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European Commission  
Internal Market and Services DG

Sent by email to: [markt-crd-consultation@ec.europa.eu](mailto:markt-crd-consultation@ec.europa.eu)

**Re: European Commission Consultation Document: Capitalisation of bank exposures to central counterparties (“CCPs”) and Treatment of incurred credit valuation adjustments (“CVAs”)**

This letter contains the response of the Association for Financial Markets in Europe<sup>1</sup> (“AFME”), the British Bankers Association<sup>2</sup> (“BBA”), and the International Swaps and Derivatives Association, Inc<sup>3</sup>. (“ISDA”) (together, the “Associations<sup>4</sup>”) to the proposals in the European Commission’s (the “Commission”) consultation document, which are envisaged by the Commission to be part of a comprehensive legislative proposal due in summer 2011.

The Associations commend the Commission for its consideration of the issues raised by the proposals. We have a number of comments on the proposals and welcome this opportunity to share these with the Commission. The Associations share the Commission’s goal of ensuring efficient, safe and sound derivatives markets and look forward to working with the Commission in advancing this work with a view to reducing risk and fostering financial stability.

This letter contains two parts. In the first part we respond to the Commission’s questions on its proposals regarding the capitalisation of bank exposures to CCPs (Section I of consultation document) and note additional comments on the proposals. In the second part we respond to the Commission’s questions on its proposals regarding the treatment of

<sup>1</sup> EC register of interest representatives 65110063986-76

<sup>2</sup> EC register of interest representatives 5897733662-75

<sup>3</sup> EC register of interest representatives 46643241096-93

<sup>4</sup> A description of the Associations is set out in the Annex 2.

incurred CVAs (Section II of consultation document). In both parts, the numbering of the Commission's questions from the consultation document is used.

### **Part I – Capitalisation of bank exposures to central counterparties**

Prior to focusing on the Commission's questions, we wish to emphasize four overarching points regarding the Commission's work on the capitalisation of bank exposures to CCPs.

First, we acknowledge that the Commission has largely followed the Basel Committee on Banking Supervision's ("BCBS") preliminary proposals on the capital treatment of the exposures to CCPs<sup>5</sup> and the Commission's statement that it will take into account the outcome of the BCBS consultation, impact assessment results and any other progress made in discussions on the international stage when finalising its legislative proposal. Broadly, we commend this approach and the Commission's efforts towards international coordination on this work and would encourage the Commission to follow BCBS standards. While acknowledging European specificities, already, there is some divergence in the need for CCPs to comply with "significantly stricter" requirements in the European Union ("EU") than are proposed by the BCBS in order to receive the same capital treatment. In case it facilitates the Commission's coordination efforts, we append our response to the recent BCBS consultative document<sup>6</sup>. We think it is critically important that work on the capital treatment of bank exposures to CCPs develops in a context of active dialogue between the BCBS, the Committee on Payment and Settlement Systems ("CPSS") and the Technical Committee on the International Organization of Securities Commissions ("IOSCO") (collectively "CPSS-IOSCO"), national and supra-national authorities, and the industry. As we emphasised to the BCBS, given the global nature of the OTC derivatives market, coordination is essential to establish effective international minimum risk management standards, avoid regulatory arbitrage, and mitigate systemic risk and adverse spillover across countries. Nevertheless, there are European specificities, as are indicated below, and the treatment of these must be balanced with international harmonisation.

Second, we strongly urge the Commission to provide greater clarity regarding the recognition criteria for third country CCPs in respect of these capital treatment proposals. On the basis of the preliminary proposals and our interpretation of the Commission's proposed Regulation on OTC derivatives, central counterparties and trade repositories ("EMIR"), it is unclear whether and on what basis the designated EU authority for recognising third country CCPs will recognise as "qualifying" third country CCPs that have been determined as "qualifying" by third country authorities (on the basis of compliance with the CPSS-IOSCO standards). An answer to this question would bring much needed clarity to supervisors and industry alike and reduce the risk of diverse and

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<sup>5</sup> Set out in a consultative document published by the BCBS on 20 December 2010 ("BCBS 190"), available at <http://www.bis.org/publ/bcbs190.pdf>

<sup>6</sup> The Associations' response to BCBS 190 is set out in the Annex 3.

inconsistent requirements between different supervisors that could in turn increase costs and frustrate the development of robust international standards.

Third, of particular concern to the Associations is the lack of clarity regarding the interaction of the proposals relating to capitalisation of bank exposures to CCPs and the large exposures regime. We strongly support the exemption of banks' exposures to CCPs from any large exposure limits. Failure to adopt such an approach would undermine the incentive to move OTC derivatives to CCPs and consequently hinder the efforts to reduce systemic risk.

Last, while the Commission's consultation does not address the capital treatment of non-cleared trades, the Associations wish to emphasize the importance of the link between capital requirements and liquidity for end users. It is vital that regulation does not seriously inhibit access to risk management services for end-users, while appropriately recognizing the risks of OTC derivatives.

This requires:

- a mandatory clearing requirement that does not place unreasonable liquidity requirements on end users; and
- a capital treatment for uncleared transactions that does not unduly penalize end-user transactions.

We would strongly encourage the Commission to ensure that capital requirements and clearing requirements are suitably aligned and support the Commission's wider objectives.

**1. Are the two conditions and the approach outlined above broadly appropriate? If not, please explain why and how they should be modified?**

In order to be deemed qualifying, the Commission proposes that a CCP would need to simultaneously fulfill two conditions:

- the CCP is compliant with EMIR and all the implementing and accompanying delegated acts; and
- the CCP is able to assist clearing member banks in properly capitalizing for CCP exposures by either undertaking the calculations and/or by making available sufficient information to its clearing members, or others, to enable the completion of capital calculations.

We think that these two conditions are broadly appropriate. As such, where the authority responsible determines that a CCP does simultaneously fulfill these two conditions, then the authority should have no further discretion in relation to the determination. This will

provide CCPs and clearing member banks with important clarity regarding the applicable standards.

In addition, we would welcome confirmation from the Commission that: (i) the authority responsible for determining whether a CCP is “qualifying” within the EU will be the competent authority of the Member State where the CCP is established; whereas (ii) the responsibility for determining whether a third country CCP is “qualifying” for EU purposes will lie with the European Securities and Markets Authority (“ESMA”). Our interpretation is based on our understanding of the Commission’s proposals outlined in EMIR. Further and within this model, we urge the Commission to develop explicit criteria on how ESMA (assuming this is the relevant authority) will treat third country CCPs determined to be “qualifying” and in compliance with the CPSS-IOSCO standards by their local authority. We urge the relevant authorities to cooperate with national and international regulators in this work.

Further, we request that the Commission considers, in addition to the designation of “qualifying” CCPs, the process for cessation of a “qualifying” designation in recognition of the fact that this could change over time. The cessation process is of particular importance given that a sudden loss of the “qualifying” status could cause considerable disruption, including the potential to change the economics of an already agreed financial contract. Please note in this context that the economics of a financial contract include the costs of any associated capital or margin requirements imposed by a CCP on parties to that contract. As a related matter, we ask the Commission to consider the benefits of a gradual approach to the relevant financial requirements deemed necessary when cessation of a “qualifying” status occurs, as a sudden change in, for instance, capital requirements gives rise to both serious concerns about the competitive settings among market participants and CCPs, and the potential disruption caused by the determination itself that the CCP is no longer a qualifying CCP. Indeed, as noted in our response to BCBS 190, in the absence of a gradual approach, it is not difficult to imagine a “run on a CCP” if one or more clearing members took a view that a CCP’s “qualifying” status was in doubt. This could give rise to systemic risk and thus defy the objective of the proposals.

Finally, we note that CPSS-IOSCO are reviewing their international standards for CCP risk management to address the particular risks associated with clearing OTC derivatives. Accordingly, we recommend that the Commission retain flexibility to readily alter the standards in its proposals (including the legal standing of the second condition) should that be desirable to reflect any revised international standards promulgated by CPSS-IOSCO.

## **2. Would the two-tier system ensure the right incentive structure for banks (and, indirectly, for CCPs)? If not, why?**

Ultimately, as emphasised in our response to BCBS 190, whether the appropriate incentive structure exists for banks will depend on whether banks will be charged higher margin than

is warranted. If clearing members are charged higher levels of margin than is required to prudently cover the related CCP risk, then two undesirable effects may result:

- This high level of margin will likely be applied to clients. This in turn will result in a system wide liquidity drain, with many clients being required to clear but having severe difficulty in funding the required margin.
- There will be a disincentive to use central clearing where it is not mandatory as institutions will understand that margin levels are too high.

