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EACH response to the BCBS consultative documents entitled "Capital treatment of bank exposures to central counterparties" and "the non-internal model method for capitalising counterparty credit risk exposures".

The European Association of CCP Clearing Houses ("EACH") welcomes the opportunity to respond to the BCBS Consultative Documents on the capital treatment of bank exposures to central counterparties and the non-internal model method for capitalising counterparty credit risk exposures ("the Consultative Documents").

The first section of the response set out general comments and the second section responds to the specific questions in the two consultative documents.

EACH remains concerned that the BCBS proposal could discourage central clearing by requiring members to overcapitalise their exposures to the default fund. We are also concerned that the proposal could have the unintended effect of lowering CCPs' risk management standards by creating incentives for CCPs to reduce the size of the member default fund. Furthermore EACH feels that Cover* is not an appropriate measure and recommends that only the NIMM method is used.

General comments

Appropriateness of using DFCover*

- The consultative document uses DFCover* to determine the capital requirements against CCP default fund contributions. DFCover* is a pre-funded financial resource based on an estimate tail loss assuming the default of 1 or 2 clearing members with the greatest impact. As such, it is not an appropriate measure of exposure, and should not be used for this purpose.
- As an illustration of the perverse effects of using this inappropriate measure, the following points are made:
    1. Based on this proposal the consequence of a CCP increasing its level of protection by moving from Cover 1 to Cover 2 would, if everything else remains unchanged, be an increase in clearing member capital requirements.
    2. Use of DFCover* in the manner proposed effectively implies that a CCP's funded default fund will be fully called each year.

Capitalization of default fund contributions

- It should be reminded that the default funds of a CCP first have to be used when the other lines of defence (intraday margin calls, daily variation margin, initial margin, dedicated own resources, default fund of member in default) have already failed.
- A risk weight of 1250% for the Reference Level of Default Fund (RLDF) largely overestimates the risk a 3rd or 4th line of defence in a default waterfall actually faces. Historical events have proven the resilience of CCPs risk management frameworks where not even the default fund contribution of defaulters had to be drawn completely
- In bilateral trades, where no default fund contribution is required, exposures to counterparts will typically attract a risk weight ranging between 20% and 100%. It is not clear why the RLDF should attract a much higher risk weight when the probability of utilization is far lower than the probability of default in bilateral trades due to the CCPs lines of defence. Under EMIR CCPs are required to have strict access criteria. Some CCPs only allow membership for financial institutions which – generally - have a risk weight of 20%. Imposing a higher risk weight of 20% for exposures to the RDLF does not seem appropriate.
- A risk weight of 1250% for the RLDF might adversely impact the CCPs risk management framework by creating the incentive to reduce the default fund in favour of increased margin requirements. As a result, tail risk will not be effectively mutualised any longer and the risk of moral hazard will increase.
- Furthermore, in line with the reduction of prefunded default funds, also the level of commitments will be reduced. Commitments are available as resources to cover potential losses in case of extreme and unlikely tail events. A reduction of these commitments would translate into an increased probability that these losses will fall on trade exposures.
- The following simple example demonstrates that the 1250% risk weight in combination with the function for determining K_{CMi} of paragraph 27 overestimates the risk run on the Clearing Member's contribution to the Default Fund.

  Assume that:

  1. The Reference Level Default Fund (RLDF) is determined by the CPSS-IOSCO minimum standard Cover 1 or Cover 2 requirement (DF^{cover*}) and is fully covered by a prefunded Default fund (DF_{CM}).
     So: RLDF = $DF^{cover*} = DF_{CM}^{pref}$

  2. The CCP has put up "skin in the game" for the same amount which is fully junior to the Clearing Members' Default Fund contributions.
     So: $DF_{CCP} = DF_{CCPjunior} = DF^{cover*} = DF_{CM}^{pref}$

  Effectively, this implies that the CCP out of its own funds fully covers the defaults of the two clearing members on which it runs the highest exposure, before the mutual fund of the surviving Clearing Members will be touched. Nevertheless, the function of paragraph 27 will result in a risk weight for the Clearing Members' contributions of 312.5%.

In this case the total amount of the prefunded default fund contribution of a clearing member (DF_i^{pref}) should be treated as trade exposure to a QCCP instead of attracting the 312,5% risk weight resulting from the formula.

