Survey on capital requirements for clearing members' exposures to clients – CRR, Article 304.

1. Introduction

1. According to Article 304 of the Capital Requirements Regulation (Regulation EU 575/2013, henceforth 'CRR'), EBA has to draft RTS specifying the margin periods of risk (henceforth 'MPOR') that institutions acting as clearing members may use as input for the calculation for their capital requirements for exposures to clients. With this mandate, CRR puts forward the interim rules of the Basel Committee ("*Capital requirements for bank exposures to central counterparties*", Publication 227, July 2012).

2. The margin period of risk plays different roles depending on whether the institution is authorised to use the internal model method ('IMM') or when the institution uses one of the non-internal methods (i.e., Mark-to-market, Standardised Method or Original Exposure Method). In the first case, the MPOR will be an input for the internal model. In the other cases (MtM, SM or OEM), the shorter MPOR will determine a multiplier, smaller than one, set in Art. 304(5) of the CRR. To notice that the draft RTS shall specify different MPORs for different classes of derivatives.

3. This survey aims to gather the industry's preliminary view on this topic. EBA plans to publish a consultation paper at least six months before the formal deadline of June 2014 and to perform a quantitative impact assessment in the same period to support the decisions of the final draft RTS.

2. Scope of the exercise

4. Central counterparties, clearing members, financial and non financial clients and industry associations are invited to contribute. The comments should focus on all the derivatives that can be subject to central clearing, on a mandatory basis or not, that are present in the list defined in Article 304 of the CRR.

3. Process

5. Respondents are invited to follow the structure suggested in the survey and to depart from it only if deemed strictly necessary.

6. Respondents can also attach any number of files to their responses to support their positions. Office formats are preferred. Scanned documents are not allowed.

4. Reporting date

7. Respondents are invited to deliver their contribution by **Friday, 27 of September 2013** directly to EBA at the email address market.infrastructures@eba.europa.eu.

8. All contributions will be treated as confidential.

Survey on capital requirements for clearing members' exposures to clients – Regulation 575/2013 (CRR), Article 304(4)

Respondent:

International Swaps and Derivatives Association

Contact details:

Ryan Ingram, ringram@isda.org, 212-901-6052

Granularity

Question 1: Is the list of derivatives proposed in CRR Art. 304 granular enough for the purposes of differentiating the treatment of instruments in terms of their Margin Period of Risk or would a more/less detailed list be more appropriate? How should the list be extended / elaborated?

Answer 1: Article 304 refers to contracts/transactions detailed in Article 301 which focus on contract/transaction type however does not consider the liquidation profile and characteristics of the contract/transaction. As a general rule we suggest to align the MPOR for cleared products with the liquidation period mandated for purposes of initial margin. This would in principle align to the time required for a CCP to liquidate these positions, the intended and stated aim of the MPOR for capital purposes.

Question 2: Should the provisions on the Margin Period of Risk introduce an explicit distinction between exotic products and plain vanilla products? What would be advantages and disadvantages of this distinction? How could 'exotic' products be formally defined in this context?

Answer 2: As central clearing is intended and safe only for liquid and standardized products, there should be no reason to explicitly distinguish between standardized and exotic products. Should a CCP clear or be mandated to clear exotic products, we would be concerned over the ability to effectively default manage such products and the overall safety of this CCP. See response to Question 3 for comments regarding definition of products.

Question 3: Should the provisions on the Margin Period of Risk introduce a distinction between OTC derivatives and exchange traded derivatives?

Answer 3: There should indeed be a distinction between cleared OTCDs and ETDs primarily to recognize the liquidation periods representative of cleared OTCDs and ETDs. ETDs generally invite a minimum MPOR of one/two days as these positions can be efficiently and timely liquidated on an exchange, whereas cleared OTDs (based on current market structure and characteristics) would generally require longer liquidation periods. Therefore, following the general principle that MPOR should follow the demonstrable liquidation period assigned by the CCP for purposes of determining initial margin, thereby an implicit distinction.

However it is important to recognize that CCPs may adjust upward from the regulatory prescribed minimum MPOR (among various other risk management mechanisms) when evaluating the appropriate MPOR to apply for initial margin purposes.

Similarly, there should also be recognition of clearing members internal methodology to determine the appropriate MPOR which considers, among other things, the liquidity profile of the contract/transaction, the concentration of the contract/transaction, the composition of the client portfolio, the ability to unwind the contract/transactions in the market as well as characteristics of the specific client (e.g. credit quality, funding arrangements). Indeed these factors are already incorporated into clearing members' capital modelling practices.

We therefore caution any granular prescription of MPOR that does not consider the above mentioned product characteristics. We do however agree that, based on current market structure (e.g. central limit order book for ETDs vs. bilaterally negotiated OTCDs) and characteristics (e.g. liquidity and turnover of ETDs vs. cleared OTCDs), that a distinction between ETDs and cleared OTCDs is appropriate, however the regulator should contain sufficient flexibility to recognize that over time cleared OTCDs may develop requisite characteristics to invite shorter MPOR for purpose of capital modelling.

We also highlight that certain relevant metrics are maintained by the BIS and should be considered when evaluating and determining an appropriate distinction between various products.