Moreover, if an artificially and unnecessarily high level of margin is needed for default fund contributions to achieve a non-punitive capital treatment, then there is an incentive to reduce the size of these default fund contributions. This is clearly not of systemic benefit. We would therefore strongly urge the Commission to adopt a proportionate and risk-sensitive treatment in the capital rules for bank exposures to CCPs.

**3. Would a single-tier system, i.e. one where only qualifying CCPs would be allowed to exist, be preferable? If so, could making condition 2 a legal requirement for CCPs be considered as a way of doing that? Are there any other ways in which this could be done?**

A system where only qualifying CCPs would be allowed to exist seems unnecessarily harsh for CCPs that do not clear OTC derivatives instead servicing specialist or small markets. Further, it would raise barriers to entry for new operators, who would from the outset be subject to strict rules, rather than be allowed to progress gradually from non-qualifying to qualifying status as they develop.

Importantly, the Commission ought to be wary of the significant disruption that could result if a qualifying CCP could suddenly become non-qualifying. As noted above, we ask that the Commission consider the benefits of a gradual approach to the relevant financial requirements deemed necessary when cessation of a “qualifying” status occurs. Such a gradual approach is compatible with a multi-tier system but difficult to employ in a single-tier system.

**4. Are there any legal, confidentiality or other obstacles that would prevent CCPs to fulfill condition 2?**

We think that competition between CCPs may hinder disclosure of the information required by condition 2. We recognise that a CCP’s margin calculation methodologies are commercially sensitive and so CCPs may be reluctant to share this information at the level of detail that is sufficient to enable the completion of capital calculations by clearing members.

To clarify, we consider that the qualifying CCP disclosure requirements should include (at a minimum):

- CCP margin levels and calculation methodologies;
- The CCP's stress test methodology and results;
- Details of the CCP margin back-testing methodology (for its initial margin calculation) and results;
- CCP counterparty exposures and concentrations;
- All elements of the CCP's financial resources;
- Volumes cleared by product;
- Details of counterparty profiles;
- Collateral concentrations and collateral liquidity profiles;
- Waterfall details and default management practices; and
- Details of other CCP risks including operational risk and any collateral management risks.

### **Qualifying vs. non-qualifying transactions**

#### **5. Are there any potential difficulties in applying this approach? If so, which?**

The Commission proposes that in addition to distinguishing between qualifying and non-qualifying CCPs, there is also a distinction between qualifying and non-qualifying transactions. The Commission proposes that to be deemed qualifying, a transaction would need to fulfill two conditions:

- The CCP counterparty credit risk exposures with all its clearing members in its arrangements are fully collateralized on a daily basis; and
- The transaction must not have been rejected by the CCP.

We consider this approach to be reasonable. An operational difficulty could be where bank is uncertain if a transaction “has been rejected by the CCP” noting that different CCPs have different processes. In order to manage this, we think that banks should capitalise transactions on a bilateral basis until these transactions have been positively accepted by a CCP.

### **Direct vs. indirect access to a CCP**

In order to allow equal treatment regardless of indirect or direct access, the Commission proposes two conditions to prevent indirectly accessing bank from being exposed to a potential insolvency of its clearing member. In summary, the conditions are:

- that the indirectly accessing bank's positions and assets are segregated such that they are bankruptcy remote should the clearing member become insolvent; and
- relevant laws, regulation and contracts allow portability of these positions and assets to another clearing member.

If these two conditions are met, the indirectly accessing bank would be able to enjoy the same capital treatment as the directly accessing one. If conditions are not met, the Commission proposes that exposures should be treated as bilateral exposures<sup>7</sup>.

## **6. Is the proposed treatment of exposures of banks accessing a CCP indirectly appropriate? If not, why?**

In order to properly assess whether the proposed treatment is appropriate, further clarity is required in relation to the following key terms used in the two conditions:

- condition 1 states “...such segregation results in these positions and assets to be *bankruptcy remote* should the clearing member become insolvent”. Further detail on “bankruptcy remote” is necessary. As we noted in our response to BCBS 190, there are a number of different collateral transfer and segregation models in different jurisdictions, reflecting local law and regulatory practice. Accordingly, further clarification is required on precisely which collateral models are effective in removing the additional capital charge. In addition, information is required on precisely who has access to collateral for the purposes of liquidity, and the meaning of the terms “*collateral*” (as it appears that the Commission’s proposed condition 1 and 2 intends to capture all collateral posted: “positions and assets”). We further urge the Commission to consider third party custodial models. Clarity is needed as to the treatment if the collateral holder is not the CCP or the clearing member.

We suggest that clear, implementable proposals in relation to collateral should be fixed by the Commission only:

- Once precise collateral models and requirements have been agreed; and
- Once efficiency and cost issues around the different models have been duly evaluated; and
- After the proposals have been considered in the light of the forthcoming CPSS-IOSCO recommendations for CCPs.

In addition, the body responsible for the determination whether a given CCP’s collateral model is effective in this regard should be clearly specified and the same across the EU to avoid potential regulatory arbitrage. Moreover, the process for any review of a determination (for instance arising from legal changes such as those contemplated in the proposed EU Netting Directive) should be clearly set out.

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<sup>7</sup> While bilateral treatment may be adequate, an optimal treatment would recognise that the financial resources which support the client exposures include the client’s margin *and* the related part of the clearing member’s default fund contribution. Accordingly, even where the insolvency protection conditions do not exist, the capital treatment CCP exposures of an indirectly accessing client ideally ought to take this benefit into account.

Finally, we believe that this provision may make it impossible for affiliates to act as Clearing Members for their affiliated banking institutions, a common practice today for large financial firms. Because pooling of the collateral associated with a Clearing Member and its affiliates is common, it would appear that the proposed language may prevent banks from qualifying for the 2% risk weight capital treatment for exposures cleared by an affiliate. If end users are not subject to an appropriate capital charge then they will be subject to the disadvantages of central clearing (including increased cost and operational complexity) without one of the key benefits.

- condition 1 states “the positions and assets...are...segregated..., provided that the *margins* that the clearing member post to the CCP...”. To be clear, the condition should state explicitly whether it refers to Initial Margin and/or Variation Margin.
- condition 2 states “relevant laws, regulation, rules and contractual arrangements ensure that in the case of the insolvency of the clearing member the bank using that clearing member will be able to transfer its positions and collateral to another clearing member”

In other words, condition 2 requires arrangements to ensure a bank’s trades *will* be taken over by another clearing member in the event a bank’s clearing member becomes insolvent. We understand that trade portability is often allowed by a CCP at a clearing member’s insolvency, but that such portability is not guaranteed. However, the absence of a guarantee would presently seem to imply that banks cannot qualify for the 2% risk weight capital treatment for their trade related exposures. We would appreciate further clarification from the Commission if this is the intended result, especially as there may also be prudential concerns with establishing a system where trade portability is guaranteed (as it would reduce the incentives for clients to exercise proper diligence and monitor the credit quality of their clearing member). We further assume that there is no capital requirement associated with being a ‘receiving’ clearing member under a portability guarantee; assurance on this point would also be appreciated.

**7. Could requiring just partial (i.e. omnibus) segregation with gross margining of client positions at CCP level qualify for the same treatment as full segregation? Why?**

It may be preferable not to alter the balance between the safety inherent in full segregation of client collateral and the cost associated with such additional protection. At the least, consideration should be given to allowing institutional clients to opt for partial or non-segregation. This is particularly the case given that, whether or not segregation exists, it is the effectiveness of portability that will determine whether the client is impacted by the failure of a clearing member.

In addition, the consultation document also provides no guidance on the treatment where there are third party custodial arrangements.

## **Capitalisation of exposures**

### **Trade exposures**

#### **8. Do you agree with the outlined approach to the capitalisation of trade exposures? If not, why?**

Instead of the current zero capital charge, the Commission proposes that trade exposures will receive a small but positive capital charge based on a 2% risk weight. The reason for the selection of the 2% charge is unclear. We therefore suggest that the 2% charge should be regularly reviewed to ensure that it is appropriate and that the right incentives are provided as central clearing of OTC derivatives evolves. We note here that in the current proposal, the risk weight does not differentiate between CCPs despite the differences in individual structures and risks.

