Saudi Banks Comments on BCBS Consultative Document regarding Capital treatment of bank exposures to central counterparties

Bank # 1

1. **Page 2 (para 13) - Issues identified in development of the interim rules**

   Bank Response:

   The definition of Qualifying CCPs (QCCPs) and non-QCCP remains unclear. For instance, what will be the capital treatment if a national supervisor determines that a CCP falls under the "Qualifying" category but supervisors in other jurisdictions have not considered it as a QCCP.

2. **Page 6 (para 22) - Risk Sensitivity**

   Under the PFMIs, a CCP's total default resources must be sufficient 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.

   Bank Reponse:

   In case of CCP default, losses are expected to spread more widely when there are more Clearing Members (CMs), which could lead to more severe systemic/contagion risks. An assumption of two simultaneous defaults seems to be reasonable for less than hundred CMs, but where the number goes higher then more simultaneous defaults is a realistic possibility. It is, therefore, suggested that the default fund should be higher to capture more simultaneous defaults, in case of CCPs with large number of CMs.

3. **Page 15 (para 66) - QIS**

   The Committee is conducting a quantitative impact study to assess the impact of the proposals and will use the underlying data to assess the impact and suitability of the proposed approaches. It expects a wide range of central counterparties to participate in the study because of the material effects of the revisions on the capital treatment that will apply to their participants' CCP exposures.

Bank Response:

Since the impact of proposed changes can be significant on the industry; preferred approach would be to conduct an observation period (rather than immediate implementation) for proposed CCR capital requirements. Observation period would provide time to evaluate the impact of such requirements and allow an opportunity for refinements, or for more appropriate and accurate assessment of the capital requirements. In case observation period is not practicle, a gradual transition (e.g. over 2 ~ 5 years) to introduce CCP capital requirements may be used.

Bank # 2

The Current Exposure Method (CEM) used by local banks to calculate the Counterparty Credit Risk (CCR) capital requirements is recognised in having material shortcomings due to risk insensitivity (e.g: failure to recognise diversification benefits and risk mitigants) which can materially overstate the true risk. The proposed Non-Internal Model Method (NIMM) is to address these shortcomings.

Bank comments are as follows:

These shortcomings in the interim rules for capital treatment of banks' exposure to central counterparties (CCPs) would be addressed by proposals brought out in the document. However, our bank’s view is that these shortcomings would not be as significant for developing countries banks as their portfolio's are generally smaller and less diversified application to measure CCP exposure to its clearing members is not as relevant given the lack of CCPs in the local banking sector of developing countries.

The QIS study will be important in determining the impacts of the application of this new methodology to local banks in order to facilitate the calibration requirements allowing an opportunity for refinements.

Banks bilateral discussions would be appropriate to further assess the applicability of the new methodology.

<u>Bank # 3</u>

<u>Bank's Comments</u>

Background

This document is the continuation of the interim draft of June 12 and the objective of the suggested changes is to establish a capital treatment that ensures banks' exposures to CCPs are adequately capitalized, while preserving incentives for central clearing, and promoting robust risk management by banks and CCPs. The changes respond to evidence in the interim rules could lead both to instances of very little capital being held against exposures to some CCPs, and potentially in certain cases, to capital charges higher than for bilateral transactions. There was also concern that, in some cases, the capital treatment might create disincentives to the maintenance of generous default funds. The proposed changes seek to address those concerns. <u>There are two aspects of the capital charge- one is related to capital treatment of bank's contribution to CCPs default fund and the other is related to the capital treatment of bank's trade exposure to CCPs</u>.

Capital Treatment of bank's contribution to the CCPs default fund

Bank agrees with the idea that the primary source of risk in a CCP comes from the possibility of a member's default on the trades cleared by the CCP, and the potential insufficiency of the margin and prefunded default fund contribution posted to the CCP by the defaulter to cover this default. The overall aim of the proposals is to achieve a quantum of total capital that satisfies the resilience and loss absorbency objectives, without undermining the broader G20 mandate to promote central clearing of OTC derivatives, and in particular, therefore, without exceeding the level of capital that would be required if the same trades were executed bilaterally and were not centrally cleared.

The document has proposed two options- "Ratio Approach" and "Tranches approach".

