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The European Commission

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European Commission compromise draft on capital requirements for bank exposures to central counterparties ("CCPs") in the Capital Requirements Regulation ("Draft CRR Text")

Dear Mr. Nava, Mr. Pearson, Mr. Van der Plaats, Mr Hrovatin and Mr. Pranckevicius

We[1] have observed a number of differences between the Draft CRR Text and the Basel international standards set out in the interim framework for determining capital requirements for bank exposures to CCPs, viz. BCBS 227 of July 2012. As you know, BCBS 227 was introduced following two public consultations and almost 2 years of engagement.

We would like to stress that these differences will impact all banks and CCPs in the European Union, and are raised here to help maintain a level playing field between EU and non-EU

[1] ISDA: Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 800 member institutions from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

The Association for Financial Markets in Europe (AFME) represents a broad range of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks and other financial institutions. AFME advocates stable, competitive and sustainable European financial markets, which support economic growth and benefit society. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

institutions. ISDA is a long-time proponent of consistent international risk management standards, which are crucial to avoid regulatory arbitrage, mitigate systemic risk and avoid spill over across countries.

A number of the proposed deviations of the Draft CRR Text from the international Basel standard would materially increase regulatory capital requirements for EU-based institutions, both as clearing members and as clearing customers, thereby effectively limiting the direct access to central clearing as well as clearing members' capacity for offering clearing services to third parties. The requirement to hold additional regulatory capital for "contractually committed contributions" to CCPs' default funds over and above the requirement under the Basel framework, which covers banks' entire exposure to a CCP's default fund, implies a double counting of risks. Similarly, the requirement that banks must hold capital for trade exposures with a CCP where the bank purely acts as financial intermediary between a client and the CCP, but does not guarantee the CCP performance to the client, implies that the risk of a CCP default is capitalised twice.

The impact of these and other rule inconsistencies can be material, and in our view are not necessary from a prudential viewpoint. Accordingly, the Annex to this letter contains two tables. The first table sets out what we view as "Material Differences" from BCBS 227. We consider it is extremely important that the EU regulations do not deviate from the international standards on these matters. As a result, in relation to these we seek alignment of the Draft CRR Text with the relevant BCBS 227 paragraphs. A second table notes additional observations and inconsistencies between the Draft CRR Text and BCBS 227. We trust that further clarity on these issues will contribute to timely and efficient local implementation of the EU regulation.

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

Yours sincerely,

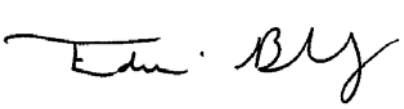

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Table 1: Material Differences

