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

27 September 2013

**Re: Basel Committee on Banking Supervision Consultative Document on Capital treatment of bank exposures to central counterparties**

Dear Sir/Madam,

UBS would like to thank the Basel Committee on Banking Supervision for the opportunity to comment on the Consultative Document on Capital treatment of bank exposures to central counterparties. Please find attached our response to the consultation.

We would be happy to discuss with you any comments you may have. Please do not hesitate to contact Andrew Bell on +44 20 7568 1385.

Yours sincerely,  
UBS AG

A handwritten signature in brown ink, appearing to read "Rahul Dhumale", with a horizontal line drawn underneath.

Rahul Dhumale  
Managing Director  
Head of Group Risk Regulatory Management

A handwritten signature in brown ink, appearing to read "Carlo Pellerani", with a horizontal line drawn underneath.

Carlo Pellerani  
Managing Director  
Deputy Group Treasurer

## **UBS response to the Basel Committee on Banking Supervision's Consultative Document on the Capital treatment of bank exposures to central counterparties**

### **EXECUTIVE SUMMARY**

UBS would like to thank the Basel Committee on Banking Supervision (BCBS) for the opportunity to respond to the Consultative Document on the Capital treatment of bank exposures to central counterparties. Please see below our general comments on the consultation and responses to the specific questions.

We fully support the stated objective of the proposals which is to ensure banks' exposures to central counterparties are adequately capitalised whilst preserving incentives for central clearing and promoting robust risk management by banks and CCPs. However, we believe that the proposed measures in this Consultative Document in aggregate would result in significantly higher capital charges for centrally cleared derivatives relative to bilateral derivatives, which seems to contradict the regulatory goal of promoting central clearing and thus runs contrary to the G20 objectives agreed in Pittsburgh in 2009.

We have three key concerns to raise with the BCBS proposals. Firstly, we are concerned that in the vast majority, if not all, cases, Cover\* rather than NIMM will be the binding Reference Level of Default Fund Resources (RLDF). We do not consider Cover\* to be an appropriate measure of RLDF as Cover\* is a scenario based stress measure whereas NIMM is a formulaic, statistical based procedure and thus consistent with the exposure measures used for bilateral trades and all other counterparty exposures.

Secondly, we are concerned that the application of a 1250% risk weight to default fund contributions equal to Cover\* or the hypothetical level of default fund resources calculated using NIMM effectively assumes a 100% probability of loss and 100% loss given default of the default fund contribution across each CCP. We do not believe this accurately reflects the risk of default fund contributions in absolute terms, and also relative to the risk weights applicable to non-cleared derivative transactions, which results in it conflicting with the G-20 goal of incentivizing central clearing. We have proposed in our response an approach that builds upon the industry's proposed risk-based approach (as set out in the joint trade associations' response to this Consultative Document) while also addressing concerns regarding bank solvency upon a default fund

drawdown. It calls for a universal capital charge founded upon the ISDA risk-based approach plus a supplemental capital charge applicable to banks for which default fund losses would threaten their viability. The combined charges could result in an effective risk weighting for default fund contributions as high as 1250% for any bank for whom loss of its full default fund contribution would threaten its viability. The risk-weighting would be floored at the risk-based level for banks whose capital ratios would not be dangerously impaired by default fund drawdowns.

Thirdly, whilst we support the BCBS's intention to take a more holistic view of bank exposures to CCPs, we do not believe this justifies increasing the risk weights for trade exposures to CCPs given the very significant protection from losses provided to such exposures by the CCP default waterfall. Rather, we believe a more holistic view of bank exposures to CCPs, and one which recognizes that clearing member risk to CCPs exists on a continuum, would be more appropriately achieved by increasing the risk sensitivity of default fund contributions.

Taken together, we believe these features of the Consultative Document will result in a non-risk based capital framework for bank exposures to CCPs which is inconsistent with the wider Basel III risk-based capital framework and will potentially make central clearing uneconomic for firms to offer clearing services.

Also, whilst we recognise that the consultation does not address the capital treatment of bank exposures to non-qualifying CCPs, we highlight that local implementation of the G20 objectives on derivatives reform could result in banks having exposures to CCPs that meet the CPSS/IOSCO QCCP criteria but still do not qualify as QCCPs for the purposes of the local rules (such as under EMIR and CRD IV in the EU). This results in a highly punitive capital treatment for bank exposures to such CCPs. We therefore encourage BCBS/IOSCO to work on a more risk sensitive capital treatment for bank exposures to non-qualifying CCPs.