As we noted in our response to BCBS 190, there is a need for a well designed quantitative impact study (“QIS”) on these proposals and their impact on both capital and liquidity. A properly designed QIS will provide the essential information required to calibrate the proposals.

The new Basel rules specify increased margin periods of risk in case of large netting sets. Netting Sets to central counterparties are likely to be large, so it would be likely that the margin period of risk would double. Given that CCP are designed to close out positions of defaulted members quickly, we suggest exempting exposures to CCP from the increased margin periods of risk in case of large netting sets.

Finally, the proposed capitalisation of trade exposures does provoke our concerns about the interaction of the proposed approach and the existing capital treatment of large exposures. We discuss this point separately as an additional comment following our responses to the Commission’s questions in Section 1.

#### **9. Should the exception for bankruptcy-remote collateral in case of use of a qualifying CCP be extended also to collateral posted to non-qualifying CCPs, provided that the latter collateral complies with the same conditions? Why?**

As noted above, clarity is needed on precisely which collateral models are effective. In this context, the important question should be ‘Is the collateral actually at risk?’ If collateral is bankruptcy-remote, then the collateral is not at risk. In such a case, we think that the exception can be extended.

As noted, the consultation document also provides no guidance on the treatment of third party custodial arrangements.

### **Default Fund exposures**

#### **10. Do you agree with the approach to the capitalisation of default fund contribution exposures outlined above? If not, why?**

We agree that conceptually the model is reasonable, though we have significant and numerous concerns with the use of the CEM for cleared OTC derivatives. These concerns and alternative models are discussed in response to question 11 below.

If the Commission wishes to adhere to its original proposal (using total margin and total hypothetical capital), then the Associations point out that there are internal departments at banks with considerable expertise and experience in the calculation of counterparty risk capital. Thus, a further possibility would be to require CCPs to provide sufficient information to allow market participants to assess their credit quality and hypothetical capital using risk sensitive methodologies.

Further discussion on who is best equipped to perform the hypothetical capital calculation is set out in the response to question 15.

#### **11. Is it possible to improve the outlined approach by making adjustments to the Current Exposure Method? If so, how?**

It is not possible to improve the CEM materially by adjustments. We propose alternatives in our response to question 13 below, while the following sets out our broad concerns.

The risk sensitivity of the core calculations is of paramount concern in the design of capital rules. In this regard the Associations have a number of significant concerns with the use of the CEM (and to a lesser extent other regulatory capital approaches to counterparty credit risk) for cleared OTC derivatives:

- Any percentage-of-notional based approach, such as the CEM, penalizes large well-hedged portfolios versus smaller riskier ones. We consider this a highly undesirable incentive, and would strongly urge the Commission to consider approaches which do not suffer from this drawback. Note in this context that the CEM would seem to require a level of margin which is much higher than prudent well-resourced CCPs currently charge due to its risk insensitivity<sup>8</sup>.

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<sup>8</sup> To get a crude estimate of the magnitude of the portfolio effect ignored by the CEM, compare the ratio of the total margin to the total notional cleared at LCH (c. 0.5 bp) with a typical CEM haircut for IRS (50bps). This comparison indicates that a CEM-based calculation is inappropriate by more than an order of magnitude. We also note that during the financial crisis, LCH margins were proven to be adequate.

- The net portfolio risk position should always form the basic exposure measure for capital purposes (assuming that netting is enforceable in the relevant jurisdictions). Some regulatory approaches, such as the CEM, violate this principle.
- The holding period used in many regulatory capital approaches to bilateral counterparty credit risk is larger than the Associations consider appropriate for OTC derivatives CCPs, given their frequent margin calls. Thus, the standardized method does not suffer from the issues discussed in the immediately preceding points, but it would require recalibration to reflect the shorter margin period of risk before adoption in an OTC derivatives CCP context. This is discussed further in the next section.
- The CEM was calibrated some years ago and has not been purpose built for credit products.

The issues outlined above are of fundamental importance. They demonstrate that the CEM is highly inappropriate both quantitatively and methodologically as a capital methodology for OTC derivatives CCPs. As we noted in the introduction, the incentive structure created by capital rules must be correct. The CEM does not meet this requirement. This is because it will suggest for a large well-hedged collection of portfolios (such as are typical of large CCPs) that the CCP's hypothetical capital is an order of magnitude higher than a risk sensitive calculation would. The consequence of this overstatement is that default fund contributions will be (erroneously) given a 1250% risk weight. Thus, there is an incentive to reduce these contributions, which may result in an increase in systemic risk.

**12. Could the outlined approach be used in a situation in which a CCP had multiple default funds covering different types of financial instruments, or would it need to be adjusted? If the latter, how?**

It would need to be adjusted. Further details and a separate analysis would be required for each default fund.

In this context, it is worth noting that the risk of a Clearing Member's default fund contribution depends critically on its position in the loss waterfall. Thus, if a defaulting member's own default fund contribution is used before that of other members (as is typical), then one critical determinant of default fund risk is an individual Clearing Member's margin versus the hypothetical capital required for *its* portfolio, rather than the total margin versus total hypothetical capital. We therefore urge the Commission to make the determination of the adequacy of margin sensitive to CCP waterfall structures. We would also stress the importance of flexibility, as different waterfall structures may be developed as central clearing of OTC derivatives evolves.

**13. Are there any other methods for calculating default fund contribution exposures or hypothetical capital that are both simple and easy to supervise? If so, which?**

An alternative to the Commission's proposal is to allow CCPs to apply for permission to use appropriately risk-sensitive models (such as an IMM model<sup>9</sup> or another form of advanced modeling of a comparable standard) for the hypothetical capital calculation. This permission should be granted under the same standards as a bank application, with the same requirements for backtesting, hypothetical portfolio validation, and other key risk controls. It is important to emphasize that qualifying CCPs are generally expected to have very robust risk management and modeling capabilities (in order to meet the still-developing CPSS-IOSCO standards for qualifying CCPs) so this should not pose a disproportionate burden.

Another alternative for many waterfalls would be to note that since the Clearing Member's default fund contribution is at risk due to their own non performance first, a hypothetical capital calculation could be performed by comparing the capital required for the Clearing Member's portfolio with the margin for that portfolio. Since this only relies on information known to the Clearing Member, they rather than the CCP could perform the calculation. In particular, this approach would allow for the use of risk-sensitive models in the determination of hypothetical capital, mitigating the serious concerns over the risk-sensitivity and potential mis-calibration of the CEM. (The risk of multiple Clearing Member defaults could perhaps be handled here by adjusting the risk weight on the resulting exposure.)

**14. Is requiring bilateral capital treatment for trade exposures to a CCP whose total default fund is less than its hypothetical capital a more appropriate way to reflect the risk of being a member of such a CCP? If not, is there any alternative methodology that would allow achieving this goal? If yes, which?**

This treatment seems appropriate on the condition that the method used to perform the hypothetical capital calculation is reasonable and the CEM method is not used<sup>10</sup> (see also our response to question 13 above for suggested alternative approaches).

**15. Should CCPs be the ones calculating the hypothetical capital or could/should this calculation be performed by someone else? If the latter, who?**

<sup>9</sup> Some modifications to the IMM approach will be needed in this case, such as a review of the margin period of risk for large netting sets. If a CCP can demonstrate (through a tested, appropriately conservative default management program) that it can liquidate a large Clearing Member's portfolio within five days, then that period is an appropriate one for capital purposes.

<sup>10</sup> However, it is worth clarifying in this context that it is the adequacy of CCPs' financial resources taken as a whole that is central to determining the capital treatment of trade exposures to CCPs. For example, a given CCP may take less default fund contributions and proportionally more margin, but if its financial resources are adequate in *total*, then it remains appropriate to have a low capital charge for trade exposures to the CCP. We urge the Commission to the capital rules address differences between CCPs appropriately.

There are clear tradeoffs between calculations performed at the level of the CCP and those performed by individual firms. In the aggregate, we can appreciate the intention to achieve greater overall accuracy by adopting CCP level calculations, although in the absence of detailed data, it is difficult to determine how material this improvement is likely to be in practice. We would also note that qualifying CCPs are expected to have very robust risk management and modeling capabilities, so this should not pose a disproportionate burden. Additionally, most CCPs already have years of practical experience and know-how in risk management and calculation / modelling process.