Topic in order of importance	BCBS 227 Rule reference	Issue	Proposed solution
1. Clearing Member bank holding regulatory capital against a trade exposure to CCP for client trades (refer Article 296 of Draft CRR Text)	BCBS 227. Para 110 states: "Where a bank acts as a clearing member for its own purposes, a 2% risk weight must be applied to the bank's trade exposure to the CCP… Where the clearing member offers clearing services to clients, the 2% risk weight also applies to the clearing member's trade exposure to the CCP that arises when the clearing member is obligated to reimburse the client for any losses suffered due to changes in the value of its transactions in the event that the CCP defaults."	BCBS 227 clarifies that a clearing member bank is not required to take regulatory capital for a trade exposure to CCP for client trades unless the bank guarantees the CCP's performance to the client. Articles 296 and 297 1a of the Draft CRR Text do not accurately reflect this and instead require that banks as clearing members have to hold capital for trade exposures with CCPs, regardless whether they act for their own purpose or as financial intermediary on behalf of a client.	If the clearing member does not guarantee the CCP's performance to the client, the clearing member has no trade exposure to the CCP in respect of client trades, therefore should not apply a risk weight.
2. Capitalisation of contractually committed contributions to a CCP's default fund (refer Article 298b of Draft CRR Text, also Article 4(74c), 298(1)(b) and 298b)	Paragraphs 121 – 125 of BCBS 227 define a framework for calculating the regulatory capital requirement for banks' overall risk exposure to a qualifying CCP's default fund, which may include funds that have already been provided to the CCP as well as commitments made by the clearing member to make further contributions. There is no requirement to hold additional capital against the contractually committed contributions. Introducing an additional capital requirement would imply double counting of risk and calculating regulatory capital for the same risks twice.	The effect of the proposal will be to require EU based clearing members to hold higher capital than non-EU participants and discourage CCPs from maintaining fall back arrangements for additional unfunded contributions as an additional layer of protection. The CRR Text is also not in line with EMIR: Article 4(74c) defines contractually committed contribution as a contribution to the default fund whereas Article 42 of EMIR determines that the default fund of a CCP consists of members' funded contributions. Art 43(3) states that CCPs may require non-defaulting members to provide additional funds, but these constitute "Other financial resources", which may be part of a CCP's default waterfall, but not its default fund. The Draft CRR Text defines own funds requirements of 100% (1250% risk weight) for contingent default fund contributions, which does not reflect the remoteness of the risk of loss associated with such commitments.	References to contractually committed contributions throughout the text should be deleted.
3. Choice between default fund capital requirement methods (refer Article 295 (2a) of Draft CRR Text)	BCBS 227 clearly gives banks flexibility to choose between either method 1 or method 2 for each qualifying CCP. Para 121: "Wherever a bank is required to capitalise for exposures arising from default fund contributions to a qualifying CCP, clearing member banks may apply one of the following approaches:"	The Draft CRR Text effectively discourages banks from applying Method 1. As ISDA has highlighted repeatedly in the past, the CEM methodology for determining a CCP's hypothetical capital requirement is not a suitable measure of risk for certain cleared OTC derivatives products. ISDA therefore welcomed the Basel Committee's decision to allow banks the flexibility to choose between this and a flat risk weight of the funded default fund contribution including a cap of total risk weighted assets for a QCCP. If firms cannot choose between method 1 and method 2, all clearing members of OTC derivative CCPs will have to choose method 2 to avoid the excessively overstated capital requirement of method 1 for these CCPs. In addition, method 2 is very penal by applying a 1250% risk weight to DF contributions, i.e. assuming that these contributions are likely to be lost and overstates the risk for ETC CCPs compared to method 1. This will disadvantage firms clearing OTC and ETC transactions for clients in favour of smaller firms that clear ETD transactions only.	We consider that banks should be free to choose the appropriate Method for each individual CCP, and for each clearing service at a CCP for which separate default waterfalls exist.
4. Porting Agreements (refer Article 296a (2) of Draft CRR Text)	BCBS 227 Para 107 makes the risk assessment from Porting Agreements a Pillar 2 requirement: 107. Where the bank is acting as a clearing member, the bank should assess through appropriate scenario analysis and stress testing whether the level of capital held against exposures to a CCP adequately addresses the inherent risks of	The appropriate capital regulation for portability is best handled as a Pillar 2 measure given the novelty and complexity of the regulation. Portability capital suggests members holding capital against client positions which they may take in a default scenario, but currently face no risk against, which presents several issues: 1) the provision of data around client positions not currently faced by the contingent institution, 2) the care needed to avoid discouragement of providing portability arrangements,	The Draft CRR Text is amended to be consistent with BCBS 227 Paragraph 107.