### **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 clearing member capital requirement on the default fund contribution is similarly captured in both the ratio and tranches approach, given the same capital factors are used in both formulations outlined in paragraphs 27 and 37 of the Consultative Document. We have a slight preference for the tranches approach as we consider this to better reflect the different level of risk within different parts of the default fund and thus be more consistent with the economics of how losses would actually be allocated. We note, however, that neither the tranches nor ratio approach accurately reflects the relative risk of different “tranches” of the default fund.

We acknowledge that the ratio approach holds appeal in terms of its simplicity of implementation. However, we strongly recommend the removal of the Cover\* function in the ratio approach due to our concerns on using Cover\* in calculating default fund capital requirements. We recommend the use of NIMM for RLDF as set out elsewhere in our response. We also recommend DFccp, the total amount of the CCP's own contribution to default resources, to be subtracted from RLDF in its use in the ratio approach formula in paragraph 27 to take into account the CCP's own capital contribution to the default waterfall structure.

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?

From a conceptual point of view, we highlight that the requirement to hold capital against the potential for losses on default fund contributions results in capital being held against a risk mitigant rather than the risk itself. This is a questionable approach in our view and is inconsistent with the Basel framework more generally where capital requirements are a function of the probability of default and loss given default of a given exposure.

Paragraph 24 of the CP states that *“The Committee expects QCCPs’ margin coverage policies and the stress scenarios used to calculate minimum default funds under the PFMLs will in most cases mean that the minimum Cover\* default fund is larger than the hypothetical default fund requirement calculated under NIMM. However, using the Cover\* requirement alone might create an incentive for QCCPs to adjust the stress scenarios used to calculate the Cover\* requirement in order to reduce the capital charges faced by their bank clearing members, possibly, to try and gain competitive advantage”*.

We believe the statement in the Consultative Document that QCCPs may have an incentive to adjust the stress scenario in order to reduce bank capital charges highlights an important concern with the proposal, namely the fact that QCCPs have a significant level of discretion as to the level of Cover\*. This is problematic because Cover\* is not an accurate measure of the probability of default and loss given default of the CCP, but is rather dependent on the methodology chosen by the QCCP to calibrate the default fund. This depends, inter alia, on the QCCP’s margining policy and risk appetite which will determine the extreme but plausible stress scenarios used to size the default fund (we recognize that discretion is constrained to some degree by the need to meet the relevant regulatory minimum default fund size calibration). This element of QCCP discretion in the calculation of Cover\* could materially undermine the extent to which default fund capital requirements are comparable across different QCCPs and mean banks may be required to hold either more or less than the level of capital that would accurately reflect the risk of loss of the default fund contributions. It appears that the BCBS recognizes this concern, as set-out in footnote 5 of the Consultative Document, but it is not clear how it proposes to address this.

We do not consider Cover\* to be an appropriate measure of RLDF as Cover\* is a scenario based stress measure whereas NIMM is a formulaic, statistical based procedure and thus consistent with the exposure measures used for bilateral trades and all other counterparty exposures. In our view, a bank’s capital requirement for its default fund contribution should be calculated via an appropriately calibrated NIMM.

Given that NIMM is a supervisory based approach we see no reason to set a less risk sensitive RLDF floor (namely Cover\*). **We therefore propose that Cover\* is not used as a determinant of the RLDF and that KCCP(NIMM) is used as the RLDF.**

Although we strongly prefer the use of NIMM over Cover\* for the reasons set out above, we note that the proposed inclusion of an alpha parameter in NIMM is likely to increase, unjustifiably in our view, the capital requirements for cleared derivative exposures vis-à-vis bilateral derivatives exposures and disincentivise the use of clearing. We understand that the 1.4 alpha parameter is designed as a wrong-way risk adjustment but we believe this should be revisited and reduced appropriately in the context of capitalizing clearing activity which has been promoted by the regulatory framework. We believe the use of the 1.4 alpha multiplier along with an effective 100% capital requirement on default funds contributions would make a centrally cleared transaction much more expensive than an equivalent bilateral transaction, which conflicts with the objective of incentivizing central clearing.

