



Futures Industry Association

2001 Pennsylvania Ave. NW
Suite 600
Washington, DC 20006-1823

202.466.5460
202.296.3184 fax
www.futuresindustry.org

September 27, 2013

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland
baselcommittee@bis.org

Re: Comments on the Consultative Document Regarding the Capital Treatment of
Bank Exposures to Central Counterparties

Dear Sirs and Madams:

The Futures Industry Association (“FIA”) appreciates this opportunity to comment on the Consultative Document, *Capital treatment of bank exposures to central counterparties* (“the Proposed Approach”), issued by the Basel Committee on Banking Supervision (“the Committee”).¹ The FIA is the primary industry association for centrally cleared futures, options, and swaps. Its core members are futures commission merchants (“FCMs”), many of which are banking organizations that are members of qualifying central counterparty (“QCCP”) clearinghouses. The FIA’s membership also includes the major global derivatives exchanges, clearinghouses, trading platforms, technology vendors, and legal services firms that make central clearing possible.

The FIA fully supports the Committee’s efforts to preserve incentives for central clearing and promote robust risk management by banks and central counterparties (“CCPs”).² We also appreciate the Committee’s significant efforts to address the industry’s concerns that the Interim Rule on *Capital requirements for bank exposures to central counterparties*³ (“Interim

¹ Basel Committee on Banking Supervision, *Consultative Document: Capital treatment of bank exposures to central counterparties* (June 2013, rev. July 2013).

² *Id.* at ¶ 3.

³ Basel Committee on Banking Supervision, *Capital requirements for bank exposures to central counterparties* (July 2012).

Rule”) created disincentives to maintain generous default funds.⁴ In addition, the FIA recognizes the Committee’s need “to ensure that CCP clearing members’ prefunded default fund contributions 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.”⁵ The proposed quantitative impact study (“QIS”) assessing the impact of the Proposed Approach on centrally cleared transactions is a welcome step toward striking the appropriate balance among these goals.⁶

Under the Proposed Approach, the capital charge for bank exposures to QCCP default funds is based on a minimum level of default fund resources that a QCCP must maintain, known as the reference level of default fund resources (“RLDF”).⁷ This level is the larger of the Cover* requirement under the *Principles for financial market infrastructures* (“PFMIs”) or the QCCP’s hypothetical capital requirement calculated using the non-internal models method (“NIMM”) to measure derivatives exposures, $K_{CCP}(NIMM)$.⁸ In practice, the Cover* requirement would almost always be the RLDF.⁹

The FIA has significant concerns that the Cover* requirement would substantially overstate actual exposures to QCCP default funds and would not be an appropriate baseline default fund measure under either the ratio approach or the tranches approach.¹⁰ The proposed 100 percent, dollar-for-dollar capital charge would further overstate the actual exposure amount. Further, when the Proposed Approach is combined with other regulatory reforms, such as the proposed Basel III leverage ratio exposure measure,¹¹ the capital requirement for transactions cleared through QCCPs potentially may be the same as or higher than non-qualifying CCPs and uncleared transactions. While the FIA recognizes the need to adequately capitalize clearing members’ contributions to default funds, the Proposed Approach to apply the Cover* default fund and impose a 100 percent, dollar-for-dollar capital charge on member contributions to a

⁴ Proposed Approach, at ¶¶ 3, 11.

⁵ *Id.* at ¶ 14(i).

⁶ *Id.* at ¶ 4.

⁷ *See id.* at ¶¶ 20–21 & Box A.

⁸ *See id.* at ¶¶ 24–25.

⁹ *See id.* at ¶ 24. The Cover* default fund is the amount of total default resources under the PFMIs that a CCP must maintain “to cover the default of either the one, or in some cases the two participants, plus affiliates, that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions (as defined in stress scenarios identified by the CCP but subject to supervisory review).” *Id.* at ¶ 22.

¹⁰ *See id.* at ¶¶ 22, 24.