Size of default fund:

- Where international harmonization is desirable, it is not clear which CCPs will have to use a cover one or cover two as input factor for DFcover* in the calculation of the c-factor. In some jurisdictions all CCPs have to apply a cover 2 approach according to national regulation. This might create a disadvantage when CCPs with similar portfolios located in other jurisdictions only have to apply a cover 1 approach.
- As set out in the opening points of this response, DFcover* is not an appropriate input factor to determine clearing members capital requirements to CCPs.
    1. International harmonization is not ensured since it is not certainly clear which CCPs will have to use a cover one or a cover two approach
    2. DFcover* and the complete default fund are measures to mitigate and distribute risks. Capital requirements should be based on the source of risk, which are the clearing members' positions.
- Under several regulatory initiatives all over the world client segregation will become mandatory and it is required to apply even more severe stress test scenarios than before. This will likely result in higher amounts necessary to cover the default of the largest / the largest two members which will further trigger the need to increase the default fund. Together with the globally increased standards for acceptable collaterals and the proposed increase of the costs of central clearing, the incentive to increase the default fund even beyond the cover two requirements as stipulated by the BCBS 253 would reduce the available amount of eligible collateral even further, incentivizing market participants to trade bilateral rather than shifting OTC business to CCPs.

Trade exposures:

- Increasing the risk weight for exposures with QCCPs is counter intuitive. QCCPs must fulfil strict requirements in order to be classified as QCCP. Therefore the goal should be to create clear capital incentives for clearing through QCCPs. This goal is not reached when risk weights for trade exposures are further increased beyond 2%.
- Moreover, the risk weight does not appear to take into account the fact that trade exposures of Clearing Members are only at risk when the CCP itself defaults, which implies that its risk mitigation measures have failed and the risk waterfall has been fully exhausted.
- The result of the functions in paragraphs 46 and 48 is that the risk weight would only be 2% if DF^{pref} is at least 2.5 times bigger than DF^{cover*} (or RLDF). Such a requirement for DF^{pref} seems excessive and difficult to justify.
- Given the expected amounts of DF^{cover*} (or RLDF) it is more realistic to expect that DF^{pref} will in the vast majority of cases be at or only slightly above DF^{cover*} (or RLDF).

As a consequence the risk weight for trade exposures to QCCPs will be 5% in most cases. The consultation document does not provide a clear justification for this significant increase of risk weight from 2% to 5%.

NIMM approach:

- The NIMM represents an improvement compared to the CEM, since it takes different product characteristics into account by using product specific effective notionals instead of gross notionals. However, the NIMM was developed for banks and is a banking model. A CCP is neither a bank nor comparable with a bank.
- Furthermore, the NIMM does not distinguish between centrally cleared exchange traded products and centrally cleared OTC products. NIMM only allows banks to use a margin period of risk of 5 days for centrally cleared derivative transactions with their clients, independent of whether it is an exchanges traded or OTC product. The industry standard margin period of risk is two days reflecting the higher liquidity of exchange-traded products.
- NIMM allows a risk reducing effect from collateral only for current value, the risk reducing effect on the PFE component is achieved via the excess collateral method which is conservatively calibrated. Under EMIR, CCPs have to calculate their margin requirements to cover the PFE component as the current value is typically low due to daily mark-to-market. The margin is calculated using data from periods of stress and including a procyclicality buffer. In such cases the conservative collateralization adjustment should be eliminated or reduced significantly.

Questions

Below EACH provides its answers to the questions posed in the Consultation Documents.

I Capital treatment of bank exposures to central counterparties

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

Given adequately defined input parameters EACH thinks that both models can result in appropriate capitalization figures. The Tranche Approach might be the preferable methodology, since it aims to provide a transparent reasoning for a certain capital charge by comparing a CCPs risk position with CCPs available resources to mutualize this risk among its members represented by the default fund, defining three scenarios depending on the relation between the risk position and the default fund.

We ask the committee to clarify the applied percentage to determine c_1 in the Tranche Approach. We assume that the 16% chosen to determine c_1 represents an error which will be corrected to 1.6% in order to be consistent with the interim rules. A capital ratio of 16% implies a risk weight of 200%. In the interim rules the risk weight for default fund contributions exceeding the hypothetical capital ranged between 2% and 20%. Furthermore, in paragraph 38 it is stated that the mentioned 16% represents a risk weight. We therefore ask the Committee for clarification of this point.

