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Clarifications on BCBS 190 Proposals regarding Indirect Access to OTC derivatives CCPs

Dear Mark

Thank you for hosting the April 13 workshop on the Committee's proposals regarding the capitalisation of exposures to CCPs, and for the prior note summarising the main issues arising from the responses to the consultative paper¹ (the "RMMG Note").

Following the workshop, we would like to raise three issues with the RMMG. First, we would like to confirm our understanding regarding the capital treatment of cleared client trade exposures at OTC derivatives CCPs. In particular we believe that when a clearing member ("CM") is acting for a client as an agent, and assuring the performance of that client to the CCP, the capital treatment for the CM should be the same as that which pertains when the CM is acts for that client as principal.

Second, we seek clarification that when the favourable risk weighting for cleared client trade exposures is achieved, a CM will record exposures to the client, but *not* to the CCP for the client's transactions.

Third, we wish to express concerns regarding the standards of portability sufficient for the extension of the favourable capital treatment for the client's trade exposures, given the multiple portability models and difficulty in achieving 'guaranteed' portability.

1. Capital treatment of the client trade under the "Agency Model"

As noted in the comment letter submitted by the Associations² of 4 February 2011, in the case of cleared transactions undertaken on behalf of clients, the BCBS proposals published in December 2010 did not address the capital treatment of the client-to-CM leg of the transaction.

¹ Circulated 7 April 2011

² The British Bankers Association, the Global Financial Markets Association, the Institute of International Finance, and International Swaps and Derivatives Association, Inc.

The RMMG Note provides further clarity stating that an extension of the favorable capital treatment for the client-to-CM leg (and thus the provision of an additional incentive to clear through CCPs) is available where a CM is acting for a client as an agent³:

The RMMG will clarify that clearing members that act as agent do not have to capitalise for the client trade exposures as the client is trading with the CCP...However, where the clearing member is acting as a principal (i.e., trades directly with the client and does a mirror/offsetting trade with the CCP), the clearing member must capitalise the client trade as a bilateral transaction.

However, as noted by several participants at the April 13 workshop, we consider that the capital treatment of a CM's exposures (both to the client and to the CCP) should be the same under the US (agency) model as under the UK (principal) model for clearing trades⁴, provided always that the risk profile is the same (or substantially the same).

Under the agency model, a CM typically acts as 'guarantor' of its customer's performance to the CCP, and in the event of customer default, the CM is responsible to the CCP for the customer's trading losses. This generally is accomplished by CCP rules that condition the membership in the CCP not only on satisfaction of minimum financial requirements and the posting of performance bond/margin by the CM, but also on an agreement by each CM to assume full financial responsibility for all transactions executed through the CCP, including transactions executed as agent on behalf of customers.

The CME Group

CME Clearing is a major US CCP and employs the agency model. CMs clearing customer trades through CME must be registered Futures Commission Merchants ("FCMs"), subject to regulation by the Commodity Futures Trading Commission. Consequently, clients clearing OTC derivatives through the CME will be required to maintain a clearing relationship with an FCM, which will serve as their agent and guarantor in respect of cleared trades.

We note in this regard that the Clearing Membership Handbook for the CME Group, which is comprised of the Chicago Mercantile Exchange ("CME"), the Chicago Board of Trade ("CBOT"), the New York Mercantile Exchange ("NYMEX"), and Commodity Exchange, Inc. ("COMEX"), states as follows⁵:

Clearing membership in CME, CBOT, NYMEX and/or COMEX ... is a privilege granted by the Clearing House Risk Committee of CME. Clearing members assume full financial and performance responsibility for all transactions executed through them and cleared by the Clearing House. They are responsible and

³ Page 7, RMMG Note Overview of the responses to the consultative document 'Capitalisation of bank exposures to Central Counterparties'

⁴ Not all US CCPs employ the agency model. For example, ICE Trust, a New York Trust Company and a member of the Federal Reserve System that has cleared credit default swaps employs the principal model. Note that the futures commission merchant requirement of section 724 of the Dodd-Frank Act is generally understood to drive the developing cleared swap market towards the agency model.

⁵ CME Clearing Membership Handbook (emphasis added) at 1-1, available at <http://www.cmegroup.com/company/membership/files/clearmemberhandbook.pdf>.

accountable for every position they carry, whether it is for the account of a member, non-member customer or their own account.

Guidance provided to OTC derivatives CMs by the CME elaborates on the relationship between this obligation and the “agency” model⁶:

[a] clearing member who clears customer business acts as agent for undisclosed principals (i.e. the customers) vis-à-vis CME Clearing and guarantees their customers’ performance to CME Clearing. Thus, from CME Clearing’s perspective, the clearing member faces CME Clearing as principal on its customer transactions.

CMs of each of the CME Group exchanges “assume full financial and performance responsibility for all transactions executed through them and all positions they carry,” including when executing trades for customers. Moreover⁷:

CME Clearing does not look to individual customers for performance or attempt to evaluate their creditworthiness or market qualifications. CME Clearing looks solely to the clearing member firm carrying and guaranteeing the account to secure all payments and performance bond obligations.

Risks in the FCM Model

CMs under the US/FCM model, therefore, that are executing a transaction on behalf of a client have essentially the same degree of exposure to client default as a CM operating under the principal model. In either case, the CM is responsible to the CCP for the client’s obligations. In the case of FCM model CCPs, the mechanism employed to reach this result is typically an omnibus guarantee on the part of a CM that it will satisfy all transactions it places with the CCP, whether proprietary or on behalf of customers, as a condition of being permitted membership. A CM’s failure to satisfy such obligations to the CCP is generally treated as a default of the CM.