¹¹ Basel Committee on Banking Supervision, *Consultative Document: Revised Basel III leverage ratio framework and disclosure requirements* (June 2013) [hereinafter “Leverage Ratio Consultative Document”]. Please see also the FIA’s comment letter in response to the Leverage Ratio Consultative Document. *See* Letter from the Futures Industry Association to the Secretariat of the Basel Committee on Banking Supervision re: Consultative Document on the Revised Basel III Leverage Ratio Framework (20 September 2013).

QCCP default fund would greatly undermine recent strides toward central clearing and standardized risk management.

We believe that two fundamental changes to the Proposed Approach are needed to reduce the costs and disincentives for central clearing through QCCPs. First, under either the ratio approach or the tranches approach, the RLDF should be the hypothetical capital requirement for a QCCP if it were a bank measured using the NIMM, $K_{CCP}(NIMM)$, instead of the Cover* requirement. $K_{CCP}(NIMM)$ appropriately takes into account the resources necessary to cover unexpected residual losses, the margin available to absorb expected losses, and the risk of loss over an extended, three-year stress period. Second, to the extent the Committee retains the Cover* requirement, the FIA supports the recommendation of the International Swaps and Derivatives Association (“ISDA”)¹² to risk weight clearing members’ contributions to default fund exposures at approximately 50 percent, and in any event, far less than a 100 percent, dollar-for-dollar capital charge.¹³ This approach would better reflect the actual exposure of default fund contributions to QCCPs and reduce the costs and disincentives for central clearing through QCCPs in the current capital framework.

The remainder of this letter discusses these issues in greater detail. Part I summarizes the financial safeguards at QCCPs. Part II recommends that any final version of the Proposed Approach should measure the baseline default fund based on only a QCCP’s hypothetical capital requirement calculated using the NIMM as if it were a bank, $K_{CCP}(NIMM)$, rather than the maximum of the $K_{CCP}(NIMM)$ and the Cover* requirement. Part III proposes that a risk weight of approximately 50 percent, and at the very least, less than a 100 percent capital charge, would be a more accurate measure of actual exposures to QCCP default fund contributions if the Cover* requirement is retained.¹⁴ Finally, Part IV describes the increased costs to end users and disincentives to central clearing through QCCPs if the recommendations set forth in this letter are not adopted.

I. Background on Financial Safeguards at QCCPs

As the Committee and national regulators have recognized, central clearing reduces the risk of derivatives transactions. QCCPs impose a number of financial safeguards that reduce the risk of trades, including: initial margin in the form of cash or highly liquid securities that covers at least 99 percent of the expected future exposures on the position within a given historical period; haircuts for non-cash collateral; maintenance or variation margin requirements in the form of cash; surveillance of clearing member positions and credit risk; daily, and sometimes twice daily, settlement of positions at mark-to-market prices; and segregation of client collateral with restrictions on collateral re-hypothecation and re-use.

¹² See Letter from the International Swaps and Derivatives Association to the Secretariat of the Basel Committee on Banking Supervision re: Basel Committee on Banking Supervision (BCBS) Consultative Document: Capital treatment of bank exposures to central counterparties (27 September 2013) [hereinafter “ISDA Letter”].

¹³ The FIA would have the same concern about the 100 percent, dollar-for-dollar capital charge using the $K_{CCP}(NIMM)$ as the RLDF if the NIMM is not appropriately calibrated for centrally cleared derivatives.

¹⁴ See *id.*

By requiring initial margin from both sides of the transaction, a QCCP-cleared transaction is always over-collateralized because only one side of the transaction is “out of the money.” Further, there is little risk of loss as daily maintenance or variation margin is based on the market value of the cleared portfolio, posted in cash, and settled at the end of each day. Thus, variation margin is a form of daily “pre-settlement.” Moreover, in practice, clearing members require customers to post collateral in excess of a QCCP’s requirements for margin.