	those transactions. This assessment will include potential future or contingent exposures resulting from future drawings on default fund commitments, and/or from secondary commitments to take over or replace offsetting transactions from clients of another clearing member in case of this clearing member defaulting or becoming insolvent.	which would stabilise the market.	
5. 4% option for omnibus segregation (refer Article 297 of Draft CRR Text)	BCBS 227 Para 115. "Where a client is not protected from losses in the case that the clearing member and another client of the clearing member jointly default or become jointly insolvent, but all other conditions in the preceding paragraph are met, a risk weight of 4% will apply to the client's exposure to the clearing member."	Art 297 of the Draft CRR Text only allows for two risk weights: 2% for QCCPs, 100% for non-QCCPs. BCBS 227 allows for an additional case that allows for a 4% risk weight, which is missing from the Draft CRR Text. Basel adopted a 4% risk-weight alongside the 2% risk-weight to cater for certain clearing arrangements which are the norm in existing exchanges and CCPs, so called omnibus segregation models. Under the Draft CRR Text, capital requirements for these arrangements appear to revert essentially to bilateral arrangements, i.e. no benefit for clearing with the 2% only available for individual segregation models. Why should a 4% possibility be excluded from the EU regime? Particularly, as it is unclear what segregation models will be offered by CCPs in the future.	The 4% option should be inserted into the EU regulation.
6. Method 2 describes risk weighted assets in BCBS 227, but capital in the Draft CRR Text	BCBS227 talks about risk weighted assets when defining method 2: "...More specifically, under this approach, the Risk Weighted Assets (RWA) for both bank i's trade and default fund exposures to each CCP are equal to: Min {(2% * TEi + 1250% * DFi); (20% * TEi)}" The commission compromise text however talks about own funds (=capital) when describing the same formula: "An institution shall apply the following formula to calculate the own funds requirement (Ki)"	The problem is not that one has to convert RWA into capital, but that the same formula with the same inputs is an RWA in BCBS 227 but a capital number in the EC Draft CRR Text - as factor of up to 12.5%. Defining this formula as capital instead of risk weighted assets would increase the capital requirements by up to 12.5 times. Method 2 is already very conservative by applying a 1250% risk weight to DF contributions, i.e. assuming that these contributions are likely to be lost. Adding own funds requirement for the unfunded default fund contribution would deviate from the BCBS227 text and would not reflect the risk of loss associated with such commitments.	We suggest to follow BCBS227 and to define method 2 as risk weighted assets, not own fund requirements, and not to add own fund requirements for the unfunded default fund contribution.

Table 2: Additional observations and inconsistencies between the Draft CRR Text and BCBS 227

Article 4, 'Definitions', (73) –
'central counterparty (CCP) means a central counterparty as defined in Article 2, point 1 of Regulation (EU) No. 648/2012.
Note that this is not in line with BCBS 227 which only applies to OTC derivatives, exchange traded derivatives, and securities financing transactions (see Article 295)
Accordingly, Article 295a Treatment of exposures related to financial products with settlement risks only is confusing: how should "trade exposures" for products with settlement risk only be calculated? As noted, Article 295a is inconsistent with BCBS 227 (reference below) and should be deleted
BCBS 227: "Annex 4, Section II. Scope of application. Paragraph 6 is replaced by the following:
6(i) Exposures to central counterparties arising from OTC derivatives, exchange traded derivatives transactions and SFTs will be subject to the counterparty credit risk treatment laid out in paragraphs 106 to 127 of this Annex. Exposures arising from the settlement of cash transactions (equities, fixed income, spot FX and spot commodities) are not subject to this treatment. The settlement of cash transactions remains subject to the treatment described in Annex 3."

Article 4, ‘Definitions’, (75) –

“*‘trade exposure’ means **the sum** of the following:*

*a) the mark-to-market exposures to a CCP and potential future exposures to a CCP ~~which are **covered by the default fund** of the CCP~~;*

b) the exposures arising from assets posted to a CCP in the form of initial margin ~~which are related to the exposures listed in point (a);Section 9, Own funds requirements for exposures to a central counterparty~~” We consider that this definition of trade exposure contains drafting errors which could be cured by deleting the above sections. Put simply, what the definition should be (as per BCBS 227) that *“trade exposure means the sum of a) current and future exposures to a CCP, and b) the initial margin collateral posted to the CCP in relation to the exposures under a) after exposures for bankruptcy remote collateral have been set to zero according to art 297 (2)”*.

In addition, a different definition of trade exposure which includes House and Client trade exposures should be used in the Method 2 default fund RWA. Otherwise, under Method 2, if you are a client clearer only with all client money segregated at a custodian, i.e. no trade exposure to the CCP, then Method 2’s use of a min(X,20%*Trade Exposure) using the counterparty credit risk definition of Trade Exposure, would give you a zero capital requirement for the default fund.