In addition, we are of the view that the 5% NIMM floor (as proposed in BCBS 254 “The non-internal model method for capitalising counterparty credit risk exposures”) should be removed when NIMM is used to calculate Kccp (NIMM) given that clearing members only post collateral to CCPs and not the other way around.

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 respect of the ratio approach, paragraph 29 of the Consultative Document states that *“The intended impact of the formula is that if members contribute sufficient default funds to achieve exactly the Cover\* requirement, or, if higher, a default fund exactly equal to the hypothetical level of default resources calculated using NIMM, and there is no junior contribution to the default fund from the CCP itself, then a 100% capital charge would apply to those contributions”*. We do not consider this appropriate as it assumes the entire default fund contribution would be wiped out which implies a 100% probability of default and a 100% loss given default. Overall, whilst cleared trade exposure capital requirements are lower than for bilateral trades, we believe the aggregate amount of the default fund and trade exposure capital requirements will make clearing more expensive than bilateral transactions. This will disincentivise central clearing and run contrary to the G20 objectives for OTC derivatives reform.

Given that QCCPs will apply robust margining requirements and other risk mitigation techniques, we believe the assumption of a 100% loss on the default fund contribution materially overstates the risk and is inappropriately calibrated relative to the capital requirements for bilateral transactions. More specifically, we note that before a non-defaulting clearing member loses any portion of its default fund contribution as a result of the default of any other clearing member, it would be necessary that (i) the defaulting clearing member's initial margin calibrated at no less than a 99% confidence interval over 5-days was insufficient, (ii) the default fund contribution of the defaulting clearing member was insufficient and (iii) the contribution to the default waterfall by the CCP itself was insufficient.

This links to a further key observation that the first dollar of the default fund is substantially more at risk of loss than the last dollar. So even if the first dollar of the default fund should attract a 100% capital charge, which for the reasons set-out in this response we do not support, the final dollar of loss should receive a lower capital charge to reflect the additional protection it receives from being more "senior" in the loss allocation structure of the default fund. Whilst we see merit in differentiating between the different "tranches" of risk within a clearing member's default fund contribution up to the level of Cover\* or the hypothetical level of default fund resources calculated using NIMM (noting that the approaches set out in the Consultative Document do give credit for tranching of risk above the RLDF), we believe it may be easier to reflect this via a weighted average risk weight for the entire default fund contribution. As discussed below, we believe a risk weight of approximately 50% would be appropriate as a base risk weighting for default fund contributions.

We acknowledge, however, that as the OTC derivatives industry evolves towards central clearing, CCPs may become concentration points of systemic risk and that the regulatory requirements relating to CCP risk must take this concern into account.

Paragraph 28 of the Consultative Document states that *"....A 100% capital charge on at least some part of default fund contributions ensures that this part can be lost without material negative impact on the capital ratios of bank clearing members, thus ensuring that at least this part of the default fund can absorb losses without undermining the financial strength of the contributing members. Thus, a risk weight of 1250% is proposed for this calculation"*. Paragraph 33 states that *"The proposed 100% capital charge on at least a minimum part of default fund contributions would ensure that consumption of that portion of the default fund would not materially affect the*

*capital ratios of bank clearing members, thus ensuring that at least this part of the default fund can absorb losses without undermining the financial strength of the contributing members. Arguably, a risk weight lower than 1250% would risk threatening clearing members' ability to absorb losses on their default fund contributions in times of stress".*

Whilst we understand the BCBS's concern regarding default fund draws triggering clearing member failures, we are concerned that such a conservative capital requirement would prove an economic disincentive to central clearing, similar to the concerns identified by the BCBS itself in paragraph 34 of the Consultative Document. In our view, a key weakness of the proposed 1250% risk weighting is that it does not consider that a well capitalized bank, for which default fund exposures are not a large concentration of its overall risk, could comfortably sustain sweeping default fund drawdowns without the viability of the bank being threatened. Consistent with this, we believe the BCBS's concerns would be better addressed through the following two-pronged approach towards risk weighting of default fund contributions:

- **A risk-based charge** reflecting the probability of default and correlation effects associated with a clearing member default. We believe a risk weight of approximately 50% would be appropriate and we direct you to the response of the joint trade associations to this Consultation Document for an explanation of why we consider this appropriate; plus,
- **A supplemental charge** applicable to clearing members for whom a default fund drawdown would leave such a clearing member insufficiently capitalised against potential losses in the remainder of its portfolio of risks.