If the client defaults, the liquid market for centrally cleared derivatives permits the QCCP to quickly liquidate the client’s position, most likely within a day, with little impact to the QCCP. Variation margin paid in cash the day of, or the day before, default also reduces the risk that the price of the position has changed substantially from the margin price. Indeed, margin requirements are calculated based on long-standing industry methodologies that assess the overall risk of a portfolio due to price and volatility changes. Thus, the likelihood of residual losses—that is, losses not covered by margin—is very low.

Further, QCCPs require clearing members to contribute to a default fund to cover unexpected, residual losses that are not covered by margin requirements. QCCPs have specific loss “waterfalls” in place to mitigate the effect of default by a counterparty, whereby losses are incurred first by margin before reaching any contributions to the default fund, as follows:

1. Defaulting client’s initial and variation margin;
2. Defaulting clearing member’s house margin¹⁵ in the clearing member’s house account;
3. Defaulting clearing member’s contribution to the default fund;
4. QCCP’s contribution to the default fund;
5. Non-defaulting clearing members’ contributions to the default fund; and
6. Assessments on clearing members.

Thus, a default fund contribution by a defaulting clearing member is the third loss position, and contributions by non-defaulting clearing members are the fifth-loss position in the event of counterparty default. Both positions are protected by at least initial and variation margin.

Further, QCCPs require clearing members to meet minimum regulatory capital requirements—and sometimes even require additional capital above minimums—to ensure that members have substantial capital to cover a default in the first instance and to employ risk

¹⁵ House margin is margin for the proprietary trades of the clearing member. The clearing member will also hold excess collateral with the QCCP to ensure sufficient margin for customer accounts. We refer to these types of margin collectively as “house” margin.

management systems to prevent client default. For all of these reasons, the risk of loss to a defaulting and non-defaulting member's default fund contribution is low.

II. Adopt Only $K_{CCP}(NIMM)$ and Remove the Cover* Requirement for the RLDF

Under both the proposed ratio approach and the proposed tranches approach, the capital charge for bank exposures to QCCP default funds is based on a minimum level of default fund resources that a QCCP must maintain, the RLDF. This level is the larger of the Cover* requirement or the QCCP's hypothetical capital requirement calculated using the NIMM to measure derivatives exposures, $K_{CCP}(NIMM)$. In practice, the Cover* requirement would almost always be the basis for the default fund calculation.¹⁶

The Cover* is designed to require enough capital to absorb losses from “the default of either the one, or in some cases the two participants, plus affiliates, that would potentially cause the largest aggregate credit exposure to the CCP” in stressed scenarios.¹⁷ This approach does not account for all of the QCCP's exposures, does not recognize the probability of default of any of the members, and does not expressly take into account the initial and variation margin in place to absorb expected losses.

$K_{CCP}(NIMM)$, rather than the Cover* requirement, is the more appropriate measure of RLDF. As a measure of exposure in the capital framework,¹⁸ the RLDF should be measured in a way that is consistent with other aspects of the capital framework. $K_{CCP}(NIMM)$ satisfies this consistency standard. In general, loss-absorbing capital is intended to cover unexpected losses not included in reserves.¹⁹ Similarly, the default fund is intended to cover unexpected, residual losses that are not covered by margin. In determining adequacy of capital for individual banks, the minimum amounts are calculated based on the ratio of a bank's capital to its total exposures. Likewise, in determining the adequacy of default funds for a QCCP, the minimum required amount should be calculated based on the ratio of the QCCP's default fund to its total exposures to derivatives.²⁰

Today, the capital framework measures derivatives exposures using the current exposure method (“CEM”). But recognizing the many deficiencies of the CEM, the Committee has recently proposed the NIMM to more accurately measure a wider range of derivatives transactions. The NIMM, like the CEM, is the sum of the replacement cost and the potential future exposure (“PFE”) of a derivatives contract. Unlike the CEM, however, the NIMM “is intended to better capture the effects of collateral and netting” and “should be more appropriate”

¹⁶ See Proposed Approach, at ¶¶ 22, 24.

¹⁷ *Id.* at ¶ 22.

