Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel, Switzerland

Sent by email: baselcommitee@bis.org

Re: Basel Committee on Banking Supervision (BCBS) Consultative Document: Capital treatment of bank exposures to central counterparties

Dear Secretariat:

This letter contains the response of the International Swaps and Derivatives Association ("ISDA"), the Institute of International Finance ("IIF"), and the Global Financial Markets Association ("GFMA") (together, the "Associations")[1] to the BCBS consultative document, *Capital treatment of bank exposures to central counterparties* issued for comment on 28 June 2013 ("BCBS253").

The Associations commend the BCBS for undertaking another consultation on these proposals and desire to provide meaningful input to ensure a viable capital framework is adopted. This response is focused on elements of the consultative document that stand to motivate and influence the expansion of central clearing. We remain concerned that the proposal discourages propagation of central clearing, in direct contrast to policy objectives stated at the G20 September 2009 summit ("G20 Objectives") and related regulatory initiatives such as the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and European Market Infrastructure Regulation ("EMIR"). We further believe the proposal fails to provide incentives for central counterparties ("CCPs") to invest in the improvement of their risk systems and methodologies and discourages fundamental CCP risk practices, notably the intended function of the default fund.

The BCBS will recognise that many of the comments within this response are similar to concerns raised in our previous comment letters. These comments focused primarily on the proposed capital treatment of default fund contributions, that when analyzed within the full cost spectrum of clearing appear to be inappropriately calibrated, encourage minimal default funds, and disincentivize firms to provide clearing services to clients.

We further consider our response alongside the BCBS consultative document, *Revised Basel III leverage ratio framework and disclosure requirements* ("BCBS251"). As further described in our response to BCBS251, the leverage ratio may act as a floor to capital requirements against CCP exposures instead of the risk-based capital framework.[2] If the leverage ratio does become the binding constraint, rather than a backstop, we consider the significant and negative impact to the broader incentives for firms to act as clearing members and facilitate client clearing.

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[1] A description of the Associations is included at Appendix B.

[2] Joint Association Response to BCBS251 *Revised Basel III leverage ratio framework and disclosure requirements*, 20 September 13. See *Section V Centrally Cleared Transactions*. Available at: http://www2.isda.org/attachment/NTkwMA==/GFMA%20Joint%20Trades%20Basel%20III%20Leverage%20Ratio%20Comment%20Letter.pdf

Our response to this consultation is organized according to the following sections:

I.   Application of Cover* without consideration to the risk of clearing members defaulting as the basis for capital requirements against default fund contributions makes clearing uneconomical in contrast to the G20 Objectives.

II.   Illustrative calculation evidencing why Cover* without consideration to the risk of clearing members defaulting will make clearing uneconomical in contrast to the G20 Objectives.

III.   Two calibrations illustrating why the proposed risk weight of the default fund is grossly overstated: (1) Incremental Default Risk Charge (IDRC) and (2) a "look through" approach.

IV.   Capital requirements against "top-up commitments" should be removed as losses beyond default fund contributions are already capitalized.

V.   Time scales of implementation.

VI.   Response to specific questions raised in the consultation.

VII.   Text within the consultation that merits clarification.

We welcome the consultation as significant progress in developing an appropriate capital framework for cleared derivatives. However, based on initial analysis of the methods proposed in the consultation, we remain concerned that resulting capital requirements could be inconsistent with stated objectives. In the sections that follow, we suggest specific adjustments to the proposal that we believe are necessary to ensure a viable capital framework that promotes central clearing is adopted.

The Associations acknowledge the efforts of the Risk Measurement Group of the BCBS and greatly support the collaboration with CPSS-IOSCO through the Joint Working Group (JWG). We very much appreciated the opportunity to meet with the JWG in Washington in June 2013; we found the discussion very constructive and useful in formulating our response to this consultation.

We are grateful for the opportunity to provide these comments. Should you require further information, please do not hesitate to contact the undersigned.
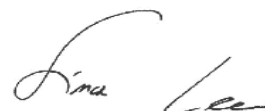
Yours Sincerely,

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I.   Application of Cover* without consideration to the risk of clearing members defaulting as the basis for capital requirements against default fund contributions makes clearing uneconomical in contrast to the G20 Objectives.