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?*

As set out above, EACH does not consider Cover* to be an appropriate measure of exposure and may lead to unwanted effects. In the opinion of EACH, NIMM does in principle correctly address the risk. EACH therefore strongly prefers that only NIMM be used for this purpose.

However, the NIMM is only applicable to determine derivatives exposures. To determine Repo as well as securities lending exposures for hypothetical capital purposes, CCPs are required to use the comprehensive method. To determine a CCP's hypothetical capital the derivatives, repo and securities lending exposures have to be summed up. This approach does not allow taking any cross product netting effects between derivatives, repos and securities lending transactions into account when calculating a CCP's hypothetical capital. Given that many CCPs offer cross product netting opportunities as risk mitigating measures as well as to increase capital efficiencies for their Clearing Members, the currently proposed approach may result into overly conservative capital requirements.

It should be reminded that CCPs already use internally developed margin models which were approved by their national competent authorities to not only determine the exposure towards their Clearing Members but to also requiring initial margin in exactly the same height, calibrated on a minimum confidence level of 99%. It is not obvious why a few banks are allowed to use internally developed models to determine their exposure values and CCPs are prohibited to use their already approved and implemented internal models for hypothetical capital 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 effect incentives to use central counterparty clearing?

EACH considers that the objectives set out in Section II.C (and especially the adequate capitalisation of exposures to CCPs and the promotion of central clearing of OTC derivatives) are best balanced by ensuring that the risk weight applied to exposures to CCPs correctly reflects the actual risk run on default fund contributions and trade exposures adequately taking into account the risk mitigating measures which are applied by QCCPs and the seniority of default fund contributions and trade exposures in the default waterfall.

As argued above, the risk mitigating measures applied by CCPs have in the recent past proven to be adequate to protect the default fund contributions of surviving Clearing Members. Since then, new regulation has resulted in even more robust levels of risk management in QCCPs.

In the opinion of EACH the probability of default on a bilateral position is therefore significantly higher than the probability of the use of a default fund contribution. In order to correctly reflect this, the risk weight should be in the order of 20-100% as for bilateral positions rather than the currently proposed 1250%.

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

EACH understands the benefit of a risk sensitive approach to capitalising trade exposures to CCPs. The currently proposed approach however, leads to an increase of capital charges in most cases and raises these charges to a level which is excessive compared to the risk actually run by Clearing Members on their trade exposures. As such, it hampers the objective to promote central clearing. CCPs performed in severe market turmoil. Since the latest financial crisis regulatory initiatives e.g. EMIR were developed to even further strengthen CCPs risk management systems. Given these developments it is not obvious why the risk weight for QCCPs fulfilling these even more stringent requirements are increased to a worst case 20%. Even the risk weight fixed at 2% is demonstrably

conservative given the CCPs' track record. Taking this into account and with the objective to avoid unnecessary complexity in mind, EACH proposes to at least remain with the fixed risk weight of 2%, or using this risk weight as a cap, allowing risk weights for trade exposures with CCPs to be even lower than 2%, reflecting an appropriate risk measure for such exposures. We want to emphasise that in the formula used to determine an appropriate risk weight DFCover* should also be replaced be the hypothetical capital, as already recommended for the capitalization of default fund contributions.

We want to further stress that according to the applied formulae a risk weight above 5% would only be possible for CCPs not fulfilling regulatory requirements and which therefore should be classified as Non-QCCPs. Thus, the proposal lacks clarification why a 20% risk weight is proposed to be applied to QCCPs when this risk weight could per definition only be applied to Non-QCCPs. For clarity and consistency, we therefore recommend deleting the 20% risk weight as it would be only applicable to Non-QCCPs which are not covered in this consultation.

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?

As already argued in the response to Question 4 above, an increase of the risk weights for bank exposures to CCPs above 2% is counterintuitive given the background of CCPs observed performance in severe market situations and the even more stringent requirements for CCPs established in the aftermath of the most recent financial crisis. As for trade exposures we propose to at least remain with the fixed risk weight of 2%, or using this risk weight as a cap, allowing a decrease below 2%.