¹⁸ See, e.g., *id.* at ¶ 14.

¹⁹ See, e.g., Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems* ¶ 31 (December 2010, rev. June 2011).

²⁰ The FIA recognizes that QCCPs also settle securities financing transactions (“SFTs”). For brevity, we do not address SFT settlement in this letter.

to measure “centrally cleared derivatives transactions than CEM.”²¹ In particular, the NIMM expressly takes into account initial and variation margin, which are designed to cover expected losses and absorb losses higher on the loss waterfall.²²

Moreover, to the extent that the Cover* requirement has prudential benefits as a measure of catastrophic or “tail risk,” we note that the NIMM similarly covers tail risk by taking into account stressed scenarios. Specifically, the add-ons for PFE are calibrated to “represent volatilities and correlations commonly observed during a stress period” generally lasting three years.²³

Finally, removing the Cover* requirement and using only $K_{CCP}(NIMM)$ would better reflect the Committee’s stated objectives for a simpler capital framework. Indeed, drawing on a criticism cited by the Committee in a related context, a capital requirement that uses the higher of the Cover* requirement or $K_{CCP}(NIMM)$ would be an “[i]mpediment[] to simplicity” by providing “a range of options to measure capital requirements.”²⁴

III. Adopt a 50 Percent Risk Weight for Bank Exposures to QCCP Default Funds

The Proposed Approach would impose a 100 percent, dollar-for-dollar capital charge on clearing member default fund contributions to a QCCP under either the ratio approach or the tranches approach.²⁵ The Proposed Approach reasons that this 100 percent capital charge is necessary to ensure that “this part of the default fund can absorb losses without undermining the financial strength of the contributing members.”²⁶ The FIA strongly disagrees with this premise for several reasons.

As the Committee has acknowledged, a 100 percent capital charge “would be disproportionate to the risk involved in default fund contributions relative to the risk weights assigned in other contexts.”²⁷ In general, under the risk-based capital framework applicable to banks, a 100 percent, dollar-for-dollar capital charge is reserved for assets or exposures thought

²¹ Proposed Approach, at ¶ 23; *see also* Basel Committee on Banking Supervision, *Consultative Document: The non-internal model method for capitalising counterparty credit risk exposures* (June 2013, rev. July 2013) [hereinafter “NIMM Consultative Document”] (recognizing the deficiencies of the CEM and noting the benefits and objectives of the NIMM). To be sure, the FIA’s members are still evaluating the effect of NIMM on derivatives exposures and believe that the NIMM should be appropriately calibrated for the central clearing context so as not to provide disincentives to central clearing. FIA’s member institutions are filing comment letters on the NIMM proposal.

²² *See* NIMM Consultative Document, at ¶¶ 16–31.

²³ *Id.* at ¶ 92.

²⁴ Basel Committee on Banking Supervision, *Discussion Paper, The regulatory framework: balancing risk sensitivity, simplicity and comparability* ¶ 12 (July 2013).

²⁵ Proposed Approach, at ¶¶ 28, 30, 33, 34, 37–38.

²⁶ *Id.* at ¶ 28.

²⁷ *Id.* at ¶ 34.

to present the very highest level of risk of loss, such as an equity investment in a corporation that stands in a first loss position if the company suffers losses or a first-loss securitization position. A bank's default fund contribution to a QCCP simply does not present this level of risk because it holds a senior position in the loss waterfall; it does *not* stand in a first loss position. Specifically, in a QCCP's loss waterfall, a defaulting clearing member holds a third-loss position, behind the defaulting client's margin and the defaulting clearing member's house margin. Such margin substantially decreases the likelihood that a loss will ever reach default fund contributions because initial margin takes into account at least 99 percent of the estimated distribution of potential future exposures, and variation margin takes into account daily changes in market price.