On the other hand, many firms are concerned at the potential increase in operational risks that could arise from reliance on a third party for calculations that may be relevant to time-sensitive regulatory filings and disclosures. In addition, there are internal departments at banks with considerable expertise and experience in the calculation of counterparty risk capital. Thus, a possibility would be to require CCPs to provide sufficient information to allow market participants to assess their credit quality and hypothetical capital using risk sensitive methodologies.

In conclusion, we would urge the Commission to consider providing flexibility in this area, at least initially, to gain more practical experience in weighing these tradeoffs. In doing so, it would be helpful if the Commission could articulate principles for the standards to be applied for the use of third party data and information as inputs to a firm's own calculations.

**16. Do you agree with the proposed treatment of default fund contributions to non-qualifying CCPs and please explain why? In your view, what should be the risk weight associated with these exposures?**

The proposed treatment seems reasonable, though we note that there is to some extent a trade off in incentivising the use of qualifying CCPs and increasing systemic risk. This trade-off exists because a large risk weight on default fund contributions to non-qualifying CCPs will create an incentive for members to reduce these default fund contributions to these CCPs.

**Additional comment**

*Interaction with large exposures:*

The Commission's consultation document contains no detail on the interaction of the proposals and the existing capital treatment of large exposures. The Associations think that banks' concentrated exposures to CCPs (such concentration often resulting from various legal and regulatory initiatives) should be permanently exempt from the large exposure limit, so long as the applicable CCP is a qualifying CCP and thus complies with the current and forthcoming CPSS-IOSCO recommendations. Failure to adopt such an

approach in the treatment of large exposures to CCPs would undermine the incentive effect that is otherwise being pursued. Given this public policy direction, it is an important component of the incentive structure that market participants should be able to rely upon CCPs and not be constrained by their necessarily concentrated exposures to them in such a way as to constrain their use.

## **Conclusion**

The public policy rationale for the Commission's proposed reforms is to require banks to more appropriately capitalise their exposures to CCPs, including trade and default fund exposures. While this is an appropriate goal, and the consultation document makes an excellent start to the discussion, significantly more consultation, dialogue and open debate among affected parties is necessary to refine the proposals to be efficient, effective and proportionate to the policy goals.

## **Section II – Treatment of incurred credit valuation adjustments**

### **Part II – Treatment of incurred credit valuation adjustments (CVA) – Recognition of CVA via reduced exposure or via provisions/increase of available capital**

#### **17. How do you currently treat incurred CVA**

**a) in the regulatory capital for market and counterparty credit risk; and**

**b) in the internal capital adequacy assessment?**

The Associations' members have a variety of treatments of incurred CVA based on their strategy and analytical framework. It is not the purpose of this consultation paper response to elaborate on the various different treatments of incurred CVA, however should the Commission wish to discuss in detail any of the current industry practices the Associations' members would welcome the opportunity to do so.

**18. Do you separate 1-year and lifetime expected future losses implicit in CVA and if so, how do you do it and how do you treat each part? Could you please characterise how such separation could be carried out? What are the main challenges arising from this separation and the respective treatment?**

The distinction between 'the next year' and 'remainder of the portfolio's life' is created by the structure of the Basel 2 IRB, so members have to date not typically separated out these two parts of the CVA. However, if a treatment of incurred CVA were to be based on this separation, we do not believe that it would be technically difficult to achieve, although it would require some systems investment.

**19. What are the key pros and cons of recognising incurred CVA via provisions/increase of available capital and recognising incurred CVA by reducing the exposure amount?**

The Associations' members are of the view that it is not appropriate to deduct CVA from exposure 'as is'. We outline what our members view as the correct treatment in Annex 1 below. If a simple treatment which does not require the CVA to be split and in the prior question is desired, then incurred CVA could be recognised by increasing available capital. This approach would have the advantage of being consistent with current regulatory practice in many EU countries.

**20. What regulatory treatment for incurred CVA do you consider conceptually as the most appropriate and why?**

The only technically correct treatment within the IRB framework is to separate out the two components of CVA (as we discuss in Annex 1). The veracity of this approach has been confirmed in separate work by Michael Pykhtin of the Federal Reserve Board<sup>11</sup>, which our members endorse.

Our members believe that the Basel III capital rules for counterparty risk charge for the same risk more than once in a number of places. While a correct treatment of incurred CVA does address one of these double counts, we would urge the Commission to work with the Basel Committee in addressing the other substantive double counts in the Accord.

**21. If you suggest recognising incurred CVA by reducing the exposure amount when calculating the counterparty credit risk charge, could you please specify the appropriate amount (e.g. CVA only, CVA divided by LGD etc) by which the exposure amount should be reduced and why?**

Please see our previous answers.

**22. If you suggest treating incurred CVA as equivalent to a provision:**

**a) What treatment should be applied to credit institutions applying the IRB approach? Please justify and elaborate on both the effect on capital resources and counter-cyclicality.**

**b) Should incurred CVA be compared to total EL for counterparty credit risk only or to total EL arising also from credit risk, or against EL on the specific asset, or netting set against which it was taken?**

**c) Should the respective increase of available capital be limited and if so, please specify the appropriate limit.**

**d) What treatment should be applied to credit institutions applying the standardised approach?**

- a) Please see our previous answers. We do not believe that counter-cyclicality should be managed micro-prudentially at the level of individual capital rules, but rather that it should be managed as a macro-prudential overlay. However, if an explicitly countercyclical approach is desired, then adding CVA back into capital would have this property.
- b) Incurred CVA should be treated based on the total capital for counterparty default and provisions-migration risk for IRB firms.
- c) The total capital  $K$  in our approach should be floored at zero.

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<sup>11</sup> *CCR Capital Charge with CVA*, Michael Pykhtin, Federal Reserve Board, October 13, 2010.

- d) For non-IRB firms a treatment as a general provision may be appropriate, with capital being increased 50%/50% tier 1 and tier 2 by CVA/LGD.

**23. If you suggest using the approach detailed in footnote 44, please explain why and indicate whether any changes to that treatment are necessary**

N/A. (We understand that footnote 42, rather than footnote 44 as quoted, is intended.)

**24. If you suggest a different alternative to the treatments mentioned in questions 21 - 23, please specify its details and why you consider that such treatment would be prudentially sound.**

N/A.

**25. Why do you consider the other alternative(s) to your preferred approach to be unsuitable?**

As we outline elsewhere in this consultation response, we believe that the treatment we propose is technically correct given the assumptions of the IRB method. Therefore, we view other approaches which lead to a different outcome as problematic to some degree. The best simple approach would be to add CVA into capital.

**26. Please assess the likely consequences and impact (both qualitative and quantitative) of all the options considered above? To the extent possible, please cover both benign and stressed periods for such assessment.**

The Associations' members are of the view that an assessment of the likely consequences and impact of the options is not possible (primarily due to time constraints) or indeed desirable to be included as part of this consultation response.

The most appropriate way to assess the impact of these proposals is via a quantitative impact study, which is both well designed and where recipients have sufficient time to complete the required questions.

We understand that the Commission has access to the Basel QIS on the impact of the proposed Basel III rules on counterparty credit risk, and would encourage the Commission to use this data to gain some insight into the likely impact.

**27. Should incurred CVA losses also be recognised in calculation of the CVA capital charge? If so, why and how? Do you recognise incurred CVA when determining VaR of CVA or when calculating CVA sensitivities for hedging purposes? If so, how? Are you able to reflect the maximum loss at individual counterparty level when simulating changes in CVA? How material is the impact?**

This is not appropriate at this point. The Basel Trading Book Group is conducting a fundamental review of the rules for the entire Trading Book. We hope that the treatment of CVA will be included in this review, and strongly encourage both the BCBS and the Commission to further work in this area. Such a review should consider including market based CVA and all its hedges as a trading book item.

**28. Please provide an estimate of the impact of the current CRD approach, the Basel III approach and your own suggested treatment for your own firm (differentiated by available own funds, exposure at default and capital requirement).**

Please see our answer to question 26 above.