The "Ratio Approach" sets a capital charge based on the minimum level of default resources that a CCP must maintain under the CPSS-IOSCO Principles for Financial Markets Infrastructure (PFMIs), or, if higher, a hypothetical level of default resources calculated using a BCBS-approved methodology for measuring derivative exposures. This approach adjusts the risk weight on members' actual contributions to prepaid default resources according to the ratio of this minimum or hypothetical level to actual prepaid default resources.

The advantages of this approach include ensuring the loss absorbency of the minimum default fund, avoiding material disincentives towards increasing the default fund, relative simplicity, and risk sensitivity.

The “tranches approach” compares the prepaid member contribution to a QCCP default fund with a reference level. For the purposes of calculating capital charges, member contributions to the default fund are split into two tranches, that part (if any) which is below the hypothetical level, and that part (if any) which is above the hypothetical level. A capital charge is calculated on each tranche. There is potentially a further capital tranche to reflect any ‘shortfall’ in prepaid default resources beneath the hypothetical level.

Our responses to the questions raised in the document are as follows:

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

Response

The Bank views “Ratio Approach” as a better approach since it is easier to implement and satisfy various objectives of the capital treatment mentioned above.

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?***

Response

In the Bank’s view, using greater of 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, is a conservative approach and should be retained as a starting point. However, as NIMM is implemented and found suitable over a period of time, it may be retained as the only option.

Q3: ***What risk weights / capital charges would best achieve, or appropriately balance, the objectives? 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?***

<u>Response</u>

Bank has no comments on this aspect as we prefer the "Ratio Approach" rather than the "Tranches Approach".

Capital Treatment of bank's trade exposure to the CCPs

A bank's trade exposures to a CCP consist of three components:

- The mark-to-market current exposure to the CCP on the banks' cleared portfolio;
- The potential future exposure to the CCP on that portfolio; and
- The initial margin posted to the CCP, where not posted in a manner that makes it remote from the insolvency of the CCP.

<u>Bank comments</u>

1. Bank supports the risk sensitive formula proposed with a minimum risk weight of 2% (where the QCCP holds prefunded default resources significantly in excess of the benchmark requirement) and a maximum of 20%. This floor is motivated by the recognition that there is a non-zero risk that the QCCP may default for reasons other than member defaults. The cap is with the aim of ensuring that the aggregate capital charge does not create a disincentive to central clearing relative to a non-cleared trade, for which the risk weight applied to trade exposures to a highly-rated counterparty would not normally be less than 20%.

2. As regards risk weights relating to posted initial margins we agree with proposal of a 2% risk weight on non-insolvency remote posted initial margin if a QCCP has legally enforceable rules establishing that losses beyond its prefunded default resources will fall first on surviving clearing members' mark-to-market exposures – for example through variation margin haircutting – and only thereafter on surviving members' initial margin.

3. As regards capital treatment of commitment to top up the default fund, we have no comments to offer as we need clarity on the legal issues regarding limited or unlimited commitment to the top up the default fund.

Bank # 4

Comments

1. While it is also acknowledged that banks should be incentivized to make increased use of Central Counterparties (CCP) and the proposed methodologies appear to be conceptually sound, the proposed capital charges are largely based on the NIMM which is currently being assessed under the QIS exercise (due for completion by Mid-august 2013). We would therefore need to await the quantification of the capital charges in order to comment fully on whether they adequately reflect the level of risk associated with these exposures.

2. Recognizing the fact that some banks' exposures to CCPs are relatively small in the context of their overall derivative book, for ease of implementation, we see merit in keeping a simplified flat 2% capital charge being applied in cases where notional exposures and/or mark to market values fall below regulatory defined thresholds.

Bank # 5

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

Bank Comments: In the Bank's opinion, the tranches approach best satisfies the objectives. It maintains the interim Method 1 formula whiles addressing "shortfall" in default fund beneath the reference level of default fund. Moreover, it addresses committed contributions to top-up default funds without imposing additional capital charge.

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?***

Bank Comments: Bank agrees with the proposal that using the greater of the minimum cover level or the hypothetical level would discourage QCCPs to reduce Cover to gain competitive advantage and reduce their capital. However, the imbedded assumption in using NIMM that CCP is bank may potentially result in calculating a punitive amount of capital.

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?***

Bank Comments: Bank believes that the impact of this can only be assessed properly after a QIS.

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

Bank Comments: Bank believes that the capital treatment of banks' trade exposure to QCCP should not be considered in isolation of the capital treatment of banks' contribution to QCCP default fund as the combined effect could create unintended disincentives to use central clearing.