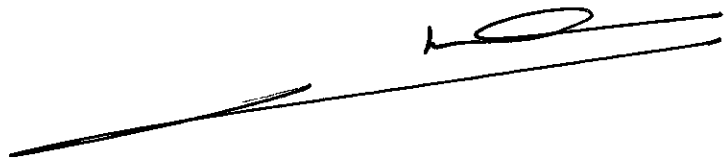
Finally we welcome the proposal to use the Non Internal Model Method "NIMM" to compute the CCP hypothetical capital. Meanwhile CCP should be entitled to use Internal Model Methods "IMM" to compute their hypothetical capital provided they have been granted authorization.

You will find in the attached appendix our specific response to this consultation which is organized in 2 sections:

- the first section consists of general comments on the consultation;
- the second one is dedicated to answers to the questions raised in the consultative document.

We thank for your consideration and remain at your disposal for any question or additional information you might have.

Yours sincerely,

A handwritten signature in black ink, consisting of a stylized 'J' followed by a series of loops and a long horizontal stroke extending to the right.

Jean-Paul Caudal

FBF RESPONSE TO BCBS 253: CAPITAL TREATMENT OF BANK EXPOSURES TO CENTRAL COUNTERPARTIES

We appreciate the opportunity to comment on the consultative document on the capital treatment of banks exposures to CCP (the consultation) and support the Committee's objective to correct the shortcomings of the interim methods enclosed in the July 2012 publication¹.

Our response to the consultation is organized in 2 sections:

- The first section consists of general comments on the consultation;
- The second one is dedicated to answers to the questions raised in the consultative document.

Section 1 : General comments

a) Use of NIMM

We welcome the proposal to use the Non Internal Model Method "NIMM" to compute the CCP hypothetical capital as we consider the main drawback of interim rules was the inability of CEM to come up with commensurate CCR exposure amounts for the calculation of K_{CCP} . We however reiterate our view that CCP should be entitled to use Internal Model Methods "IMM" to compute their hypothetical capital provided they have been granted authorization.

b) Introduction of DF^{Cover*}

We would like to express our deepest concern with respect to the introduction of DF^{Cover*} as a basis to compute capital requirements for exposures to CCP.

The risk faced by clearing members for their cleared transactions is a counterparty credit risk (CRR) to the other clearing members. This counterparty credit risk is appropriately captured by the hypothetical capital and must be shared between clearing members. This is precisely what was done in the Basel framework until the new proposal (BCBS 227), calculating the hypothetical CCR capital toward all clearing members, K_{CCP} , and allocating it to the members on a default fund contributions pro-rata basis. We are supportive of this approach.

In contrast, the Committee's new proposal is to split the max between K_{CCP} and DF^{Cover*} between clearing members pro rata to their contributions to the DF.

DF^{Cover*} is defined as the minimum prefunded DF contributions required to cover the risk of the largest clearing member default (Cover 1) or the two largest clearing members' default (Cover 2) consistently with CPSS-IOSCO PFMI standards. So we think DF^{Cover*} is not representative of the total capital that should be held against the risk of losses arising from clearing members' defaults.

¹ Capital requirements for bank exposures to central counterparties, July 2012
(<http://www.bis.org/publ/bcbs227.htm>)

It is a stress measure of what could be lost conditionally on the probability of one or 2 clearing members defaulting. As such, it does not account for the probability of such an event occurring. It is unduly penalizing compared to a capital measure for at least 2 reasons:

- It is not risk weighted ;
- It is based on a stressed exposure measure rather than on an expected exposure measure.

In a nutshell, DF^{Cover*} is a fully valuable risk indicator but inappropriate to capture an unexpected loss at a high confidence level.

Then we understand that the introduction of DF^{Cover*} reflects the Committee's concern to ensure clearing members are conservatively capitalized due to the systemic role of CCPs. This target could be met more appropriately through multiplying NIMM supervisory factors by a number greater than 1 (for instance 1.32, the inverse normal distribution for a 0.1% percentile over the inverse normal distribution for a 1% percentile). However, in our view, there is no ground to over-capitalise cleared trades over non-cleared trades. Besides it will jeopardise the incentive of centrally clearing.