**29. Please provide any further information (both of qualitative and quantitative nature) you consider relevant for the purposes of finalising the upcoming legislative proposal on this issue**

One additional point that the Commission may wish to consider is that the Basel III CVA charge can be larger than the exposure at default for the counterparty. We urge the Commission to consider limiting the incremental contribution to the CVA for a single counterparty to the EAD for that counterparty, and we would be happy to discuss the implementation of this suggestion in detail with the Commission.

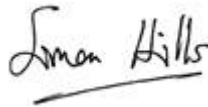
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We appreciate the opportunity to provide these comments. Should you require further information, please do not hesitate to contact the undersigned.

Sincerely,



Peter Beales  
Managing Director  
*Association for Global  
Financial Markets  
Association*



Simon Hills  
Executive  
Director  
*British Bankers  
Association*



David Murphy  
Global Head of Risk and Research  
*International Swaps and  
Derivatives Association, Inc.*

## Annex 1 - IRB Capital on Counterparty Credit Risk

Based on work by *Eduardo Canabarro*, Morgan Stanley

The objective of this note is to advance a proposal for the calculation of capital on counterparty credit risk (CCR) according to the Internal Ratings-Based (IRB) framework and taking into account the existence of Credit Valuation Adjustments (CVAs).

For the purpose of this note it is useful to think of CVA as akin to a “credit reserve” which is available to cover expected default losses of the counterparty over the life of the portfolio of OTC derivatives. This is not what CVA really is, but it is useful to use this analogy within the context of the IRB framework.

The IRB formula for the capital ( $K$ ) on wholesale exposures is:

$$K = EAD \cdot LGD \cdot [Q - PD] \cdot T$$

where

- $EAD$  is the exposure at default;
- $LGD$  is the loss given default;
- $Q$  is the 1-year probability of default conditional on the 99.9% realization of the systematic credit factor of the ASFR model, see Gordy (2003)<sup>12</sup>.
- $PD$  is the 1-year unconditional probability of default; and
- $T$  is the multiplicative maturity adjustment designed to capture the economic effect of credit migrations over 1 year on the economic value of the credit portfolio.

The objective of the IRB formula is to calculate capital on unexpected loss (i.e. beyond the expected loss  $PD \cdot LGD \cdot EAD$ ) and to adjust the result to capture the economic impact of credit rating migrations over the one year capital horizon.

We propose modifying the formula above for counterparty credit risk to:

$$K = (EAD \cdot LGD - CVA_2) \cdot Q - CVA_1$$

Here

- $CVA_1$  is the portion of the total counterparty’s CVA that corresponds to default over the first year;
- $CVA_2$  is the portion of the total counterparty’s CVA that corresponds to default losses beyond the first year.

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<sup>12</sup> Gordy, M, “A risk-factor model foundation for ratings-based bank capital rules”, Journal of Financial Intermediation 12, 199-232.

The rationale behind our proposed formula is the following:

- $CVA_1$  is a credit reserve that offsets default losses of the entire credit portfolio over the first year. This is because this reserve will be reverted during the first year even if the specific counterparty does not default. In this way it will reduce total credit portfolio losses;
- $CVA_2$  is a credit reserve that will be reverted during the first year only if the specific counterparty defaults. If the counterparty does not default,  $CVA_2$  will continue to exist and will not be available to offset default losses of other counterparties. Thus, the benefit of  $CVA_2$  to offset unexpected default losses of the portfolio in the first year is conditional on the specific counterparty defaulting.
- Observe that we count  $CVA_2$  as an offset to unexpected default loss in the first year even though it reflects “expected losses” beyond the first year. This is correct within the IRB framework since this amount is available (via its reversion) to offset the default loss of the specific counterparty during the first year, which is the capital calculation horizon.
- The maturity adjustment  $T$  has been removed from the capital formula because the variability of the CVA will be captured by the VaR of the CVA in Basel III.

## **Annex 2 - A description of the Associations**

### *Association for Financial Markets in Europe (“AFME”)*

AFME (Association for Financial Markets in Europe) promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association).

### *British Bankers Association (“BBA”)*

The British Bankers’ Association (“BBA”) is the leading association for the UK banking and financial services sector, speaking for over 230 banking members from 60 countries on the full range of the UK and international banking issues. All the major and less big commercial banks in the UK are members of our association as are the large international EU banks, the US banks operating in the UK and banks from India, Japan, Australia and China. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit taking and other conventional forms of banking.

### *International Swaps and Derivatives Association, Inc. (“ISDA”)*

ISDA is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 830 member institutions from 57 countries on six continents. These members include most of the world’s institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on OTC derivatives to manage efficiently the financial market risks inherent in their core economic activities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business through documentation that is the recognized standard throughout the global market, legal opinions that facilitate enforceability of agreements, the development of sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

**Annex 3 - Response to BCBS 190**4<sup>th</sup> February 2011

Secretariat of the Basel Committee on Banking Supervision  
Bank for International Settlements  
CH-4002 Basel, Switzerland  
Sent by email to: baselcommittee@bis.org

**Re: Basel Committee on Banking Supervision Consultative Document: Capitalization of bank exposures to central counterparties (“CCPs”)**

Dear Secretariat:

This letter contains the response of the British Bankers Association (“BBA”), the Global Financial Markets Association (“GFMA”), the Institute of International Finance (“IIF”), and International Swaps and Derivatives Association, Inc<sup>13</sup>. (“ISDA”) (together, the “Associations”) to the Basel Committee on Banking Supervision’s (the “Committee”) proposed Basel III reforms as set out in the Committee’s consultative document.

The Associations commend the Committee for its consideration of the issues raised by the capitalization of bank exposures to CCPs. We have a number of comments on the proposals and welcome this opportunity to share these with the Committee. The Associations look forward to working with the Committee in advancing this work with a view to reducing risk and fostering financial stability.

At the outset, the Associations wish to emphasize three points that inform our comments throughout the discussion that follows.

First is *the importance of the incentive structure arising from the capital rules for exposures to CCPs*. CCPs have been broadly promoted as a key tool in mitigation of counterparty credit risk in the OTC derivatives market. Some authorities wish to increase the use of CCPs, while quite correctly appreciating that CCPs must themselves be subjected to very high risk management standards. This is important as the movement of contracts to a CCP is not a panacea itself, since it also concentrates counterparty and operational risk. Best-practice risk management, a sound regulatory framework, extensive

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<sup>13</sup> A description of the Associations is set out in the Annex.

disclosure, and thorough, ongoing oversight are necessary to ensure that CCPs will indeed reduce risk. In this context, the capital framework is key. If it incentivizes Clearing Members to charge higher levels of margin than is required to prudently cover the risks they face, then two undesirable effects may result:

- This high level of margin will likely be applied to clients. This in turn will result in a system wide liquidity drain, with many clients being required to clear but having severe difficulty in funding the required margin.
- There will be a disincentive to use central clearing where it is not mandatory as institutions will understand that margin levels are too high.

Moreover, if an artificially and unnecessarily high level of margin is needed for default fund contributions to achieve a non-punitive capital treatment, then there is an incentive to reduce the size of these default fund contributions. This is clearly not of systemic benefit. We would therefore strongly urge the Committee to adopt a proportionate and risk-sensitive treatment in the capital rules for bank exposures to CCPs.

Second is *the importance of an integrated analysis of the risks that are managed by clearing houses and their participants*. The capital held by participants in support of the risks they assume is only one of multiple elements that will determine whether these arrangements achieve the objective of reducing systemic risk. It is therefore critical that these reform proposals are developed by the Committee in an active dialogue with the industry, the Committee on Payment and Settlement Systems (“CPSS”) and the Technical Committee on the International Organization of Securities Commissions (“IOSCO”) (collectively “CPSS-IOSCO”), and other stakeholders. Given the global nature of the OTC derivatives market, coordination is essential to effectively establish international minimum risk management standards, avoid regulatory arbitrage, and mitigate systemic risk and adverse spillover across countries. In particular, we believe that further development of these proposals by the Committee should be jointly coordinated with the anticipated release and consultation on revised international standards for derivatives clearing houses by CPSS-IOSCO. Liaison with individual CCP regulators is also a prerequisite for the construction of an effective harmonized international framework for the supervision of OTC derivatives markets, trading, risk and infrastructure.

