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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
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27 September 2013

Dear Sirs

BCBS Consultative Document on Capital treatment of bank exposures to central counterparties

Standard Chartered is pleased to provide our response to the Basel Committee on Banking Supervision's (BCBS) consultative document "*Capital treatment of bank exposures to central counterparties*" (BCBS253), issued for comment on 27 September 2013.

We support the BCBS target for meaningful and feasible framework. Our response focuses on elements of the consultative document that stand to motivate and influence the expansion of central clearing. The calibration of the requirements in BCBS253 departs materially from the previously proposed 2% capital charge. This appears to be overly conservative and disproportionate to the level of credit risk involved in central clearing, which may ultimately discourage the propagation of central clearing itself.

We also believe that the proposal may not provide sufficient incentives for the central counterparties (CCPs) to invest in the improvement of their risk systems and methodologies and discourages fundamental CCP risk practices, notably the intended function of a default fund.

Our detailed responses are included in the Appendix.

Yours faithfully



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Appendix

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

Two approaches – Ratio and Tranches approaches – were proposed in BCBS 253 in order to calculate the capital requirements for Client Members ("CM") pre-funded contributions to the QCCP's default fund.

Ratio Approach:

$$K_{CM_i} = 8\% \cdot 1250\% \cdot \left[\left\{ \frac{RLDF}{DF_{CCP} + DF_{CM}^{pref}} \right\} \cdot \left(\frac{DF^{cover*}}{DF^{cover*} + DF_{CCP,junior}} \right) \cdot (DF_i^{pref}) \right]$$

Tranches Approach:

$$K_{CM_i} = \frac{DF_i^{pref}}{DF_{CM}^{pref}} \cdot \begin{cases} c_2 \cdot \{(RLDF - DF_{CCP}^{pref}) + DF_{CM}^{pref}\} & \text{if } DF_{CM}^{pref} < RLDF & (i) \\ c_2 \cdot (RLDF - DF_{CCP}^{pref}) + c_1 \cdot (DF_{CM}^{pref} - RLDF) & \text{if } DF_{CCP} < RLDF \leq DF_{CM}^{pref} & (ii) \\ c_1 \cdot DF_{CM}^{pref} & \text{if } RLDF \leq DF_{CCP} & (iii) \end{cases} \quad \text{Where:} \quad \begin{cases} c_1 = 16\% \cdot \frac{RLDF}{DF_{CM}^{pref}} \\ c_2 = 100\% \end{cases}$$

Both proposed approaches include the concept of RLDF on which we have specific comments regarding the level of conservatism implied in its calculation. Standard Chartered has provided comments on BCBS 254 regarding the proposed methodology to calculate capital requirement based on the NIMM approach. Although we are in favour of a more granular and more consistent approach with IMM methodology to calculate exposure, we believe the proposal introduces a high level of conservatism in the calculation. Furthermore, our answer to Q2 in this paper indicates that we do not support the concept of maximum of NIMM and CPSS-IOSCO PFMI cover in the calculation of RLDF.

Notwithstanding our concerns around the calibration of the RLDF level, Standard Chartered believes that the Tranches approach provides a better way to calculate capital related to the Default Fund contribution of a CM. Our analysis indicates that the capital requirement of the Tranche approach is higher when the total capitalisation of the CCP default fund (DF^{pref}) is below the theoretical capital required for the CCP operations (RLDF). However, the capital requirement is about the same level for both approaches when DF^{pref} is between the RLDF and the capitalisation level provided directly by the CCP. This situation puts the CM contribution at greater "risk" and both approaches reflect this fact adequately. Finally, the capital requirement is lower in the Tranche approach when the CCP has been capitalised by its own funds at a level higher than the RLDF, at which point the capitalisation requirement for the Tranche approach is a fraction of the Ratio approach.

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On this basis, the Tranche approach appears to provide a much more risk-sensitive capital requirement, with a higher capitalisation level required in case of weak CCP coverage by own funds, and a lower level when a CCP is well capitalized reducing therefore the risk to its CMs.

Therefore, we favour the Tranche approach over the Ratio approach. However, we continue to believe that the RLDF calibration as it stands is extremely conservative and needs to be reconsidered.

Q2. What are the pros and cons of using the greater of the minimum Cover* level required by the CPSS-IOSCO PFMIIs 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?

We do not support the proposal to use the greater of the minimum Cover* level required by the CPSS-IOSCO PFMIIs and the NIMM hypothetical level of default resources. We believe that a single measure of CCP capital requirement should be used, that this measure should be universally accepted and provide no arbitrage opportunities. Based on these principles, Standard Chartered favours the use of the NIMM approach as the single measure of CCP hypothetical capital requirements. However, as stated in Q1, we have prepared a response to the BCBS 254 paper concerning the calibration of the NIMM approach and strongly believe that the current proposal includes a large amount of conservatism in the assessment of CCP hypothetical capital. We have identified the following concerns around the use of the greater of CPSS-IOSCO PFMIIs and NIMM.

1. The inclusion of CPSS-IOSCO PFMIIs in the calculation of the RLDF may bring arbitrage opportunities or inconsistent theoretical capital requirements. Whilst the current proposal may appear to be more stringent as it ensures the reference default resources are always set at the higher of the two levels, it potentially creates an inconsistency problem as PFMIIs requirements may vary in different jurisdictions for the same CCP. As a result, CMs located in different countries may end up applying different RLDF for their CCP exposure estimation, leading to potential large variations in the regulatory capital requirements modeling and thus introducing an unlevel playing field.
2. Conservatism in the assessment of the Cover*. The Cover* method combined with a 1250% risk weight (RW) implies that DF contributions are likely to be lost in their entirety on a regular basis. This has not been the case historically; moreover, industry risk management practices have advanced both naturally and through regulatory initiative. We believe that the application of a 1250% risk weight fails to consider these advancements and is further misaligned to activities of similar risk profile within the risk-based capital framework.

