27 September 2013

Via Email: baselcommittee@bis.org

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Dear Sirs,

FEEDBACK ON BASEL COMMITTEE ON BANKING SUPERVISION'S CONSULTATIVE DOCUMENT ON CAPITAL TREATMENT OF BANK EXPOSURES TO CENTRAL COUNTERPARTIES

1. We refer to the consultative document on the capital treatment of bank exposures to central counterparties issued by the Basel Committee on Banking Supervision ("**BCBS**") in July 2013.

2. We welcome the opportunity to submit our comments on the proposed changes to the capital treatment of bank exposures to central counterparties. Our response to the consultative document is enclosed.

3. If you require further clarification, please do not hesitate to contact Mr Shekhar Mehta (Email: Shekhar.mehta@sgx.com) or Mr Jerome Amon (Email: Jerome.amon@sgx.com).

Yours sincerely,

GRACE MOK
HEAD, MEMBER SUPERVISION
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CONSULTATIVE DOCUMENT ON CAPITAL TREATMENT OF BANK EXPOSURES TO CENTRAL COUNTERPARTIES

SGX Comments

27 September 2013

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1. INTRODUCTION

1.1 Singapore Exchange Limited ("**SGX**") welcomes the opportunity to submit its comments on the Basel Committee on Banking Supervision's ("**BCBS**") consultative document issued in July 2013 in relation to the capital treatment of bank exposures to central counterparties ("**CCPs**").

1.2 SGX operates two clearing house entities in Singapore, namely the Singapore Exchange Derivatives Clearing Limited ("**SGX-DC**") and The Central Depository (Pte) Limited ("**CDP**"). SGX-DC provides clearing services for exchange-traded derivatives contracts and over-the-counter commodities and financial derivatives contracts. CDP provides clearing services for securities and security-based derivatives contracts. The two clearing house entities are regulated by the Monetary Authority of Singapore as approved clearing houses under the Securities and Futures Act of Singapore.

2. COMMENTS

2.1 ***Question 1: Which of these two proposed methodological approaches best satisfies the objectives which the capital treatment seeks to achieve and why?***

The tranches approach is conceptually easier to understand and apply, because it clearly identifies the different thresholds giving rise to different capital charges. It is also consistent with the current methodology set out in the interim framework.

Notwithstanding the above, SGX is of the view that both approaches unduly emphasise the junior contribution of the CCP. The overall contribution of the CCP (comprising junior and intermediate layers) is designed to reduce contagion risk and should be taken into account when assessing the level of protection afforded to clearing members' monies.

2.2 ***Question 2: 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?***

DF Cover* is the combination of two conservative assumptions: the default of the largest member (or of the two largest members) under extreme but plausible scenarios. While this serves as the basis for sizing the total Default Fund, using it as the determinant of capital requirements would lead to an excessive capital charge given the remoteness of such tail event. In that respect, SGX is of the view that DF Cover* should be associated or incorporated with a probability or confidence level to provide a consistent measure of capital and be in line with the overall bank capital adequacy framework.

Moreover, stress losses are scenario- and position dependent and can vary greatly from one day to another as the underlying portfolio changes on specific roll, rebalancing dates or arbitrage positions traded/cleared at two venues. This could lead to material changes in DF Cover*.

While "extreme but plausible" scenarios have been clearly defined under the CPSS-IOSCO Principles for Financial Markets Infrastructures ("**PFMI**") and include the coverage of peak historic volatilities, banks under the Basel framework are not required to meet the stringent PFMI standards in their stress test scenario definitions. Thus, this discrepancy could potentially lead to a form of "arbitrage" when assessing capital charge between centrally cleared- and bilateral transactions.

While we are cognisant of the limitations of Kccp (NIMM) and DF Cover* as a capital measure, SGX is not in favour of using DF Cover* for the reasons above, and is of the view that Kccp (NIMM) alone should be considered.

2.3 ***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?***

Our analysis suggests that capital charges on Default Fund contributions could substantially increase under the proposed framework, in particular following the introduction of DF Cover* in the models.

SGX is concerned by this potential sharp increase in capital requirements due to the new methodology.

While SGX is mindful of BCBS' objective to ensure adequate capitalisation of bank exposures to CCPs, imposing excessive capital charges would further narrow the gap with bilateral transactions and could jeopardise the G20 commitment to promote central clearing.

On the proposed 1250% risk weight, SGX is of the view that this is too punitive and will likely disincentivise central clearing as it substantially increases the cost of clearing in many CCPs. Default Fund contributions are intended to cover only the "tail risk" beyond margin requirements and are seldom used (in the case of SGX, never used). BCBS is requested to consider a lower risk weight for the Default Fund contribution.

SGX has assessed the impact of the proposed framework and the results indicate a significantly higher increase of capital charge for Default Fund exposures as compared to trade exposures. This could have undesirable effects. For example, CCPs might be tempted to increase margins and reduce clearing members' default fund contributions, thus diminishing the benefits of risk mutualisation.

This is also expected to give the larger CCPs (with a greater number of clearing members) an unfair advantage as they would have lower Default Fund exposure per clearing member and therefore most of the clearing member's capital charge would come from trade exposures. As such, the proposal would go against the objective of promoting financial stability by pushing banks to concentrate their transactions in few large CCPs, and which might eventually lead to huge concentration risks.

2.4 ***Question 4: The Committee invites comments on this potential risk sensitive approach to capitalising trade exposures to CCPs.***

While not fundamentally opposed to a risk sensitive approach, SGX would like to reiterate its concerns regarding the use of DF Cover* and its recommendation to use Kccp (NIMM) alone as the numerator in the proposed formula.

Also, the choice of 5% as a parameter in the proposed formula implies a Default Fund size of at least 2.5 times the DF Cover* (or RLDF in the alternative formula) in order to maintain a risk weight of 2% on clearing members' Default Fund contribution. We believe that this is too severe and would instead recommend using a 2% parameter in order to preserve the 2% risk weight as long as the total Default Fund remains equal or above DF cover* (or RLDF).

In addition, SGX also considers the cap of 20% excessive. Applying a 20% risk weight does not recognise the structural benefits of clearing as compared to a bilateral transaction with a bank.

Finally, SGX notes that client exposures have not been covered in the consultative document[1]. SGX urges BCBS to revise/scale accordingly capital charges for client clearing so as to avoid distortion between clearing members and clients of clearing members.

2.5 ***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?***

SGX does not have comments on this proposal.

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1 Under the interim framework, where a bank is a client of a clearing member, the applicable risk weight would be either 2%, 4% or as bilateral transaction, depending on certain conditions.

2.6 ***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?***

SGX is of the view that it is pertinent to include unfunded commitment in the denominator of the proposed trade exposure risk sensitive approach. However, SGX does not have comments on the proposed factor of 0.5 at this stage as additional analysis would be required to ensure suitability of this number.

3. CONCLUSION

3.1 SGX would like to thank BCBS for the opportunity to participate in the consultation process. Please do not hesitate to contact Mr Shekhar Mehta (Email: Shekhar.mehta@sgx.com) or Mr Jerome Amon (Email: Jerome.amon@sgx.com) if you have any questions. We look forward to being involved in future public consultations.

3.2 As the proposed changes to the interim framework in the current consultation are extensive, more time is needed to conduct a full impact analysis and SGX might provide additional comments at a later stage.