Third is *the need to recognize the dynamic nature of market developments with respect to CCPs*, including their structure, design, membership, and risk management practices. It is critical that the Committee’s work in this area be based on a solid foundation of guiding principles which can be applied broadly as these structures evolve. In this regard, we are concerned about the absence of information from the Committee on how the proposed reforms would interact with other regulatory initiatives impacting on clearing and/or the derivatives markets, including the United States’ Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) and the European Union’s Regulation on OTC derivatives, central counterparties and trade repositories (“EMIR”). This is a concern as diverse and inconsistent requirements between different supervisors will increase costs and make it less likely that robust international standards can be developed. Close

international cooperation between various supervisory bodies including bank, CCP, and systemic risk supervisors would mitigate these risks, with key standards being set and interpreted at the international rather than the national level.

Further, with the efforts being made to increase the use of OTC derivatives CCPs, effective CCP regulation, prudential supervision and oversight are critical. At a domestic level, there should be a clear legal basis that assigns explicitly the role of the market regulator, prudential supervisor, and systemic risk overseer, with appropriate coordination and division of competencies. In addition, due to its systemic importance, a CCP should have appropriately conditioned access to emergency liquidity should that become necessary. For internationally active CCPs, there should be an enhanced international framework for their prudential supervision and oversight. Furthermore, subject to appropriately conservative membership requirements, such international oversight should aim to make access to CCPs as widely available to international participants as possible. This would avoid cordoning off any part of the market, or introducing competitive distortions, whether among market participants or CCPs.

Finally, before turning to our detailed comments, we would note that a key concern of the Associations is the definition of “exposure measure”. We provide detailed comments on this below and strongly urge the Committee to provide a more risk sensitive measure.

### **Comments on the proposed reforms**

The remainder of this letter contains eleven parts covering our comments in relation to the following topics:

1. The Need for a Systemic Risk Assessment and Impact Study
2. Risk Weight for Qualifying CCPs
3. Scope of Proposals and Interaction with Other Areas of the Capital Framework
4. Bankruptcy Remoteness of Collateral and Related Issues
5. The Determination of a “Qualifying CCP”
6. Concerns over Risk Sensitivity and the CEM
7. Capitalization of Default Fund Exposures and Hypothetical Capital Methodologies
8. Unfunded Capital
9. Implications of the Proposed Reforms for Client Clearing
10. Definitional Issues
11. Technical Basel II and Basel III Implementation Concerns

#### *1. The Need for a Systemic Risk Assessment and Impact Study*

The significantly enhanced role of CCPs is designed to address important aspects of systemic risk identified during the recent crisis. This is welcomed. However the increased role of such entities and approaches also carries the risk of new forms of systemic risk. It is important that the approach to the regulation of such new forms of risk not be based on the assumption that what is necessary is the simple extension of existing capital requirements. Rather, we suggest that a comprehensive and integrated analysis of how expanded use of CCPs will alter the potential for systemic risk should be carried out. This analysis should include an open consideration of the best ways of addressing such risks, both via capital requirements on members as well as through other design elements.

We therefore urge the Committee, in conjunction with other relevant supervisory bodies, to carry out a thorough systemic risk assessment. A robust and in-depth impact assessment of micro- and macro-economic effects of the proposed supervisory framework is essential to avoid unintended consequences and to ensure that the framework achieves the desired supervisory objectives.

One element of this is the need for a well designed quantitative impact study ('QIS') on the Committee's proposals. A properly designed QIS will provide the essential information required to calibrate the proposals. To enable this, the Associations urge the Committee to continue and broaden their collaboration with the industry in the design of the QIS. Such a collaborative process will better ensure that the data gathered is sufficiently robust to support an accurate calibration of the capital standard.

We think a meaningful robust QIS process requires:

- (a) More time than is proposed in the consultative document. We are concerned by the very tight deadlines of the Committee's process for this work, namely: QIS completed by July 2011; finalization of rules by September 2011. Such short deadlines are likely to substantially increase the risk of a flawed impact analysis;
- (b) Greater clarity on the key data elements and requirements than is currently provided in the consultative document;
- (c) Careful consideration of the scope of the exercise. While a QIS on banks' current exposures to CCPs is useful, it is important to recognize and calibrate for the implications that broad mandatory clearing requirements (resulting for instance from the Dodd-Frank or EMIR initiatives) will have on banks' capital requirements under the methodologies described in the consultative document.
- (d) In particular, an assessment of the liquidity impact of the proposed reforms on end users, and on their likely behavior, to ensure that the effects of the transformation of credit risk to liquidity and the reduction in corporate hedging are understood within the context of the financial system and the broader economy.

## *2. Risk Weight for Qualifying CCPs*

Instead of the current zero capital charge, the Committee proposes that trade exposures will receive a small but positive capital charge based on a 2% risk weight. The Associations have concerns about the appropriateness of the risk weight as it appears to have been proposed without an explanation as to the basis for the decision. Previously, in discussing counterparty risk management, the Committee said

*“Banks’ mark-to-market and collateral exposures to a central counterparty (CCP) should be subject to a modest risk weight, for example in the 1-3% range, so that banks remain cognizant that CCP exposures are not risk free”<sup>14</sup>.*

The reason for the selection of both this range and the 2% charge is unclear. We therefore suggest that the 2% charge should be regularly reviewed to ensure that it remains appropriate and that the right incentives are provided as central clearing of OTC derivatives evolves. We note here that in the current proposal, the risk weight does not differentiate between CCPs despite the differences in individual structures and risks (as noted below).

In the absence of a disclosure of the Committee’s analysis, we can only state that we think that the optimal approach should begin with consideration of the new market structure and the new risks associated with that structure, and in that context determine what capital regulation should be set and whether capital regulation is the most appropriate tool. Disclosure by CCPs also has a role. Disclosure requirements should include (but not be limited to):

- CCP margin levels and calculation methodologies;
- The CCP’s stress test methodology and results;
- Details of the CCP margin back-testing methodology (for its initial margin calculation) and results;
- CCP counterparty exposures and concentrations;
- All elements of the CCP’s financial resources;
- Volumes cleared by product;
- Details of counterparty profiles;
- Collateral concentrations and collateral liquidity profiles;
- Waterfall details and default management practices; and
- Details of other CCP risks including operational risk and any collateral management risks.

We note in this context that market participants require further information from CCPs to do appropriate impact analysis and credit assessments. Therefore we recommend that

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<sup>14</sup> Annex of the press release about the Group of Governors and Heads of Supervision reaching broad agreement on Basel Committee capital and liquidity reform package, page 2, available at <http://www.bis.org/press/p100726/annex.pdf>

extensive governance and transparency requirements are imposed on CCPs to enable this work to be done.

### *3. Scope of Proposals and Interaction with Other Elements of the Capital Framework*

Turning to the scope of the proposals, we feel that more transparency around the determination of the risk weight will also lend itself to transparently attributing benefit to the long history of sound and successful risk management evidenced by existing exchange trading platforms. The industry recognizes the importance of ascribing an appropriate risk weight, but feels that the framework has to reflect both past and prospective performance, the latter being assessed through globally harmonized and appropriate prudential supervision and regulation.

Additionally, the consultative document contains no detail on the interaction of the proposed reforms and the existing capital treatment of large exposures. The Associations think that banks' concentrated exposures to CCPs (such concentration often resulting from various legal and regulatory initiatives) should be permanently exempt from the large exposure limit, so long as the applicable CCP is a Qualifying CCP and thus complies with the current and forthcoming CPSS-IOSCO recommendations. Failure to adopt such an approach in the treatment of large exposures to CCPs would undermine the incentive effect that is otherwise being pursued. Given this public policy direction, it is an important component of the incentive structure that market participants should be able to rely upon CCPs and not be constrained by their necessarily concentrated exposures to them in such a way as to constrain their use.

### *4. Bankruptcy Remoteness of Collateral and Related Issues*

The Committee proposes that where collateral posted with a Qualifying CCP is remote from bankruptcy of the firm holding the collateral, no additional capital charge is required for the collateral.

However, there are a number of different collateral transfer and segregation models in different jurisdictions, reflecting local law and regulatory practice. Accordingly, further clarification is required on precisely which collateral models are effective in removing the additional capital charge. In addition, information is required on precisely who has access to collateral for the purposes of liquidity, and the meaning of the terms "collateral" (as it appears that the Committee's proposal intends to capture all collateral posted) and "access". We further urge the Committee to consider third party custodial models. Clarity is needed as to the treatment if the collateral holder is not the CCP or the Clearing Member.