Non-defaulting members' default fund contributions are even less likely to sustain loss. In the QCCP's loss waterfall, such contributions hold a fifth-loss position in the event of counterparty default, behind the defaulting client's margin, the defaulting clearing member's margin, the defaulting member's contribution to the default fund, and the QCCP's contribution to the default fund. All of these loss-absorbing funds would have to be insufficient or exhausted for a non-defaulting member to sustain any loss—a remote possibility.

In addition, the dollar-for-dollar capital charge on each clearing member's full default fund contribution is based on mistaken assumptions. Such a capital charge assumes that a QCCP will exhaust all of its default funds, a result that has not been borne out by historical experience. Even in the most severe crises, such as in the fall of 2008, the amount of margin has been sufficient to confine the losses to the defaulting member, with no need to resort to the non-defaulting clearing members' contributions to the default fund.

Thus, to the extent the Committee retains the Cover* requirement, the risk weight should instead better reflect the senior position of default fund contributions as well as the margin available to absorb the first loss.²⁸ As described more fully in the ISDA letter responding to the Proposed Approach, a 50 percent risk weight better captures the actual exposure to default fund contributions to QCCPs and reduces the costs of, and disincentives to, central clearing.

Two measurement methods support this 50 percent risk weight. First, using the NIMM to calculate derivatives exposure, the Incremental Default Risk Charge ("IDRC") provides an adjusted risk-weight of 51 percent for default fund exposures to QCCPs.²⁹ Second, using a more rudimentary "look-through" approach, a conservative risk weight for default fund exposures would range from 20 percent to 50 percent, depending on the credit quality of the QCCP's members.³⁰ The look-through approach uses the proposed measurement methodologies

²⁸ As discussed in footnote 13, the FIA would have the same concern about the 100 percent, dollar-for-dollar capital charge using the $K_{CCP}(NIMM)$ as the RLDF if the NIMM is not appropriately calibrated for centrally cleared derivatives.

²⁹ See ISDA Letter. The March 2013 ISDA paper details the methodology behind the IDRC measure. See ISDA, *Risk Sensitive Capital Treatment for Clearing Member Exposure to Central Counterparty Default Funds* (March 2013).

³⁰ See ISDA Letter.

for bilateral trades (*i.e.*, the CEM or the NIMM) and conservative exposure at default estimates to reach risk weights of 20 to 50 percent. Thus, even under the more conservative, less risk-sensitive look-through approach, the estimated risk weight would be far lower than the proposed 100 percent capital charge for default fund exposures to QCCPs under the Proposed Approach.

The FIA strongly believes that the estimated risk weight of approximately 50 percent would better achieve the Committee's goal to properly capitalize default fund exposures while maintaining adequate incentives for central clearing through QCCPs. At the very least, the capital charge should be far less than dollar-for-dollar.

IV. The Proposed Approach Increases Costs for End Users and Provides Disincentives to Clear through QCCPs

Without the adjustments proposed in this letter, a 1,250 percent risk weight based on the Cover* would substantially overstate actual bank exposures to QCCP default fund contributions. These higher capital charges ultimately will be passed on to end users, with several negative consequences.

First, the more expensive QCCP membership becomes for clearing member banks, the fewer the number of firms that are able to participate in QCCPs. The clearing broker market will become more concentrated as only a few clearing members will have the resources necessary to provide services to multiple QCCPs due to the high capital charges imposed on clearing members. This will decrease competition and further increase the costs to end-users.

Second, the higher costs for QCCP-cleared transactions will reduce the demand for, and the number of, such transactions. Where clearing is mandated, such as for swaps in the United States, end users may simply hedge fewer transactions. Where clearing is not mandated, users may choose to engage in bilateral, uncleared derivative trades. As the number of transactions decreases, market liquidity will decrease. Fewer transactions and less liquidity will result in less data available to QCCPs, thus increasing margin costs to account for price volatility in the market. Thus, the higher margin requirements from a less liquid, more volatile cleared derivatives market would further increase costs to clearing member banks and their clients, the end users. These effects provide additional disincentives—and potentially introduce new risks—to centrally clear transactions through QCCPs.