Last but not least, we would like to underscore that keeping DF^{Cover*} as a floor for $K_{CCP}(NIMM)$ comes down in practice to applying a 1250% risk-weight to the default fund contributions as DF^{Cover*} is likely to be higher than K_{CCP} . Ultimately, it will make clearing uneconomical in contrast to the G20 objectives.

c) Capitalization of trade exposures

Considering the above, we do not see the rationale to capitalise the trade exposures as the risk they bear is part of the counterparty credit risk that has been already capitalised via the waterfall framework. We understand that in extreme instances, the losses following a clearing member's default might exceed the waterfall; however those losses result from the same CCR exposures facing the other clearing members that have been capitalised.

Section 2 : Answers to specific questions

I. Capital treatment of banks' contributions to QCCP default funds: options for change

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

The fact that the Ratio approach will involve a 100% capital charge on default funds prefunded contributions when "DF pref" equals "DF cover" and there is no "DF CCP junior" is very conservative and penalizing and will not create an incentive for central clearing. It will indeed ensure losses absorption by all members in case prefunded default funds are fully used but it also takes the assumption that default funds from all members would be called which is an extreme case. Application of a cap in line with the trade exposure (in the same framework as method 2 of interim rules) is necessary.

Besides, the ratio approach for capital charge determination for default funds prefunded contribution could lead to equivalent capital requirements for qualifying and non-qualifying CCP; this is clearly contradictory with global European trend to encourage central clearing with CCP applying sound risk practices.

Default funds are aimed at securing the system and are calibrated so that default funds of defaulting members are sufficient to cover losses arising from their default first. Defaulting members should not be required to fully capitalize their contributions.

The capital charge should be a pro-rata of the hypothetical capital net of the CCP dedicated own resources where the hypothetical capital is based on the NIMM exposures accounting for the over-capitalisation provided by collected initial margins and clearing members' default fund contributions.

In light of this, the ratio formula should be amended as below:

$$K_{CM_i} = \frac{\text{Max}(0, K_{CCP}(NIMM) - DF_{CCP,junior})}{DF_{CCP} - DF_{CCP,junior} + DF_{CM}^{pref}} \times DF_i^{pref}$$

Alternatively, the tranches approach should be amended as follows:

- RLDF should be replaced by $K_{CCP}(NIMM)$;
- The Committee should reintroduce the distinction between DF_{CCP} and $DF_{CCP,junior}$ to better account for the waterfall structure of the CCP as was the case in the previous Committee's proposal² ;
- Finally c_1 should be set to 0 as the aggregate capital to be required from clearing members should not be higher than $K_{CCP}(NIMM) - DF_{CCP,junior}$.

The tranches approach would then become:

$$K_{CM_i} = \frac{DF_i^{pref}}{DF_{CM}^{pref}} \cdot \begin{cases} c_2 \cdot (K_{CCP}(NIMM) - DF_{CCP}) & \text{if } DF^{pref} < K_{CCP}(NIMM) \\ c_2 \cdot (K_{CCP}(NIMM) - DF_{CCP,junior}) \cdot \frac{DF_{CM}^{pref}}{DF^{pref} - DF_{CCP,junior}} & \text{if } DF_{CCP,junior} < K_{CCP}(NIMM) \leq DF^{pref} \\ 0 & \text{if } K_{CCP}(NIMM) \leq DF_{CCP,junior} \end{cases}$$

Which is similar to the amended Ratio approach.

² See BCBS consultative paper on capital requirements for bank exposures to CCP – July 2012 version, (<http://www.bis.org/publ/bcbs227.htm>), § 123: "If ... a part of CCP's own financial resources is used in combination, on a pro rata or formulaic basis, with the clearing members' default fund contributions (DFCM) to cover CCP losses, then this equation needs to be adapted, in consultation with national supervisors, such that this part of CCP contribution is treated just like a clearing member's default fund contribution."