The supplemental default fund charge would ensure a minimum capital ratio ("cushion ratio") of X% for a bank against its RWAs, exclusive of its default fund related RWAs, after deducting from capital an amount equal to the bank's total Cover\* amount (or Kccp(NIMM) amount) across all QCCPs. Such an approach would have the benefit of implementing risk-based principles in capitalising the default fund contributions of banks whose risk profiles are diversified beyond its contributions to CCP default funds, while still providing the systemic protection against potential serial clearing member defaults by scaling the default fund capital requirement to the bank's ability to sustain default fund drawdown. Importantly in this regard, the combined charges could result in an effective risk weighting for default fund contributions as high as 1250% for any bank for whom loss of its full default fund contribution would threaten its viability. This



approach would also remove the potential economic impediment to cleared OTC trades relative to bilateral clearing posed by the default fund capital requirement.

We acknowledge that a potential concern with this proposal is that, should a bank's overall capital ratio deteriorate due to losses elsewhere in its portfolio, its capital requirements for its CCP default contributions would potentially increase at the same time given the linkage between a bank's overall capital ratio and its supplemental charge under the proposal. In this sense, it could be considered pro-cyclical. However, we would counter this argument by noting that the supplemental charge provides strong positive incentives for a bank acting as a clearing member to be well capitalised in relation to its overall risk profile in order to mitigate the impact of the supplemental charge. In this sense, it could be considered counter-cyclical. Moreover, the X% equity ratio cushion could be subject to supervisory adjustment to enhance the counter-cyclicality of the measure.

We attach for illustration purposes a simple example in the Appendix to this response that sets out how the risk weighting of default fund exposures would vary as function of the bank's concentration of risk, its internally established capital ratio, and the minimum post-drawdown risk weighting requirement (the cushion ratio) that would apply to RWAs exclusive of default fund exposures.

A related issue which will exacerbate the over-conservativeness of the 1250% risk weight is that, although this results in a 100% capital charge for banks subject to an 8% minimum capital requirement, in several jurisdictions, banks will be subject to a minimum regulatory capital ratio higher than 8%. In such a case, the application of a 1250% risk weight will result in a capital charge that exceeds 100% of the exposure amount. In other words, a bank will be required to hold more capital than its exposure and thus the maximum amount it can lose. We do not consider this appropriate.

## 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.

Paragraph 54 states that the capital charge for trade exposures to CCPs would rise to above 2% if pre-paid default fund resources are less than 2.5 times larger than the Cover\* minimum and perhaps to as high as 20% if prepaid default resources do not exceed a hypothetical minimum default resource level calculating using NIMM. We are unclear why the trade exposure capital requirement should increase from 2% in cases where Cover\* is not at least larger than 2.5x the minimum. Provided Cover\* is accurately calibrated to reflect the risk of default fund contributions (although we note our previous comments that this is likely to not be the case), default fund capital requirements should be adequate to absorb a bank's losses to a CCP in a severe stress scenario. We do not therefore believe that it is justified to require multiples of that amount of default fund capital to be held in order to avoid more conservative trade exposure capital requirements.

We believe the current approach where there is a cliff effect between capital requirements for default fund contributions relative to trade exposures is inappropriate. However, we feel the appropriate means of smoothing the cliff is by tying capital requirements more closely to actual risk rather than increasing trade exposure capital requirements when not justified by risk. We therefore believe the existing 2% risk weight for trade exposures should be maintained as we do not consider there to be a risk based justification for increasing it.

We also consider it important that the BCBS clarifies what is meant in paragraph 48 of the consultation where it is stated that "*Alternatively, the hypothetical level of capital resources calculated using the NIMM could be used as the reference point, or as a floor for the Cover\* value. If hypothetical capital using NIMM is used as a floor,  $RW_{TE}$  would become:*" In particular, we are unclear whether the proposal is that NIMM could be used as an alternative to Cover\* in the numerator of the equation in this paragraph, or whether NIMM would somehow floor the risk weight generated by using Cover\* in the numerator.