Article 294, ‘Definitions’, (1) –

“*'bankruptcy remote', in relation to **client assets**, means that effective arrangements exist which ensure that those assets will not be available to the creditors of a CCP or of a clearing member in the event of the insolvency of that CCP or clearing member or that the assets will not be available to the clearing member to cover losses it incurred following the default of a client or clients other than the ones that provided those assets;*”

This isolates bankruptcy remoteness to refer only to client assets, whereas member assets can also be pledged in a bankruptcy-remote manner – would such member assets therefore receive no preferable capital treatment under CRR?

Article 296, ‘Treatment of clearing members' exposures to CCPs’, (2) –

“*Where an institution acts as a clearing member, either for its own purposes or as a financial intermediary between a client and a **non-qualifying CCP**, it shall calculate the own funds requirements for its trade exposures and exposures arising from default fund contributions to that CCP in accordance with the treatment laid down in **Article 300*** [‘Method 2’ Min{} calculation].”

This must be an error, as it states that own fund requirements to a non-qualifying CCP should be equivalent to those used for a qualifying CCP.

Further: Article 296a, ‘Treatment of clearing members' exposures to clients’, (1) –

“*Where an institution acts as a clearing member and, in that capacity, acts as a financial intermediary between a client and a CCP, it shall calculate the own funds requirements for its CCP-related transactions with the client in accordance with the **previous Sections of this Chapter*** [Article 296, (2)], *as applicable.*”

This is erroneous by association with the above.

Article 297, ‘Own funds requirements for trade exposures to CCPs’, (1 (b)) –

“*it shall apply a risk weight of 100% to the exposure values of all its trade exposures with non-qualifying CCPs.*”

This is a departure from the BCBS227 rules, which state the Standardised Approach should be used (which would indicate a risk weight dependent on category and rating of CCP).

Article 298a, ‘Own funds requirements for pre-funded contributions to the default fund of a QCCP’, (3 (c) where:) –

c_1 = *a capital factor equal to* $\max\left\{\frac{1.6\%}{\sqrt{\frac{DF^*}{K_{CCP}}}}, 0.16\%\right\}$;

This is a mathematical divergence from BCBS227, where $c_1 = \frac{1.6\%}{(DF^b/K_{CCP})^{0.8}}$

Article 298b, 'Own funds requirements for pre-funded contributions to the default fund of a QCCP', (3) & (4) –

"*Where the amount of* DF_i^c *is not defined, because the CCP has the contractual right to ask non-defaulting clearing members for as many contributions as necessary, an institution should apply the* ***treatment specified in [the next paragraph]*** *to its contractually committed contributions to that CCP.*"

"***EBA shall develop draft regulatory technical standards to specify the methodology for establishing the amount of contractually committed contributions for the purposes of paragraph 3 and Article 299****. EBA shall submit those draft regulatory technical standards to the Commission* ***by 31 December 2013****. Power is conferred on the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with the procedure laid down in Articles 10 to 14* [those referring to RTS] *of Regulation (EU) No 1093/2010.*"

This appears to mean that until after RTS are published (January 2014 onwards) there will be no capital requirements for unlimited contractual contributions. What interim guidelines or rules are contemplated?

Article 299, 'Own funds requirements for default fund contributions to non-qualifying CCPs' –

"*An institution shall apply the following formula to calculate the own funds requirement (Ki) for the exposures arising from its pre-funded (DFi) and contractually committed contributions (⟦DF⟧_i^c) to the default fund of a non-qualifying CCP:*

$K_i = c_2 \cdot \mu \cdot (DF_i + DF_i^c)$"

This equates to: 100% * 1.2 * (Total funded and contractually committed default fund contributions) = 120% capitalisation. This differs from the BCBS227 rules, in that they require a RWA calculation of 1250% - which is ostensibly equal to 100% capitalisation under an 8% capital ratio, but would in reality represent a range of approximately 130% to 163% capitalisation with target capital ratios of 10.5% to 13% (taking Basel III conservation and countercyclical buffers into consideration).

Also, under EMIR an EU firm would not be able to be a member of a non-qualifying CCP (except only temporarily in the event that a CCP's authorisation had been revoked?