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By email: giuseppe.siani@bancaditalia.it; rwasserman@cftc.gov

Re: Shortcomings of hypothetical capital with a standard model

Dear Mr Siani and Mr Wasserman

Thank you for speaking with our members on 10 May 2013 about ISDA’s proposed alternative capital treatment for the central counterparty (“CCP”) default fund exposure. We are grateful for the time taken by the Basel and CPSS-IOSCO Joint Working Group (“JWG”) to develop the capital treatment for CCP exposures. To incentivise market participants towards more central clearing we believe it is crucial that the capital framework is proportionate to the risk a given CCP poses, regardless of product mix and size. A capital model based on a too simplistic standard model is likely to discourage central clearing by driving unnecessarily high costs from Clearing Members (“CMs”) to their clients for some CCPs, whilst undercapitalising exposures to other CCPs. The fragmented nature of the clearing market will also multiply regulatory capital burdens.

We recognise that the development of an appropriate treatment for the default fund exposure is a difficult exercise and re-iterate our thanks for the time taken and substantial work done to set this capital appropriately. Accordingly, we think it may be useful, ahead of our meeting this week to re-state the fundamental criteria that should be satisfied by a CCP capital framework. We consider the satisfaction of these five criteria to be essential and that the criteria themselves stand as a measure by which capital methods for the default fund exposure could be adjudicated.

- 1. The capital framework needs to provide the right incentives to the market*
- 2. The capital framework needs to be in line with the risk a CCP poses, regardless of size or product mix*
- 3. Assumptions in the underlying models need to be transparent and in line with the use of these models*
- 4. The capital framework should not add to systemic risk*
- 5. The capital framework should capture contagion and correlation risk*

Below we explain each of these criteria in more detail.

1. The capital framework needs to provide the right incentives to the market

Obviously, the capital framework should not discourage the propagation of central clearing, in contrast to the G20's stated policy objective. The capital requirements for trade exposures, default fund contributions and other exposures to CCPs need to be in line with the true risk and not pose artificial costs on clearing participants. The G20 have selected central clearing as a way to reduce risk in the system, and it would be counterintuitive that such a risk reducing solution would generate higher capital requirements than uncleared bilateral transactions. Whilst we believe the incentives for trade exposures are right, the capital requirements for default fund contributions would increase the absolute cost of cleared transactions and their cost relative to that of uncleared transactions. This would create a significant disincentive for CMs to provide clearing services to other market participants and would likely increase the cost of those services and encourage:

- i. the use of alternative structures, driven by an artificially high capital cost of clearable derivatives;
- ii. the use of non-bank CMs; and/or
- iii. a decision by end users not to manage risk through derivatives at all, thus increasing risk in the non-financial economy.

2. The capital framework needs to be in line with the risk a CCP poses, regardless of size or product mix

As you know, the wide range of volumes and product mix of global CCPs means that it is important that the capital framework is risk sensitive. Using overly simplistic models will make it virtually impossible to result in appropriate capital requirements. The products cleared by global CCPs vary in the level of standardisation, portfolio effects and transaction volumes. A method that is based on nominal values will struggle to take netting effects into account for OTC derivatives and potentially underestimate risk for more standardised products like futures. Calibration based on top level capital numbers is not a solution to this, as it is difficult to see how a model that overestimates risk on one side of the spectrum can appropriately mirror risk on the other side.

Given the reduction in the minimum capital to qualify as a CM, and the potential moral hazard of risk mutualisation, having robust IM and a "defaulter-pays" approach is important in the context of CCPs. These features militate against thinly capitalised CMs being encouraged to clear more risk (where losses are covered in part by others)

and for-profit CCPs competing by reducing IM requirements. A too simplistic model risks not taking the available mitigation afforded by robust levels of IM into account.¹

3. *Assumptions in the underlying models need to be transparent and in line with the use of these models*

All assumptions used in the CCP capital model need to be fully understood. For instance, standardised valuation methodology used by the hypothetical capital construct is based on the Basel 1 risk-weighting approach, which is in turn based on assumptions of “portfolio invariance” and broad diversification. In other words, the valuation methodology assumes that the nature of the portfolio does not affect the probability of default. In fact, CCPs do not have such a portfolio but instead have very large, concentrated portfolios, which means that the distributional assumption in the standard model in a hypothetical capital construct is risk insensitive.

In relation to our proposed alternative, we accept that the recent risk-weighted assets variability exercise² has highlighted the variation in capital requirements generated by Incremental Default Risk Charge (“IDRC”) models and we fully understand the need to ensure a prescriptive and conservative calibration of an IDRC model used for the purpose we propose. Further, with CCP support the historical drawdown measure input could be calibrated more accurately and be based on a longer history including a period of stress. An appropriate stress multiplier could also increase the resulting figure.

4. *The capital framework should not add to systemic risk*

Furthermore, in distressed market conditions, CCPs are expected to have a stabilising influence on the market. In particular, after a CM default a capital model should not trigger an increase in regulatory capital requirements for surviving CMs’ default fund contributions after those CMs have already absorbed loss arising out of the default. Any models that would generate such a cliff effect will misallocate capital and liquidity on a macroeconomic scale with strong pro-cyclical effects when market conditions become distressed.

¹ In November 2011, ISDA published a study that demonstrated that due to the overly simplistic mechanics of CEM and the present state of OTC derivatives clearing, the use of CEM would impact certain product portfolios more than others (ISDA Research Notes, A Note on the Impossibility of Correctly Calibrating the Current Exposure Method for Large OTC Derivatives Portfolios, June 2011). Large, well-hedged portfolios of Interest Rate Swaps would be particularly affected. Were CEM amended to produce capital requirements that are not exorbitant for such portfolios, there would be a risk that the resulting capital requirements would not be sufficiently conservative to satisfy other CCPs.

² <http://www.bis.org/press/p130131.htm>

5. *The capital framework should capture contagion and correlation risk*

The majority of proposals for CCP capital models consider exposure to each CCP in isolation, and do not consider cross-CCP risk, or that a CM has simultaneous exposure to all of the CCPs on which it clears. Such connected exposures should not be capitalised to each on a standalone basis. Mathematically this is analogous to combining Value at Risk (“VaR”) measures obtained from several CCPs rather than looking at VaR of the consolidated portfolio. Accordingly, the risks of contagion and correlation are not captured.

As noted, our proposed alternative to incorporate a historical drawdown measure into an IDRC framework captures the risk of multiple CM defaults, not only on a single CCP but across all CCPs on which the CM clears. In contrast, many alternative proposals overlook the risk of multiple CM defaults and thus the potential contagion risk across CCPs.

Given that CMs typically operate on multiple CCPs the contagion risk entailed by central clearing should not be understated, and the risk of multiple defaults across CCPs should not be underestimated.

We welcome the proposed meeting with you and members of the JWG, and look forward to the opportunity to provide further details on the thoughts presented in this letter. Should you require additional information, please do not hesitate to contact the undersigned.

Yours sincerely,

A handwritten signature in blue ink, appearing to be 'GH', followed by a horizontal line and a comma.

George Handjinicolaou, Ph.D
Deputy CEO and Head of ISDA Europe, Middle East and Africa