Furthermore, initial analysis done by the industry have shown that Kccp (NIMM) will not exceed Cover*, which means the resultant capital requirements will be based on a measure of risk that is inconsistent with the other elements of the risk based capital framework and would result in capital charges that make central clearing uneconomical.

3. Incompatible basis of reconciliation of capital requirements between both the Cover* and NIMM approach. We note that Cover* is a funded tail loss estimate, conditioned on the default of 1 or 2 clearing members with the largest impact, whereas hypothetical capital is a risk weighted expected exposure measure. The two methods are different measures of risk, intended for different purposes. Hence, we doubt whether they could be compared directly for the purpose of computing capital requirements against DF exposures.

In view of above arguments, we support RLDF = Kccp (NIMM) as the more appropriate approach to compute the hypothetical capital of CCP's. NIMM will correctly consider and scale with a future-state clearing environment, notably client clearing, and create a level of capital that encourages FIs to act as clearing members and thereby serve the G20 purposes.

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?

We believe that the hypothetical capital should be calculated based on NIMM. We further believe that NIMM should be less conservative than what is currently proposed in BCBS 254. In the situation where Cover* has to be used, we believe that the risk weight applied should be in line with the probability of one or two members defaulting.

The 1250% risk weight is only appropriate if RLDF represents a risk-weighted hypothetical capital amount. This is the case if the cover funds measure is appropriately risk weighted, i.e. $RLDF = \max\{ (RW \times Cover^*), Kccp (NIMM) \}$, where RW is an appropriate risk weight; or alternatively, if $RLDF = Kccp (NIMM)$. For any other condition, the application of 1250% RW (specifically to the Cover* measure) without consideration of the risk of clearing members defaulting could render clearing uneconomical.

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

Comparing with the previously fixed 2% RW for trade exposures to CCPs, the new proposal now only takes 2% as floor and the actual RW is determined by the size of total pre-funded default funds (contributed by both the CCP and the members) relative to the RLDF of the QCCP, as shown below.

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$$RW_{TE} = \min \left[\max \left\{ 5\% \cdot \frac{RLDF}{DF_{CCP} + DF_{CM}^{pref}}; 2\% \right\}; 20\% \right]$$

We welcome the risk adjusted capital requirement for trade exposure as better capitalized CCP are less likely to require additional funds to compensate for losses on trade exposure due to a clearing member default. Although the approach has some merits, as specified in the drafted response of the [TCH], the [GFMA], the [IIF], and the International Swaps and Derivatives Association ("ISDA") to BCBS 253, the 2% calibration was already too high and therefore the proposal to adjust the capital requirement for trade exposures starting at 5% seems to be overly conservative. We recommend considering an amendment of the calculation as follows:

$$RW_{TE} = \min (2\% * RLDF / (DF_{CCP} + DF_{CM}^{pref}); 20\%).$$

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?

We think it is fair to consider IM as a senior claim to VM in the event of losses exceeding the default fund resources when one or multiple clearing members default and the QCCP has legally enforceable rules on initial margins. In addition, we consider this to be a strong argument supporting our point under Q4 that the risk weight for trade exposures should be less than 2% in cases where the CCP is well capitalized.

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?

We noticed that calculation for capital requirements on committed contribution exposures (CCEs) was removed in the latest CRR regulation. As CCE represents a part of the contingent exposure that arises only after the default fund depletes, it might be appropriate to be incorporated into the DFE formula. In this aspect, the two proposed modified models seem to be intuitive. Nevertheless, since DF_i^{comm*} and DF_{CM}^{comm*} refer to committed contributions in contingent cases where replenishment for DF is required in future, the way to incorporate DF_i^{comm*} and DF_{CM}^{comm*} into the DFE K_{CMI} formula should be slightly different from that how DF_{CCP} or DF_{CM}^{pref} is incorporated – perhaps by probability-weighting to these parameters to reflect the contingency nature of future DF replenishments.

Modified DFE capital requirement:

$$K_{CM_i} = 8\% \cdot RW \cdot RLDF \cdot \left[\left(\frac{DF_i^{pref} + DF_i^{corren*}}{DF_{CCP} + DF_{CM}^{pref} + DF_{CM}^{corren*}} \right) \cdot \left(\frac{DF^{corret*}}{DF^{corret*} + DF_{CCP,junior}} \right) \right]$$

Modified TE RW:

$$RW_{TE} = \min \left[\max \left\{ RW \cdot \frac{RLDF}{DF_{CCP} + DF_{CM}^{prefunded} + \alpha \cdot DF_{CM}^{comm*}}, 2\% \right\}, 20\% \right]$$

We also agree to incorporate this contingent future commitment in the denominator of the Modified TE RW formula since such commitment should make the CCP DF more robust and hence reduce the institutions' RW_{TE} .

In addition to the above points, we have the following comments about the above modified formula:

1. We suggest RLDF be replaced by $K_{ccp}(NIMM)$ – reasons as given in the response to Q2.
2. The rationale for " $\alpha = 0.5$ " in the modified TE RW formula remains unclear to us though it appears to be reasonable as at this stage in the waterfall some large clearing members may have defaulted therefore certain top up default funds will no longer be available.
3. Proper values for RW in above two formulas are yet to be defined. For modified RW_{TE} , as proposed in our response to Q4, we believe the RW should be set at a maximum of 2%; on the other hand, for modified DFE K_{CM_i} , as pointed out in our response to Q3, the RW value should be much smaller than 1250% due to the CPSS-IOSCO PFMI approach.