We suggest that clear, implementable proposals in relation to collateral should be fixed by the Committee only:

- i. Once precise collateral models and requirements have been agreed in major jurisdictions; and
- ii. Once efficiency and cost issues around the different models have been duly evaluated; and
- iii. After the proposals have been considered in the light of the forthcoming CPSS-IOSCO recommendations for CCPs.

Finally, the body responsible for the determination whether a given CCP's collateral model is effective in this regard should be fixed, and the process for any review of a determination (for instance arising from legal changes such as those contemplated in the proposed EU Netting Directive) should be clearly set out.

In addition to the above comments, we also note specific concerns regarding banks' ability to qualify for the 2% risk weight capital treatments for cleared exposures where the bank is a client of a Clearing Member:

- (a) Paragraph 112(a) of the consultative document requires that the CCP and/or Clearing Member segregate positions and assets belonging to the client, and that such segregation should result in bankruptcy remoteness. We believe that this provision may make it impossible for affiliates to act as Clearing Members for their affiliated banking institutions, a common practice today for large financial firms. Because pooling of the collateral associated with a Clearing Member and its affiliates is common, it would appear that the proposed language may prevent banks from qualifying for the 2% risk weight capital treatment for exposures cleared by an affiliate. If end users are not subject to an appropriate capital charge then they will be subject to the disadvantages of central clearing (including increased cost and operational complexity) without one of the key benefits.
- (b) Paragraph 112(b) of the consultative document requires arrangements to ensure an institution's trades will be taken over by another Clearing Member in the event a bank's Clearing Member defaults or becomes insolvent. We understand that trade portability is often allowed by a CCP at a Clearing Member's insolvency/default, but that such portability is not guaranteed. This would seem to imply that banks cannot qualify for the 2% risk weight capital treatment for their trade related exposures. We would appreciate further clarification from the Committee if this is the intended result, especially as there may also be prudential concerns with establishing a system where trade portability is guaranteed (as it would reduce the incentives for clients to exercise proper diligence and monitor the credit quality of their Clearing Member). We further assume that there is no capital requirement associated with being a 'backup' Clearing Member under a portability guarantee; assurance on this point would also be appreciated.

Finally, we note that this aspect of the proposal incentivizes segregation of client assets. However, it may be preferable not to alter the balance between the safety inherent in

enhanced segregation of client collateral and the cost associated with such additional protection. At the least, consideration should be given to allowing institutional clients to opt for non-segregation. This is particularly the case given that, whether or not segregation exists, it is the effectiveness of portability that will determine whether the client is impacted by the failure of a Clearing Member.

#### *5. Determination of a “Qualifying CCP”*

The consultative document<sup>15</sup> suggests that the home CCP supervisor and potentially various bank supervisors have a role in determining whether a CCP is compliant with CPSS- IOSCO standards.

In general, we think that a clear, coordinated, and internationally standardized process is required here. It must be evident at all times whether a particular CCP is a Qualifying CCP, which authority makes that determination, and when that designation is subject to review.

OTC derivatives markets are highly international in nature. This international scope brings significant benefits. It is essential that as the use of central counterparties and trade repositories increases, this is done in a manner that reduces systemic risks while retaining the benefits of existing markets, such as the availability of risk management services. Inward-looking approaches which result in the fragmentation of these markets along national or regional lines are to be avoided. The work of CPSS-IOSCO should make a significant contribution in this regard. Consideration should also be given to agreed international methods for assessing the implementation of such standards, possibly building on the work of the FSB Standing Committee on Standards Implementation in this general regard.

To that end, we recommend clarity concerning the body responsible for the determination of Qualifying CCP status for the purposes of these proposed reforms. In this context, we further urge the Committee to consider the process for a cessation of a “Qualifying” designation in addition to the designation of Qualifying CCPs in recognition of the fact that this could change over time. The cessation process is of particular importance given that a sudden loss of the “Qualifying” status could cause considerable disruption, including the potential to change the economics of an already agreed financial contract. Please note in this context that the economics of a financial contract include the costs of any associated capital or margin requirements imposed by a CCP on parties to that contract. As a related matter, we ask the Committee to consider the benefits of a gradual approach to the relevant financial requirements deemed necessary when cessation of a “Qualifying” status occurs, as a sudden change in, for instance, capital requirements gives rise to both serious concerns about the competitive settings among market participants and CCPs, and the potential disruption caused by the determination itself that the CCP is no longer a Qualifying CCP. Indeed, in the absence of a gradual approach, it is not difficult to imagine a “run on a CCP”

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<sup>15</sup> Paragraphs 107 and 108, Annex A.

if one or more members took a view that a CCP's "Qualifying" status was in doubt. This could give rise to systemic risk and thus defy the objective of the proposals.

In light of the above, we would also request that the criteria for both processes (entry to and exit from the Qualifying CCP status) be as transparent as possible. Thus we recommend the existence of an official international repository listing the Qualifying CCPs and the timing of reviews so that this information is public and readily accessible (for instance on the BIS website). We urge the national and international regulators to cooperate in these processes.

#### *6. Concerns over Risk Sensitivity and the CEM*

The risk sensitivity of the core calculations is of paramount concern in the design of capital rules. In this regard the Associations have a number of concerns with the use of the current exposure method ("CEM") (and to a lesser extent other regulatory capital approaches to counterparty credit risk) for cleared OTC derivatives:

- Any percentage-of-notional based approach, such as the CEM, penalizes large well-hedged portfolios versus smaller riskier ones. We consider this a highly undesirable incentive, and would strongly urge the Committee to consider approaches which do not suffer from this drawback. Note in this context that the CEM would seem to require a level of margin which is much higher than prudent well-resourced CCPs currently charge due to its risk insensitivity<sup>16</sup>.
- The net portfolio risk position should always form the basic exposure measure for capital purposes (assuming that netting is enforceable in the relevant jurisdictions). Some regulatory approaches, such as the CEM, violate this principle.
- The holding period used in many regulatory capital approaches to bilateral counterparty credit risk is larger than the Associations consider appropriate for OTC derivatives CCPs, given their frequent margin calls. Thus the standardized method does not suffer from the issues discussed in the immediately preceding points, but it would require recalibration to reflect the shorter margin period of risk before adoption in an OTC derivatives CCP context. This is discussed further in the next section.
- The CEM was calibrated some years ago and has not been purpose built for credit products.

The issues outlined above are of fundamental importance. They demonstrate that the CEM is highly inappropriate both quantitatively and methodologically as a capital methodology for OTC derivatives CCPs. As we noted in the introduction, the incentive structure created by capital rules must be correct. The CEM does not meet this requirement. This is

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<sup>16</sup> To get a crude estimate of the magnitude of the portfolio effect ignored by the CEM, compare the ratio of the total margin to the total notional cleared at LCH (c. 0.5 bp) with a typical CEM haircut for IRS (50bps). This comparison indicates that a CEM-based calculation is inappropriate by more than an order of magnitude.

because it will suggest for a large well-hedged collection of portfolios (such as are typical of large CCPs) that the CCP's hypothetical capital is an order of magnitude higher than a risk sensitive calculation would. The consequence of this overstatement is that default fund contributions will be (erroneously) given a 1250% risk weight. Thus there is an incentive to reduce these contributions, and an associated increase in systemic risk.

### *7. Capitalization of Default Fund Exposures and Hypothetical Capital Methodologies*

The Committee proposes that a bank should capitalize its default fund exposures to a Qualifying CCP according to an approach that is based on the CCP's "hypothetical capital". The approach is therefore based on CCP specific information.

The risk of a Clearing Member's default fund contribution depends critically on its position in the loss waterfall. Thus if a defaulting member's own default fund contribution is used before that of other members (as is typical), then one critical determinant of default fund risk is an individual Clearing Member's margin versus the hypothetical capital required for *its* portfolio, rather than the total margin versus total hypothetical capital. We therefore urge the Committee to make the determination of the adequacy of margin sensitive to CCP waterfall structures. We would also stress the importance of flexibility, as different waterfall structures may be developed as central clearing of OTC derivatives evolves.

