ISDA® Safe, Efficient Markets

15 February, 2013

Secretariat
Committee on Payment and Settlement Systems ("CPSS")
Bank for International Settlements
By email to: cpss@bis.org

Secretariat
Technical Committee
International Organization of Securities Commissions ("IOSCO")
By email to: fmi@iosco.org

Copy to: Svein Andresen
Secretary General, Financial Stability Board ("FSB")
By email to fsb@bis.org

Qualifying Central Counterparties ("CCPs")

Dear Secretariats

We wish to alert you to a matter which, in our view, may adversely impact the consistent global implementation of the CCP capital requirements. Our concern, in summary, is that without a centrally held and internationally agreed list of Qualifying CCPs ("QCCPs") or CPSS-IOSCO compliant regimes, it is unclear how the CPSS-IOSCO Principles for Financial Market Infrastructures ("PFMI") could be consistently assessed for CCPs, including for capital purposes. While latitude is being given to resolve this during 2013 for most jurisdictions, banks' risk assessment and business viability review process means that an urgent resolution is required to remove uncertainty from the market place.

The principal issue is one of cross-border supervisory equivalence. There is doubt as to how, absent a definitive and globally consistent regulatory view, a bank can prudently determine whether a CCP is a QCCP for the purposes of complying with the Basel capital requirements. This is especially relevant given potential questions of equivalence between different bank and CCP supervisors. After outlining our concern in more detail, this letter proposes potential solutions that we are exploring to address this matter, while acknowledging that some of our proposed solutions contain their own difficulties and risks.

Background

We refer you to the interim framework for determining capital requirements for bank exposures to CCPs published by the Basel Committee on Banking Supervision ("BCBS") in July 2012 ("BCBS 227"). BCBS 227 sets out favourable capital rules for bank exposures to a QCCP. The rules define a QCCP as follows:

> …an entity that is licensed to operate as a CCP (including a license granted by way of confirming an exemption), and is permitted by the appropriate regulator/overseer to operate as such with respect to the products offered. This is subject to the provision that the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to

> the CCP on an ongoing basis, domestic rules and regulations that are consistent with the CPSS-IOSCO Principles for Financial Market Infrastructures.
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> As is the case more generally, banking supervisors still reserve the right to require banks in their jurisdictions to hold additional capital against their exposures to such CCPs via Pillar 2. This might be appropriate where, for example, an external assessment such as an FSAP has found material shortcomings in the CCP or the regulation of CCPs, and the CCP and/or the CCP regulator have not since publicly addressed the issues identified.
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> Where the CCP is in a jurisdiction that does not have a CCP regulator applying the Principles to the CCP, then the banking supervisor may make the determination of whether the CCP meets this definition.
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> In addition, for a CCP to be considered a QCCP, the terms defined in paragraphs 122 and 123 of this Annex for the purposes of calculating the capital requirements for default fund exposures must be made available or calculated in accordance with paragraph 124 of this Annex.

In December 2012, BCBS release a "FAQ" on these rules. One question raised was:

> **Industry would like to seek clarification as to 1) who will determine whether a CCP is qualifying; and 2) If it is the national supervisors, when will the list be available?**
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> If a CCP regulator has provided a public statement on the status of a CCP (QCCP or non-qualifying), then banks will treat exposures to this CCP accordingly. Otherwise, the bank will determine whether a CCP is qualifying based on the criteria in the definition of a QCCP in Annex 4, Section 1.
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> During 2013, if a CCP regulator has not yet implemented the CPSS-IOSCO *Principles for Financial Market Infrastructures* (PFMIs), but has publicly stated that it is working towards implementing these principles, the CCPs that are regulated by the CCP regulator may be treated as QCCPs. However, a CCP regulator may still declare a specific CCP non-qualifying.
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> After 2013, if a CCP regulator has yet to implement the PFMIs, then the bank will determine whether a CCP subject to such a CCP regulator's jurisdiction is qualifying on the basis of the criteria outlined in the definition of a QCCP in Annex 4, Section 1. The bank will provide its supervisor with a list of CCPs that it has exposure to, including its evaluation of the relevant criteria. An important consideration for this purpose is whether a CCP is subject to domestic rules and regulations that are consistent with the CPSS-IOSCO *Principles for Financial Market Infrastructures*.

Our concern

Of all the implementation issues relating to CCPs, the approval as QCCPs is the most taxing. Several firms based in jurisdictions where these rules are in force (for example, Switzerland) have produced their own list of QCCPs.

Further, it is unclear to the external observer that each IOSCO member state has a commitment to comply with CPSS-IOSCO PFMI in a timeframe that will allow banks to make a credible determination of QCCP status within the Basel 3 framework's timeframe.

From the text and various questions raised, we consider that the hierarchy of approval to become a QCCP is:

1. The CCP supervisor states that the CCP qualifies,
2. Clearing members evaluate and state that the CCP qualifies,
3. The clearing members' supervisor makes the final decision that the CCP qualifies.

However, potentially the bank supervisor may not consider the CCP supervisor to be equivalent, with capital consequences for the bank dealing with the CCP.

Additionally, in Europe, a CCP must register under EMIR in order to be considered a QCCP. For CCPs that are not European, and do not deal with European firms, there is no incentive to register. If a CCP's clearing member is a non-European subsidiary of a European bank, then on a consolidated basis exposure to the CCP will presumably have to be considered non-qualifying, again leading to a capital impact for the clearing member.