The consultation introduces two approaches to calculate counterparty capital requirements against CCP default fund (DF) contributions: the Ratio Approach or the Tranches Approach. Both approaches use a Reference Level of Default Fund resources (RLDF) as input to quantify the risk that contributions to the DF may be utilized as a result of a clearing member (CM) default at a CCP. The RLDF is defined as the maximum result under two methods: (1) Cover* and (2) hypothetical level of default resources needed ("Kccp") utilizing the Non-Internal Model Method (NIMM, together "KccpNIMM"). At the outset we highlight that these two methods are different measures of risk, intended for different purposes, that we believe are not comparable for purposes of quantifying capital requirements against DF exposures.

Default funds deposited with the CCP are substantially higher than the CM's weighted risks facing the CCP so as to guaranty, to a very high level of confidence, the continued existence of the CCP. It would be appropriate that the capital requirement applicable to a CM's exposure to the CCP reflect the counterparty credit risk (CCR) of other CMs through the CCP, which we believe is appropriately captured by the Kccp method.

Additionally, the risk-based capital framework evaluates CCR as the product of a risk-weight (RW) that quantifies the risk of counterparty default and an exposure-at-default (EAD) measure that quantifies the magnitude of the risk. It is our view that only the Kccp method appropriately conforms to these foundational criteria.

Nonetheless, through initial analysis we observe that KccpNIMM will not exceed Cover*, therefore resultant capital requirements will be based on Cover*, a measure of risk that is inconsistent with the risk-based capital framework and result in capital requirements that make clearing uneconomical. Instead, the capital requirement should be a pro-rata of a Kccp measure, net of the CCP-dedicated resources, that utilizes NIMM and recognizes the over-capitalization provided by initial margin and CM DF contributions.

As the default of a CM is a rare event, it would be appropriate for the KccpNIMM method to provide a result lower than one based on DF contributions (i.e. the Cover* method). Regardless, Cover* is not a suitable capital measure as it does not consider the likelihood of a CM default (i.e. is not risk-weighted). It is, rather, a stressed EAD measure conditioned on the default of the one or two largest CMs creating the largest credit exposure in extreme but plausible circumstances. Interpreting Cover* as a capital measure, without consideration to the risk of a CM default, effectively assigns a 1,250% RW to DF contributions, implicitly assuming with 100% probability that one or two of a CCP's CMs will default across multiple CCPs in any given year and that in 100% of such cases the losses will exceed all pre-funded resources (e.g. initial margin and default fund).

Furthermore, the interim final framework ("BCBS227") and each of preceding consultations consistently proposed a Kccp method. This rightly provided the industry multiple years to evaluate the appropriateness of the method and to consider its interaction within the context of clearing. The Cover* method, first introduced within this consultation, is a significant departure from a Kccp method that will not benefit from multiple consultations that provided adequate time for the industry to analyze. As supported in our previous responses, the primary issue with BCBS227 related to the inability of the Current Exposure Method (CEM) to quantify commensurate CCR exposures for the calculation of Kccp. We believe that these concerns are addressed where NIMM (subject to comments in our response to BCBS254)[3] replaces CEM for purposes of calculating Kccp.

We therefore recommend the removal of the Cover* method in favor of KccpNIMM as the basis to quantify exposures against CCP DF contributions or to sensibly calibrate applied RWs. We further raise that KccpNIMM will correctly consider the future-state clearing environment and create a level of capital that

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[3] Joint Association Response to BCBS254 *The non-internal model method for capitalising counterparty credit risk exposures*, 27 September 2013. Available at: http://www2.isda.org/functional-areas/risk-management/

incentivizes firms to act as CMs and thereby protect the G20 Objectives. Further consideration is required related to the inclusion of client exposures in determining the appropriate level of capital to hold against DF contributions. Where client exposures are supported by individual segregation regimes that promote porting in the event of a CM default event, such exposures should be excluded when quantifying exposures against DF contributions. As CMs are required to measure capital requirements for client exposures under the bilateral framework (adjusted only for MPOR), we believe these exposures are already sufficiently capitalized.

We are also concerned that basing a capital requirement on the size of a CCP's DF may unduly influence and disrupt the flexibility of existing CCP risk management practices and likely incentivize minimal default funds. This would appear to be contrary to the desired outcome, creating structural and systemic issues as a result.

Concern over inherent assumptions in applying a 1,250% risk weight to the RLDF

We are also troubled with the inherent assumptions in applying a 1,250% RW to demonstrably remote risk. Before a non-defaulting CM loses even a *single* dollar of its DF contribution as a result of other CM's default(s) would require that (a) a defaulting CM's initial margin sized at no less than 99% confidence interval over a 5-day period was insufficient, (b) the DF contribution of the defaulter was insufficient, and (c) any contribution by the CCP itself was insufficient.