## **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?

We fully support a 0% risk weight for initial margin collateral that is bankruptcy remote, given that it is protected against the insolvency of the CCP. Consistent with our previous comments that the capital framework for bank exposures to CCPs should recognise the relative seniority in the CCP's default waterfall of a given exposure, we agree that initial margin that is senior to other trade exposures by virtue of legally enforceable CCP rules should benefit from a lower risk weight than such other trade exposures. Again however, we do not believe that ensuring such relativity of capital requirements between exposures of different risk should be achieved by increasing risk weights for other trade exposures as it is important that both the absolute risk weight given the risk and the risk weight relative to the risk of other types of exposure are appropriately calibrated.

## **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  $\alpha$  value of 0.5 appropriate?

As already stated in our response, we strongly believe that Kccp (NIMM) should always be used to calculate the RLDF. We also believe NIMM implicitly captures the risk of multiple clearing member defaults by construction and capitalizes the potential for losses beyond the default fund. We therefore consider it inappropriate to impose any requirement to hold additional capital over and above that required for funded contributions (which already covers a bank's entire funded exposure to the CCP comprising the default fund contribution and trade exposures). In our view, to require additional capital for commitments to top-up default funds would result in double counting of risk and unjustifiably high capital requirements.

## **Other issues**

### **Treatment of bank exposures to non-QCCPs**

We note that the proposals do not cover the capital treatment of exposures to non-qualifying CCPs (non-QCCPs). We are concerned that the existing Basel treatment of such exposures is highly penal and may not accurately reflect the risk of exposures to such CCPs. Whilst we understand that one of the objectives of the existing capital treatment for bank exposures to non-QCCPs is to incentivise clearing members to only participate in QCCPs, and for non-QCCPs to seek to meet the standards necessary to qualify as a QCCP, it may be the case that a CCP meets the relevant standard but still does not achieve QCCP status.

For example, under the EU implementation of the BCBS interim framework for bank exposures to CCPs set out in CRD IV, it is necessary for a CCP to be authorised or recognised under EMIR to be a QCCP, even if the CCP satisfies the CPSS-IOSCO QCCP criteria. As a non-EEA CCP may not wish to transact with EU firms, it may not seek recognition under EMIR. But many banks subject to CRD IV will have non-EU subsidiaries that are clearing members of such non-EEA CCPs that are not EMIR recognized. This means that for the purposes of CRD IV application on a consolidated basis, the bank will have to treat its exposures to the CCP as exposures to a non-QCCP. This will have a significant capital impact as the capital requirements for trade exposures to a non-QCCP are up to 50 times higher (2% risk-weight goes to a standardised risk weight (e.g. 20%, 50% or 100%) than for a QCCP and the default fund contributions (both pre-funded and unfunded/contractually committed) are risk-weighted at 1250%. We therefore believe a more risk sensitive approach to capitalizing bank exposures to non-QCCPs is required to avoid disproportionate capital requirements in scenarios such as the one outlined above.

## APPENDIX

### Example of supplementary capital charge proposal

Example of relationship of Default Fund risk weighting to overall risk and capitalization								
<b>Assumptions:</b>								
Basel min T1+T2 ratio	8%							
Cushion ratio	8%							
Standard D-Fund risk wtg	50%							
					Standard Def Fund			
	Bank target	Bank capital held	Min capital required	Funded Amt	Capital Requirement	Supplemental	Total D-Fund	Default Fund
RWA ex D-Fund	Capital Ratio	Excl Default Fund	after D-Fund drawdown	Default Fund	@ 50% risk weight	Capital Requirement	Capital Requirement	Risk Weighting
-	10%	-	-	50	2	48	50	1250%
250	10%	25	20	50	2	43	45	1125%
500	10%	50	40	50	2	38	40	1000%
750	10%	75	60	50	2	33	35	875%
1,000	10%	100	80	50	2	28	30	750%
1,250	10%	125	100	50	2	23	25	625%
1,500	10%	150	120	50	2	18	20	500%
1,750	10%	175	140	50	2	13	15	375%
2,000	10%	200	160	50	2	8	10	250%
2,250	10%	225	180	50	2	3	5	125%
2,500	10%	250	200	50	2	-	2	50%
2,750	10%	275	220	50	2	-	2	50%
3,000	10%	300	240	50	2	-	2	50%