Accordingly, notwithstanding the agency relationship between the client and CM, there is in practice no difference in credit risk exposure between the two models, given that both relate to the CM’s exposure to the client. This supports the application of the same capital treatment.

In any event, and in relation to both models of client clearing, the mechanics of the risk transfer should be taken into account by the RMMG. In the event of default of the client, the corresponding cleared positions can be closed out almost immediately on the exchange or through the central clearer. Accordingly, the margin period of risk is much shorter, and largely is differentiated only by client type (institutional, retail, etc) and their ability to effectuate the transfer of margin. Firm’s internal risk management procedures already assess and take this into consideration. Accordingly, a bilateral capital treatment that may be appropriate where a longer liquidation time or close-out may be necessary (for example, in

⁶ CME OTC Derivatives Clearing Membership: Summary of Membership Requirements at 1, available at http://www.cmegroup.com/company/membership/files/CME_OTC_Clearing_Membership_Summary.pdf.

⁷ CME Group, CME Clearing: Financial Safeguards, available at <http://www.cmegroup.com/clearing/files/financialsafeguards.pdf>.

relation to a bank's exposures to another bank) does not seem appropriate in terms of the CM's risk exposure to the client position.

2. Clarification regarding capital treatment when "indirect access" achieved

A further clarification would be appreciated in respect of the CM-to-CCP leg in the principal-to-principal model where the client achieves "indirect access". Where the client is able to achieve segregation and portability (see below) they are able to look through to the CCP and achieve a 2% risk weight rather than receiving a normal risk weight on the CM. It would seem perverse for both the client and the CM to record exposures to the CCP in respect of the same trades. We therefore assume that where "indirect access" is achieved the regulatory capital treatment for the principal-to-principal model and agency-with-guarantee model will be identical: the client will record exposures to the CCP (but not to the CM), while the CM will record exposures to the client (but not to the CCP for the client's transactions). We would be grateful for your confirmation that this is the intention.

3. Clarification regarding segregation and portability

There are many different ways that margin can be segregated depending on how the margin is posted and held and the segregation in place in a given situation. This is critical in relation to whether customer positions and related margin are likely to be successfully ported.

One variable in margin posting is whether a CCP collects margin from CMs on a gross basis (i.e. the CCP collects from each CM all margin posted by the CM's customers on account of CCP-imposed margin requirements) or on a net basis (i.e. the CCP collects from each CM a level of margin sufficient to account for the net risk to the CCP of the combined customers' positions, with offsetting customer positions resulting in a corresponding reduction in the aggregate margin requirement).

An important consideration in how margin is held is the degree to which the margin is commingled with other assets and where the margin is held. Customer assets may be comingled with the CM's proprietary assets or segregated from the CM's proprietary assets in an omnibus or on an individual client basis. Margin may be held at the CCP (in the client's name or in the CM's name), at the CM, or at a third-party custodian. In a situation where margin is posted by the client on a gross basis, but collected by the CCP on a net basis, it is possible that client margin is held at both the CCP and the CM.

Initially, we understood from the BCBS consultative paper that the favourable capital treatment could only be extended to the client trades where the conditions for the highest degree of segregation and portability exist, namely individual client segregation, and margin is posted by CMs on a gross basis and held at the CCP in an account in the client's name. However, at the 13 April workshop, the RMMG indicated that so long as the client can transfer or novate its positions and related margin or has assertable rights in that regard (without interference from other parties' assertable rights), the favourable treatment is available regardless of other aspect of the segregation and portability regime.

However, this standard would mean that the favourable treatment could apply where a CCP collects margin from CMs on a net basis and where the CM has individually segregated and

bankruptcy remote client accounts – even though, in the event of a CM default, the CCP cannot control all of the client’s margin given that some is held by the CM.

In addition, this standard would have implications for the jurisdiction in which a CM is based. For example, French law requires customers who have deposited cash margin (whether via security interest or title transfer) or security margin (via title transfer) with the French CM to share in any shortfall on a pro rata basis with all other unsecured claimants of the French CM. In other words, the existence of assertable legal rights by a client does not remove the considerable uncertainty regarding portability of positions and related margin, due to the differing insolvency rules in different jurisdictions.

In recognition of equivalent difficulties in respect of bankruptcy remoteness⁸ and segregation, the RMMG Note states⁹:

Effective segregation and bankruptcy remoteness is a question of fact and law based on the circumstances. National supervisors could be consulted to determine whether such objectives are achieved. Defining bankruptcy-remoteness further may not be practicable given CCP and local variations (e.g. legal regimes).

We support this approach and consider that it should also apply in respect of portability. That is, we urge the BCBS to allow for consultation with local supervisors regarding the standard of portability that exists and whether that standard is sufficient to warrant the extension of the favourable capital treatment for the client’s exposures.

Given the considerable impact on capital of the standards of segregation, bankruptcy remoteness and portability, we urge the BCBS to be mindful of the particularities of individual jurisdictions, so that local regulators have some guidance in their review and the same principles are applied to ensure a level playing field despite of potential differences in local bankruptcy laws.

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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.

Kind regards,



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⁸ For example: is margin in a model where the clients post margin gross, which is held by the CCP in the client’s name but not segregated and with clauses in the clearing agreements that the collateral is returned to the client in case of the CM’s default (i.e. the LCH margin model) “bankruptcy remote”?

⁹ Page 6, RMMG Note Overview of the responses to the consultative document ‘Capitalisation of bank exposures to Central Counterparties’