By construction, therefore, the probability of a CCP depleting the *entire* financial resources of its funded DF as defined by Cover* is designed to be very low. Where this has happened historically, the relevant CCPs did not meet the Cover* requirement. However, the probability that this will happen in all CCPs and in all segregated clearing lines simultaneously, is extraordinarily small. In fact, it appears outright inconceivable. Yet, the requirement that CMs and CCPs hold loss absorbing equity capital against the full notional of all CCP DFs implicitly assumes that such an event happens with near certainty in any given year. We believe such assumptions are unsuitable to the actual risk that a CCP (particularly a Qualified-CPP) are exposed to and without necessary justification and would only unnecessarily impose an economic disincentive to towards clearing. However, if indeed this was the intention we question the motivations to make CCPs a central component of the new market structure.

II.   Illustrative calculation evidencing why Cover* without consideration to the risk of clearing members defaulting will make clearing uneconomical in contrast to the G20 Objectives.

The Cover* method combined with a 1,250% RW implies that DF contributions are likely to be lost in their entirety on a regular basis. This has not been the case historically, even in the most severe cases – e.g. Lehman Brothers – where the size of the IM, haircuts and DF ensured that losses were confined to the defaulting CM. As industry risk management practices have since advanced both naturally and through regulatory initiative, we believe the application of a 1,250% RW lacks prudent consideration to such advancements and is further misaligned to activities of similar risk profile within the risk-based capital framework.

Simplified cost example between cleared and non-cleared if utilizing Cover[4]*

The below example provides a simplified cost comparison for directional portfolios between cleared and non-cleared derivatives that demonstrate why a 1,250% RW applied to a Cover* measure will disincentive central clearing. Each input to the example is independently conservative that when combined, provide results that are exceedingly conservative. The results show that even in the most conservative of estimates, the cost of cleared will exceed the cost of non-cleared. It should be mentioned that there are additional CCP-related costs that could be considered, however for simplicity of the example have not been included in the analysis.

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[4] The simplified cost example intentionally does not consider dynamic or complex portfolios that may provide natural offset within the capital framework. Additionally for purposes of clarity, we assume the same amount of initial margin for cleared and non-cleared adjusted only for a 10-day MPOR vs a cleared 5-day MPOR. The example also applies an exceedingly conservative 7% WACC that in most practical cases would be higher and create a further disparity between cleared and non-cleared.

assumptions:

1. Funding cost (FC) = 0.5%,
2. Weighted average cost of capital (WACC) = 7%,
3. DF to IM (initial margin) Ratio of 8%,
4. **M** = 5-day cleared IM requirement,
5. Bilateral margin requirement = 1.4 x **M** based on a 10-day non-cleared IM requirement,
6. Application of an individual segregation model

therefore:

Cost of Cleared	= (0.5% FC of M) + (0.5% FC + 7% WACC) of (8% of M)	= **1.10% of M** + **CCP-related Clearing Costs**
Cost of non-Cleared	= (0.5% FC of 1.4 x M)	= **0.70% of M**

where:

- Funding cost considers the spread between short-term funding and return on investing in Treasury Bills, as example
- WACC considers both cost of debt and cost of equity
- DF to IM ratio is based on a Cover 2 standard
- Bilateral margin requirement is based on a 10-day margin period of risk applicable to non-cleared derivatives. The 1.4 multiplier is derived from the 5-day margin requirement for cleared derivatives and computed by using the square root of time (sqrt(10/5))
- CCP-related Clearing Costs include clearing fees and costs to prefund margin calls, for example

III.   Two calibrations illustrating why the proposed risk weight of the default fund is grossly overstated: (1) IDRC (incremental default risk charge) and (2) a "look through" approach.

In prior discussion and consultation response, the industry presented the IDRC measure which builds on existing frameworks and more holistically evaluates the risk of multiple CM defaults across multiple CCPs, instead of a single CCP in isolation. We also consider evaluating the appropriateness of a 1,250% RW against that derived from a "look-through" approach where the RW considers the credit profile of a CCP's CMs, consistent with the bilateral framework.

Both calibrations independently conclude that a 1,250% RW applied to Cover* is unsuitable and that a risk-based RW ranging from 20-50% would be appropriate. For CCPs maintaining a DF in excess of Cover* the RW should be scaled down proportionately. The following describes each of the methods used to evaluate a more appropriate RW.

Incremental default risk charge

We propose that the IDRC measure be considered, at least as a benchmark, to evaluate exposures related to CCP DF contributions. The IDRC measure indicated a capital requirement between 10%-20% of the DF contribution for exposures to a single CCP DF.[5] For purposes of this analysis we have conservatively assumed the maximum of this range.