Furthermore, we question the incorporation of variation margin haircutting as a measure to reduce risk weights for posted initial margin, in the consultation. We understand that variation margin haircutting as described in the consultation would be applied after the defaulter's pre-funded default resources (initial margin and default fund contribution) are drawn, but before any prefunded contributions of non-defaulting Clearing Members have been touched. It is not clear to us which influence such a mechanism is expected to have on the initial margin posted by non-defaulting members. I.e. in Europe EMIR prohibits CCPs to use initial margin posted by non-defaulting members to cover losses resulting from the default of another Clearing Member.[1] Thus in Europe posted initial margins of non-defaulted Clearing Members are already protected by regulatory requirements. We want to highlight that initial margins posted by non-defaulting Clearing Members which can be used to cover losses resulting from the default of other members are rather exposed to the default risk of the other CCP's participants than to the CCP's default risk. Hence the risk weight for such initial margins should be increased to adequately reflect this.

[1] Article 45 (4) EMIR 'Default waterfall'

Finally, we want to clarify that a method like variation margin haircutting should not be applied before the reliable and successful risk mutualisation mechanism, represented by the default fund, has been applied. This would render an interference which would adversely impact a CCPs' default waterfall. A tool like variation margin haircutting may be appropriate for replenishing the default fund, as a recovery toolor as resolution tool. . However, it has to be taken into account that variation margin haircutting is not a tool which could be used for every CCP.

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 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?

In the opinion of EACH the capital charges on commitments should correctly reflect the fact that they are further down the default waterfall and that the risk of these commitments being called upon is remote. These lower capital charges should, however, not lead to the unwanted effect that commitments are being preferred over funded default fund contributions.

II The non-internal model method for capitalising counterparty credit risk exposures

Q6. Is the proposed approach of using a different methodology for determining the add-on for each asset class appropriate? Is each proposed add-on methodology for each asset class effective at capturing the main risk driver of that asset class?

The general approach to use different methodologies for determining the add-on for each asset class seems appropriate however; the calibration of the supervisory factors is not fully transparent and especially for electricity seems overly conservative, considering currently available data.

The approach seems to allow for national regulators to require more detailed definitions of commodities if they are significantly exposed to basis risk i.e. prescribe lower correlations than those in table 1. It should also be allowed to use higher correlations where a low basis risk can be established.

Q7. Are the proposed minimum time risk horizons for each transaction category (unmargined, non-centrally cleared, centrally cleared) appropriate? Should the Basel Committee consider factors other than the IMM for determining the appropriate time risk horizon for the NIMM (eg harmonising with other international or national legislation)?

The proposal of using a uniform 5 business days for centrally cleared derivatives does not seem appropriate, as

- CCPs clear standardized, non-exotic derivatives with a low close-out time horizon, which they must prove to their competent authorities
- CCPs employ intraday margins which significantly reduce risk, as significant developments on the markets can be collateralized in practice before a subsequent member default happens.

The EMIR legislation and the regulatory technical standards[2] contain requirements to use 2 days for derivatives other than OTC derivatives. Those, or the time horizon set for the margin calculation of the CCP should be allowed for the calculation of the minimum time risk horizon.

Q8. Do the suggested formula and 5% floor appropriately recognize the benefits of overcollateralization?

As mentioned above the method seems overly conservative when collateralizing the exposure based on the margin calculation of a QCCP.

[2] Commission Delegated Regulation (EU) No 153/2013 Article 26

Q10. Are there any risk factors that should be included in their own category or accounted for in another manner?

CCPs currently only clear standardized, non-exotic contracts. The conservative calibration of NIMM will lead to higher capital charges for centrally cleared contracts which might be conflicting to the goal of strengthening central clearing. This might be achieved by allowing the conservativeness factor in the down-scaling formula of the MPOR to be 2/2 for centrally cleared, standardized non-exotic contracts. The question whether a CCP clears standardized non-exotic contracts should be determined by the local competent authority.

EACH urges the Secretariat of the Basel Committee on Banking Supervision to carefully assess the above mentioned observations and implications and offers a meeting, in which these points can be further discussed.

Should you require further information, please do not hesitate to contact the undersigned.

Yours sincerely,

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About EACH

European central counterparty clearing houses (henceforth CCPs) formed EACH in 1992. EACH's participants are senior executives specialising in clearing and risk management from European CCPs, both EU and non-EU. Increasingly, clearing activities are not restricted exclusively to exchange-traded business. EACH has an interest in ensuring that the evolving discussions on clearing and settlement in Europe and globally, are fully informed by the expertise and opinions of those responsible for providing central counterparty clearing services.

EACH has 22 members:

AthexClear S.A.

BME Clearing S.A.

CC&G (Cassa di Compensazione e Garanzia S.p.A.)

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CME Clearing Europe

CSD and CH of Serbia

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This document does not bind in any manner either the association or its members.

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