Third, the Proposed Approach must be viewed in the context of other regulatory reforms and proposed reforms that collectively result in substantially increased costs for end users. For example, the proposed denominator of the Basel III supplementary leverage ratio³¹ would use the CEM to measure derivatives exposures, which would substantially overstate actual

³¹ The FIA provided comments on the proposed Exposure Measure to the Committee. In that letter, we detailed the aspects of the proposed Exposure Measure that would penalize transactions cleared through CCPs on behalf of clients relative to bilateral, uncleared derivative trades. *See* Letter from the Futures Industry Association to the Secretariat of the Basel Committee on Banking Supervision re: Consultative Document on the Revised Basel III Leverage Ratio Framework (20 September 2013).

exposure by failing to recognize margin and netting,³² and would effectively double count derivatives exposures collateralized by cash—a common practice for derivatives cleared through QCCPs.³³ Needlessly penalizing QCCPs through aspects of the Proposed Approach would only exacerbate the costs of central clearing.

Finally, the 100 percent capital charge—applied without a cap on the total capital charge—would mean that banks are subject to nearly the same capital charge for default fund contributions to a QCCP as to a non-qualifying CCP. Under the July 2012 Interim Rule, banks must apply a 1,250 percent risk weight to their funded and unfunded default fund contributions to a non-qualifying CCP.³⁴ Where there is liability for unfunded contributions, national supervisors will then determine the amount of unfunded commitments to which the 1,250 percent risk weight would apply.³⁵ Both in substance and in practice, this approach for default fund contributions to non-qualifying CCPs is nearly the same as the Proposed Approach for default fund contributions to QCCPs—even though the latter is subject to more stringent regulatory requirements than the former. And, when combined with the proposed Basel III leverage ratio’s penalizing treatment of collateral, the capital requirement for transactions cleared through QCCPs potentially may be the same as or higher than non-qualifying CCPs and uncleared transactions. Thus, to the extent clients seek to clear transactions, they may use non-qualifying CCPs instead of QCCPs. This result is inconsistent with the Committee’s efforts to incentivize clearing through QCCPs.

Together, these increased costs of central clearing as a result of the capital required for default fund contributions to QCCPs and increased margin requirements is at cross-purposes with the G20 mandate to centrally clear all over-the-counter derivatives and will provide further disincentives for central clearing, in direct conflict with the Committee’s and national regulators’ efforts to migrate derivatives transactions to central clearing through QCCPs. Thus, it is critical that any final version of the Proposed Approach more accurately reflect actual bank exposures to QCCP default funds by using only the $K_{CCP}(NIMM)$ as the RLDF and a 50 percent risk weight, or at least less than a 100 percent capital charge, for the exposure to avoid these negative consequences.

* * *

³² See Leverage Ratio Consultative Document, at ¶¶ 23–29

³³ See *id.* at ¶¶ 19, 27.

³⁴ See Interim Rule, at 12.

³⁵ *Id.*

Thank you for considering the concerns and recommendations raised in this letter. If you have any questions or need further information, please contact Allison Lurton, Deputy General Counsel, at 1 202-466-5460 or alurton@futuresindustry.org, or Jacqueline Mesa, Senior Vice President, Director of International Relations and Strategy, at 1 202-466-5460 or jmesa@futuresindustry.org.

Respectfully submitted,

A handwritten signature in cursive script that reads "Walt L. Lukken".

Walt Lukken

President & Chief Executive Officer
Futures Industry Association

About the Futures Industry Association

Based in Washington, D.C., FIA is the primary industry association for centrally cleared futures and swaps. Its membership includes the world's largest derivatives clearing firms as well as exchanges and clearinghouses from more than 20 countries. FIA seeks to promote best practices and standardisation in the cleared derivatives markets, provide policymakers with an informed perspective on the derivatives markets, and advocate for the interests of its members, its markets and its customers. FIA strives to protect open and competitive markets, protect the public interest through adherence to high standards of professional conduct and financial integrity, and promote public trust and confidence in the cleared markets.