Question 4: Should the provisions on the Margin Period of Risk introduce an explicit distinction based on the venue where derivatives are traded (Regulated Exchanges, MTF, etc)? What distinction would fit better the purpose of this technical standard?

Answer 4: Refer to response at Question 3.

Question 5: Should the provisions on the Margin Period of Risk introduce a distinction between physically settled and non-physically settled derivatives?

Answer 5: MPOR provisions should focus primarily on the liquidation characteristics of the contract/transaction. As there are various settlement practices (e.g. Fx payments via CLS, pork bellies via a warehouse) it would be difficult to assign at such a granular level. We also call attention that clearing members already consider such characteristics when modelling capital based on existing market practices and expertise. Nevertheless, when closing out transactions it less important how the contracts/transactions settle, instead the focus should be towards the liquidity of the contract/transaction in the market. This consideration has already been incorporated to derivatives regulation as being linked to ETDs or cleared OTCDs (i.e. one/two days vs five days).

Estimates of the Margin Periods of Risk

Question 6: Can you provide a list of different derivatives types/classes and an estimate (in terms of days) of the Margin Period of Risk for each type/class? If yes, please attach to your answer the list[1] and the corresponding Margin Period of Risk estimates.

Answer 6: MPOR provisions are sufficiently granular at the determination of ETD and cleared OTCD. However, as described in our response to Question 3, any prescribed provisions should recognize current practices of both CCPs and clearing members in determining an appropriate MPOR and need also to maintain sufficient flexibility to recognize requisite characteristics (e.g. turnover, liquidity) that would qualify for a reduced MPOR.

Based on current regulation and market characteristics, ETDs are prescribed a *minimum* MPOR of one/two days and cleared OTCDs are prescribed a *minimum* MPOR of five days. It should be further recognized that, at most CCPs, the default fund also considers the liquidation characteristics of various contracts/transactions and in many cases, as input to the DF-sizing stress test, incorporate MPOR assumptions.

Question 7: Can you provide a list (the same of the previous question or a separate one) ranking the type of contracts based on their expected close-out periods? If yes, please attach the list[1] to your answer to this survey.

Answer 7: See response to Question 6.

Question 8: What quantitative factors should be considered when setting the margin periods of risk for each type of derivative? Are these factors available and observable at any point in time? Which factors play a major role and which are less important? Please express an explicit view on, besides the factors you propose, the following specific factors: i) derivatives turnover; ii) markets concentration; ii) number and availability of Market Makers.

Answer 8: See response to Question 3.

Question 9: The CRR explicitly requires that the margin periods of risk reflected the close-out period of the contracts with respect to the clients. What is the best approach to make this link as transparent as possible?

Answer 9: See response to Question 3. This is already considered as part of current capital modelling and risk management practices.

Questions specific to broad derivative classes

[1] The format of the list is open. That means that the respondents can choose the granularity, characteristic and terminology that they believe better fit the purpose of this technical standard. Respondents are invited to provide the list and the comments explaining the choices made to build the list in a separate file attached to the response to this survey.

Question 10: Interest rates derivatives: do factors like reference currency and remaining maturity determine different margin periods of risk? What other factors should be considered?

Answer 10: See response to Question 1 and Question 3, the assessment should consider the applicable liquidation characteristics of the contract/transaction or the asset class, not the asset class itself.

Question 11: FX derivatives: do factors like reference currencies and remaining maturity determine different margin periods of risk? Should the margin period of risk be different by currency pairs? What other factors should be considered?

Answer 11: See response to Question 1 and Question 3, the assessment should consider the applicable liquidation characteristics of the contract/transaction or the asset class, not the asset class itself.

Question 12: Derivatives on commodities: do factors like geography and type of commodity determine different margin periods of risk? What other factors should be considered?

Answer 12: See response to Question 1 and Question 3, the assessment should consider the applicable liquidation characteristics of the contract/transaction or the asset class, not the asset class itself.

Question 13: Credit derivatives: what classification better explains different margin periods of risk?

Answer 13: See response to Question 1 and Question 3, the assessment should consider the applicable liquidation characteristics of the contract/transaction or the asset class, not the asset class itself.

Incentives

Question 14: Is it possible that certain choices on the margin period of risk for certain type of derivatives end up to give competitive advantage to certain market participant with respect to others?

Answer 14: As described in our response to the prior questions, related provisions must recognize the MPOR applied (by regulatory minimum or otherwise assigned, in many cases higher) by the CCP for initial margin purposes as well as that utilized by clearing members for purposes of capital modelling. Should related provisions be overly prescriptive and not appreciate current market practices or contract/transaction characteristics, the capital treatment applicable to certain products may become a competitive determinant and influence product selection.

Implementation in the IMM

Question 15: For IMM-banks: is there any methodological issue that could influence the choice on margin periods of risk to be set in this technical standard?

Answer 15: IMM is a portfolio measure and MPOR is applied to the overall exposure profile, therefore it would be considerably difficult for firms that utilize an IMM for capital modelling to apply various MPORs at the contract/transaction level. Further, where it would be required to break up netting sets to allow for various MPORs, the increased exposure may outweigh the benefit of a reduced MPOR.

Additional remarks

Question 16: Is there any other important aspect that should be considered?