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[5] See Appendix A for expanded detail of the IDRC calculation.

We consider that NIMM calculations would imply an EAD of 98% of DF (not quite 100% due to CCP-provided contributions). Therefore applying a simple capital ratio we <u>derive an adjusted risk weight of 51% for default fund exposures</u>, calculated as follows:

assumptions:

1. Capital formula: Capital = Capital Ratio x (RW x EAD),
2. IDRC determined DF capital requirement = 20% of DF,
3. EAD under the non-internal model method = 98% of DF,
4. Target capital ratio of 8%

therefore:

- **Capital Requirement** = 8% x (RW x (EAD under NIMM))
- (20% of DF) / 8% = RW x (98% of DF)
- RW = 20% / (8% x 98%)
- RW = 255% based on a 1 year capital horizon
- **Adjusted RW = 51%** (NIMM-adjusted capital horizon sqrt(10/250))

Although we are not proposing to incorporate the IDRC measure within the regulatory framework, we do consider that the measure is more risk sensitive than a standardized model.

Look through approach

To further evidence that a 1,250% RW is overstated, we consider a "look through" approach where an appropriate RW considers the credit quality of CMs, consistent with the bilateral treatment contemplated for purposes of computing hypothetical capital (e.g. Kccp under CEM and Kccp under NIMM), and conservative estimates of EAD to each CM are assumed. In such a case RWs ranging between 20% and 50% would be applied, dependent on the quality of the CCP's membership. We therefore consider that the proposed 1,250% RW is between 63 and 25 times that as would otherwise apply to bilateral exposures.

IV.   Capital requirements against "top-up commitments" should be removed as losses beyond default fund contributions are already capitalized.

We support the implementation of KccpNIMM and the tranches approach (see our response to Question 1) where Kccp implicitly captures the risk of multiple CM defaults by construction and capitalizes the potential for losses beyond the DF. We believe that any requirement to hold additional capital over and above that required for funded contributions, which already cover a bank's entire exposure (trade exposure and DF exposure), would imply a double-counting of risk and lead to excessive capital requirements.

V.   Time scales of implementation

The consultation requires that a CCP, bank, supervisor, or other body share sufficient information related to the computation of hypothetical capital requirements on quarterly basis at minimum or more frequently as required by national regulators. However in practical terms, CMs will require such information on a more frequent basis. We also consider the draft implementing technical standards issued by the European Banking Authority that will require CCPs maintain the capability to compute hypothetical capital requirements on a daily basis.

We believe that sufficient time is required for CCPs to implement NIMM and perform testing to ensure that calculations that drive CM capital requirements are robust and reliable. The operational wherewithal of a CCP to compute and provide CMs and relevant regulators required information on a daily basis should also be considered. We therefore urge the BCBS and national regulators to instigate a parallel reporting process

during a predefined transitional period for the industry, including CCPs, to analyze and validate related calculations.

We further recommend the BCBS carefully analyze results of the recently instituted comprehensive quantitative impact study (QIS). As prior QIS focused primarily on the impact of capital requirements of DF contributions based on superseded methodologies, results of the proposed methodologies are yet to be assessed. In addition to potentially punitive capital requirements against DF contributions, there are additional material considerations (e.g. leverage ratio, capital required for client clearing, large exposure framework, a mature clearing environment) that have not been comprehensively assessed. Adverse consequences of the new regulation may therefore be underestimated.

VI.   Response to specific questions raised in the consultation

Q1. Which of these two proposed methodological approaches best satisfies the objectives which the capital treatment seeks to achieve and why?

The consultation introduces two approaches to calculate capital requirements against CCP DF contributions: the Ratio Approach or the Tranches Approach. Both approaches include the concept of RLDF for which we have specific comments regarding the level of conservatism applied (see Section I and response to Question 2). As stated in Section I, the capital requirement should be pro-rata of a Kccp measure, net of the CCP-dedicated resources, utilizing a risk-based measure (e.g. NIMM) that recognizes the over-capitalization provided by initial margin and CM DF contributions. This is most effectively achieved by adopting the proposed KccpNIMM measure and the tranches approach and is therefore represented in our response to this question. A combination of other measures and/or methods would require specific and potentially different response to this question.