Q2: What are the pros and cons of using the greater of the minimum Cover* level required by the CPSS-IOSCO PFMI 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 stated in the first section, Cover* is unsuitable to adequately capture the relative risk of clearing members' contribution to QCCP default funds as it is not homogeneous to a risk weighted measure. It is a stressed exposure measure that does not take into account the probability of occurrence of some clearing members' defaulting. Cover* is expected to be higher than K_{CCP} which will ultimately result in a capital charge equal to 100% of the default fund contributions and will drastically undermine the clearing incentive sought by the G20.

Finally, the use of DF^{Cover*} may vary depending on CCP and/or jurisdictions and will not provide consistent level playing field. Also it will create a dependency on CPSS-IOSCO principles.

We therefore urge the Committee to only rely on $K_{CCP}(NIMM)$ for the sake of computing the capital clearing members should hold against their exposures to CCP.

Finally we reiterate our welcome of the introduction of NIMM for the sake of computing K_{CCP} and recommend the Committee to make a few adjustments to the initial proposal³ to improve its soundness and risk sensitivity while keeping it simple.

Those adjustments are detailed in our answer to BCBS 254.

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?

In this proposal, the risk weight on qualifying CCP for default funds (1250% in the ratio approach) remains the same as the one on non-qualifying CCP though qualifying CCP implement IOSCO principles.

As 1250% risk weight on default fund serves the purpose of having no impact on institution's own funds, it does not take into account the credit quality of the CCP's members (between 20% and 100%) ; besides the 1250% risk weight on default fund contribution can be considered as "double impacts" as prefunded contribution are paid in cash or securities.

³ See BCBS consultative paper on non-internal model method for capitalising counterparty credit risk exposures - consultative document (<http://www.bis.org/publ/bcbs254.htm>)

II. Capital treatment of banks' trade exposures to QCCPs: options for change

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

The level of 2% for RW can be obtained if default fund (including CCP's own contribution and members' contributions) are 2.5 times higher than DF^{Cover*} (option 1) or RLDF (option 2). In order to really be a "level playing field" framework, this formula should at least be based on comparable value : NIMM is thus a better candidate than DF^{Cover*} or RLDF.

We would like to underscore that the proposal, as is, is likely to result in trade exposures being capitalized with a 5% risk weight given that DF^{Cover*} is expected to drive RLDF and called default fund contributions are likely to be closed to DF^{Cover*} .

As raised in section 1.c, we do not see the rationale for an additional layer of capital applied to trade exposures as the risk they bear is already addressed through the capitalization of the waterfall under either the ratio approach or the tranches approach. We however concede that for good risk management practices, a weighting such as 2% might be attributed to trade exposures as an incentive for banks to closely monitor their trade exposures but anything higher than 2% is not warranted.

III. Treatment of posted initial margin

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?

Bankruptcy remote margins will still remain weighted at 0%, which will promote this treatment across CCP ; no specific comment on this point.

IV. Capital treatment of commitments to top up default funds

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?

Inclusion of committed unfunded in default fund calculation will represent a very high impact compared to current CRR regulation where unfunded contributions are not taken into account for qualifying CCP, even if this impact will be capped at 3 times the prefunded contribution (which is already the case for some CCP).

Besides, adding a capital charge on committed unfunded default funds with QCCPs would mean that pre-funded default funds are not enough conservative compared to the real risk involved by members' transactions.

Considering that all risks have been already captured via the waterfall framework we do not see the rationale to capitalize committed unfunded default fund contributions. Those are only additional resources committed to cover any exceptional losses.

Other major point: in the current CRR (and in the interim rules), when clearing member does not provide to its clients with a guarantee in case of CCP default, a risk weight of 0% can be used on client related trades with CCP. There is no mention in this new proposal. Will this disposal be maintained?

Finally, we have noted some inconsistencies in the parameter c_1 of Tranches Approach. Is it 16% or 1.6%?

As per the formula, c_1 represents a capital charge, not a risk weight so it would involve a potential capital charge of 200% for high default funds contribution which seems quite high (in iii case).