An alternative to the Committee's proposal is to allow CCPs to apply for permission to use appropriately risk-sensitive models (such as an IMM model<sup>17</sup>) for the hypothetical capital calculation. This permission should be granted under the same standards as a bank application, with the same requirements for backtesting, hypothetical portfolio validation, and other key risk controls. It is important to emphasize that qualifying CCPs are generally expected to have very robust risk management and modeling capabilities (in order to meet the still-developing CPSS-IOSCO standards for qualifying CCPs) so this should not pose a disproportionate burden.

Another alternative for many waterfalls would be to note that since the Clearing Member's default fund contribution is at risk due to their own non performance first, a hypothetical capital calculation could be performed by comparing the capital required for the Clearing Member's portfolio with the margin for that portfolio. Since this only relies on information known to the Clearing Member, they rather than the CCP could perform the calculation. In particular, this approach would allow for the use of risk-sensitive models in the determination of hypothetical capital, mitigating the serious concerns over the risk-sensitivity and potential mis-calibration of the CEM. (The risk of multiple Clearing

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<sup>17</sup> Some modifications to the IMM approach will be needed in this case, such as a review of the margin period of risk for large netting sets. If a CCP can demonstrate (through a tested, appropriately conservative default management program) that it can liquidate a large Clearing Member's portfolio within five days, then that period is an appropriate one for capital purposes.

Member defaults could perhaps be handled here by adjusting the risk weight on the resulting exposure.)

If the Committee wishes to adhere to its original proposal (using total margin and total hypothetical capital), then the Associations point out that there are internal departments at banks with considerable expertise and experience in the calculation of counterparty risk capital. Thus, a further possibility would be to require CCPs to provide sufficient information to allow market participants to assess their credit quality and hypothetical capital using risk sensitive methodologies.

There are clear tradeoffs between calculations performed at the level of the CCP and those performed by individual firms. In the aggregate, we can appreciate the intention to achieve greater overall accuracy by adopting CCP level calculations, although in the absence of detailed data, it is difficult to determine how material this improvement is likely to be in practice. On the other hand, many firms are concerned at the potential increase in operational risks that could arise from reliance on a third party for calculations that may be relevant to time-sensitive regulatory filings and disclosures.

We urge the Committee to consider providing flexibility in this area, at least initially, to gain more practical experience in weighing these tradeoffs. In so doing, it would be helpful if the Committee could articulate principles for the standards to be applied for the use of third party data and information as inputs to a firm's own calculations.

#### *8. Unfunded Capital*

The Committee proposes a 1.2 scalar in the hypothetical capital calculation for unfunded CCP capital. Given that historically no credit has been given for unfunded capital, we would urge the Committee to publish the rationale for taking this approach.

#### *9. Implications of the Proposed Reforms for Client Clearing*

We seek greater clarification from the Committee on how it sees the capital treatment of cleared trades that Clearing Members undertake on behalf of clients.

The consultative document is unclear on the client-to-Clearing Member leg of these transactions. We urge the Committee to clarify their intent here, both with respect to OTC derivatives clearing and the clearing of exchange-traded derivatives. The latter case is especially pertinent as the existing Basel rule states<sup>18</sup> that that if a product is exchange-traded (which could be a proxy for sufficient liquidity) and there is initial and daily margining, then no risk weight on trade exposures is required. Clients will suffer

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<sup>18</sup> Basel Committee on Banking Supervision (2006) *International Convergence of Capital Measures and Capital Standards' A Revised Framework Comprehensive Version* (Bank for International Settlements: Basel, Switzerland) Annex 4, page 258, paragraph 6.

significant liquidity demands under central clearing due to margin; any further burden due to increases in their capital requirements may not provide the right systemic incentives.

On a closely related matter, we would ask the Committee to confirm that Clearing Members are not required to apply the Basel III CVA charge to trades which they clear for clients.

#### *10. Definitional Issues*

OTC derivatives clearing models include both Agency-based and Principal-based approaches. We therefore urge the Committee to provide definitional clarity on the key term “trade exposure” under both models.

Similar comments apply to “collateral”, which can be held at both the Clearing Member and the CCP in the Principal model or just at the CCP in the agent model. Moreover slightly different collateral models can sometimes be applied to initial and variation margins. Clarity over which amounts apply to which parts of the capital calculation (for both clients and Clearing Members) is required. Furthermore, since client funds can appear in the CCP loss waterfall, they must be separately considered in any capital proposal.

Finally, the term “default fund” is also subject to multiple interpretations so we urge the Committee to provide greater precision in this area.

#### *11. Technical Basel II and Basel III Implementation Concerns*

With respect to Basel II, the consultative document (paragraph 119) uses the Standardized Approach for credit risk in the main framework as a fall back mechanism for capturing the risk of transactions with a non-qualifying CCP or to a qualifying CCP that do not meet the requirements in paragraph 106. A number of jurisdictions, such as the US, have not implemented a standardized approach. While we recognize that this is an issue unique to banks in those jurisdictions, further guidance on what approach may be applied to these exposures (in the absence of a Standardized Approach) would be helpful for those banks’ efforts to gauge the implications of these proposals.

### **Conclusion**

The public policy rationale for the Committee’s proposed reforms is to require banks to more appropriately capitalize their exposures to CCPs, including trade and default fund exposures. While this is an appropriate goal, and the consultative document makes an excellent start to the discussion, significantly more consultation, dialogue and open debate among affected parties is necessary to refine the proposals to be efficient, effective and proportionate to the policy goals. As stated at the outset, effective reforms require the Committee to continue an active dialogue with the industry, CPSS-IOSCO and other stakeholders.

We appreciate the opportunity to provide these comments. Should you require further information, please do not hesitate to contact the undersigned.

Sincerely,



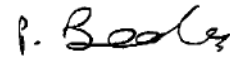
Simon Hills  
Executive Director  
*British Bankers  
Association*



David Schraa  
Director, Regulatory  
Affairs  
*Institute of  
International Finance*



David Murphy  
Global Head of Risk and  
Research  
*International Swaps and  
Derivatives Association,  
Inc.*



Peter Beales,  
Managing Director  
*GFMA*

## **Annex**

### *British Bankers Association (BBA)*

The British Bankers' Association ("BBA") is the leading association for the UK banking and financial services sector, speaking for over 230 banking members from 60 countries on the full range of the UK and international banking issues. All the major and less big commercial banks in the UK are members of our association as are the large international EU banks, the US banks operating in the UK and banks from India, Japan, Australia and China. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit taking and other conventional forms of banking.

### *Global Financial Markets Association ("GFMA")*

The Global Financial Markets Association (GFMA) joins together the common interests of hundreds of financial institutions across the globe. GFMA's mission is to develop policies and strategies for global policy issue in the financial markets, thereby promoting coordinated advocacy efforts across its partner associations. GFMA is partnered with the Association for Financial Markets in Europe (AFME), the Asian Securities and Financial Markets Association (ASIFMA), and, in the United States, the Securities Industry and Financial Markets Association (SIFMA).

### *Institute of International Finance ("IIF")*

The Institute of International Finance, Inc. (IIF) is the world's only global association of financial institutions. Created in 1983 in response to the international debt crisis, the IIF has evolved to meet the changing needs of the financial community. The IIF now serves its membership in three distinct ways:

- Providing analysis and research to its members on emerging markets and other central issues in global finance.
- Developing and advancing representative views and constructive proposals that influence the public debate on particular policy proposals, including those of multilateral agencies, and broad themes of common interest to participants in global financial markets.
- Coordinating a network for members to exchange views and offer opportunities for effective dialogue among policymakers, regulators, and private sector financial institutions.

The Institute is headquartered in Washington, D.C., and in November 2010 opened its Asia Representative Office in Beijing.

IIF members include most of the world's largest commercial banks and investment banks, as well as a growing number of insurance companies and investment management firms. Associate members include multinational corporations, trading companies, export credit agencies, and multilateral agencies. Approximately half of the Institute's members are European-based financial institutions, and representation from the leading financial institutions in emerging market countries is also increasing steadily. By 2010, the Institute's members include over 420 of the world's leading banks and finance houses, headquartered in more than 70 countries.

*International Swaps and Derivatives Association, Inc. (“ISDA”)*

ISDA is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 830 member institutions from 57 countries on six continents. These members include most of the world's institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter (“OTC”) derivatives to manage efficiently the financial market risks inherent in their core economic activities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business through documentation that is the recognized standard throughout the global market, legal opinions that facilitate enforceability of agreements, the development of sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.