Further, Australia[1] and India[2]'s local implementations of BCBS 227 do not include the 'Method 1' or 'hypothetical capital' construct to calculate the capital requirements for default fund exposures. Some other jurisdictions may follow this approach. In the Australian Prudential Risks Authority's ("APRA") discussion document the explicit rationale is "Given the interim nature of the rules and to reduce complexity, APRA proposes to implement only the simpler of these two methods."[3]

Consequently, CCPs will not be required to calculate "Kccp", which is necessary for Method 1 in the interim framework. We consider that the APRA and the Indian Central Bank have been sufficiently transparent on their decision for other supervisors to accept this. Indeed, we consider the approach is sensible given our long held concerns with the hypothetical capital construct. However, we are conscious that under the proposed CRD IV text this may negatively impact CCP designation for EU bank capital purposes.

It has been mooted that banks might integrate the CPSS-IOSCO PFMI into their own risk assessment of each CCP (as a fall back option for internal consistency) and make a judgement based on that where there is lack of CCP supervisory guidance. While beneficial for internal risk management and assessment purposes, there may be practical impediments to this and it will raise further questions of consistency across banks and jurisdictions. The CCP is unlikely to provide banks as much information as would a supervisor and as such the judgement would have an element of subjectivity. We consider that QCCP status should not be a subjective decision taken from an individual bank's perspective but should rather be based on objective criteria that apply universally to all organisations interfacing with the CCP. Accordingly, we recommend approaching this designation in a coordinated manner. To that end, we support a central list, or at the very least a public statement by each supervisor.

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[1] Australian Prudential Regulation Authority *Discussion Paper Implementing Basel III capital reforms in Australia – counterparty credit risk and other measures*, August 2012, available at http://www.apra.gov.au/adi/PrudentialFramework/Documents/APRA_Discussionpaper_BASEL3_CCR_FINAL_2.pdf

[2] Exposures to Qualifying CCPs refer 5.15.3.9(ii)(c) of the Reserve Bank of India's Guidelines draft guidelines on capital requirements for bank exposures to central counterparties, based on the interim framework of the Basel Committee on Banking Supervision, available at http://rbidocs.rbi.org.in/rdocs/content/pdfs/CCDGCR100113_A1.pdf

[3] Australian Prudential Regulation Authority *Discussion Paper Implementing Basel III capital reforms in Australia – counterparty credit risk and other measures*, August 2012, available at http://www.apra.gov.au/adi/PrudentialFramework/Documents/APRA_Discussionpaper_BASEL3_CCR_FINAL_2.pdf, page 17.

Materiality of QCCP status

Where a national supervisor determines that a CCP is Qualifying, but supervisors in other jurisdictions have not so approved, then the capital calculation for the trade exposure to the CCP is up to 50 times higher (2% risk-weight goes to a standardised risk weight (e.g., 20%, 50% or 100%), and the default fund contributions (both pre-funded and unfunded/ contractually committed) are risk-weighted at 1250%.

Given the stark cost implications, there are clear incentives for national supervisors, CCPs and banks to treat their CCPs as QCCPs. At first sight, this appears to align with a policy goal of encouraging CCPs to become QCCPs through compliance with CPSS-IOSCO PFMI. However, there is a risk that important PFMI risk management standards will be applied inconsistently (if at all). For example, certain CCPs are treated as QCCPs notwithstanding that these CCPs provide unlimited liability for their clearing member guarantors. It is also likely, and equally unwelcome, that each CCP will be encouraged to seek approval in numerous jurisdictions even if none of its clearing members are connected to a given jurisdiction (given the application of the capital rules at a consolidated level). Put simply, fragmented and inconsistent QCCP designation will detract from the application of CPSS-IOSCO FMI and create unnecessary costs for CCPs and industry.

The CPSS-IOSCO Assessment Methodology

We recognise that the CPSS-IOSCO Assessment Methodology provides a way to evaluate an FMI's observance of the FMI Principles and that frequent internal and external reviews provided for by the Assessment Methodology will be helpful in reducing the risk posed by CCPs.

However, as we have submitted previously, the Assessment Methodology does not specify the frequency with which assessments should be performed (by an FMI itself, national authorities or external assessors). Instead, the Assessment Methodology merely states that FMIs "may have to" periodically conduct self-assessments and that national authorities are "expected" to "regularly assess" FMIs.

We believe that, without frequent internal and external compliance reviews, FMIs will be more likely to fail to observe the principles and responsibilities dictated by the FMI Principles. Accordingly, we believe that internal and external assessments should be mandatory, and that national authorities and FMIs should be required to conduct these assessments on at least an annual basis.

Similarly, in order to ensure that any potential problems identified during the assessment process are resolved, we urge CPSS-IOSCO to require that material concerns be reported to the FSB. Additionally, we believe that the FSB should function as a centralized repository for all assessment reports by national authorities, evaluating such reports for consistency and providing external oversight with respect to developing issues. We also suggest that the Assessment Methodology include clear instructions for national authorities, as well as the International Monetary Fund and the World Bank (both of whom will function as external assessors under the Assessment Methodology), as applicable, to bring promptly to the attention of the FSB any relevant issues regarding an FMI or its oversight.

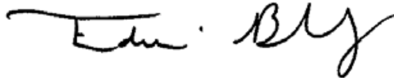
Proposed solutions

We feel strongly that CPSS-IOSCO, as owners of the PFMI, ought to address this issue, for example by maintaining an official list of QCCPs that would be accepted globally by bank supervisors. We understand consideration is being given to CPSS-IOSCO forming a new independent college of regulators that would assess third country CCP adherence to the PFMI. We would support such an initiative.

As an alternative (albeit one that the industry considers inferior), ISDA is exploring the idea of maintaining a list of QCCPs. CCPs would need to demonstrate to ISDA that they are compliant according to agreed criteria (for example, based on an official statement or other disclosure) in order to be included on the list. Given that ISDA is not a regulator, the list would be published for information purposes only. However, ISDA and industry would make every effort to ensure its credibility.

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

Yours sincerely,



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