Even though the risk of loss on DF contributions for non-defaulting CMs is very small, it is nonetheless true that the risk of losing the first dollar of clearing fund contribution is higher than the last dollar. Consequently, a dollar contributed to the DF by a CCP that is junior to non-defaulting members' contributions reduces the risk of loss on non-defaulting members' contributions by more than a dollar contributed by the CCP that will be used on a pari passu basis. Neither ratio nor tranches approach fully reflect the different level of riskiness in various layers of the DF, yet the tranches approach offers the better reflection. In the remainder of our response to this question we will argue that a series of reasonable modifications to the proposed ratio approach will actually result in the tranches approach. Therefore, the tranches approach is the preferred method in our view.

Under the ratio approach each CM's capital requirement, $K_{CM(i)}$, is equal to the CMs' DF contribution, $DF_{CM(i)}$, times a factor that should reflect the "riskiness" of the contribution. Firstly, the CCP's contributions to the DF should be deducted from the reference level RLDF in order to reflect the fact that CMs are not exposed to the risk backed by the CCP's own capital. As a first approximation the riskiness of CMs' DF contributions would then be reflected by the ratio:

$$K_{CM_i} = \max\left(\frac{RLDF - DF_{CCP}}{DF_{CM}}; 0\right) * DF_{CMi}$$

The max() function ensures that CMs' capital requirements are floored at zero. The second factor $DF^{Cover^*}/(DF_{CCP} + DF^{Cover^*})$ should be discarded, (a) because the CCP's own contributions have already been deducted from RLDF and (b) because the factor is based on DF^{Cover^*}, which in our view is not a meaningful risk measure. With these adjustments, the total capital requirement for all CMs collectively would equal the below and be seemingly independent of DF_{CM}:

$$K_{CM} = \max[(RLDF - DF_{CCP}); 0]$$

However, as argued in the [fourth] section of our response, RLDF itself should be a function of $DF_{CM(i)}$. In the Cover* definition, the (prefunded) DF contributions of the one or two largest members would be deducted, but the DF contributions of all other members neglected. Under the Kccp method, the (prefunded) DF contributions of each member should reduce the CCP's exposure measure to the respective member. Thus, the revised ratio approach neglects the additional risk borne by CMs collectively through the provision of larger DF resources. In order to account for this additional risk, another term should be introduced that reflects the increasing remoteness of the risk to which DF contributions beyond the RLDF level are exposed, i.e. some decreasing function should be introduced.

Elsewhere in the consultation paper, a risk weight of 5% is assigned to trade exposures to QCCPs that have a fully funded DF equal to the RLDF requirement. The risk weight scales up and down in proportion to the ratio $RLDF/DF_{CM}$ and is capped at 20% and floored at 2%. We suggest that the probability of incurring losses on DF contributions beyond the RLDF requirement is no higher than the risk of incurring losses on trade exposures. In order to be consistent with the treatment of trade exposures, we suggest that the additional capital charge on DF contributions beyond the RLDF level should be:

$$8\% * 5\% * \frac{RLDF}{DF_{CM}} = 0.4\% = c1$$

If we define this expression as the function "c1", the capital calculation according to our modified ratio approach is:

$$K_{CM_i} = DF_{CMi} * \frac{\max[(RLDF - DF_{CCP});0]}{DF_{CM}} + c1 * \frac{\max\left[\left(DF_{CM}^{pref} - RLDF\right);0\right]}{DF_{CM}}$$

Where DF_{CM} only counts prefunded member contributions. As it turns out, this is mathematically equivalent to the tranches approach, except that the equation is written in a more compact form.

The only difference between our modified ratio approach and the proposed tranches approach is the definition of the function c1, which in the consultation paper has a capital weight of 16%, whereas we believe it should be 0.4% in order to maintain consistency with the treatment of trade exposures.

Q2. What are the pros and cons of using the greater of the minimum Cover level required by the CPSS-IOSCO PFMIs or the hypothetical level of default resources calculated using NIMM as a model for calculating the relative risk of clearing members contributions to QCCP default funds? Should the Committee consider any adjustments to NIMM to improve its measurement of derivative exposures in the context of CCPs? Would it be better to use only one of these measures, or are there other suitable alternatives?*

The RW for CCP DFs should reflect the risk of loss due to CM defaults. We are concerned that the current formulation over-emphasizes the CCP's calibration of the DF. In particular the formulation of the reference level of DF resources, which takes the maximum of the minimum prefunded amount to meet CPSS-IOSCO recommendations for PFMIs (cover funds) and hypothetical capital, gives an inappropriate implied risk-weight when the cover funds measure is larger than the hypothetical capital measure. In particular, equating funds with a risk-weighted capital estimate is comparing different measures of risk – one an extreme measure of exposure conditioned on the default of two clearing members and affiliates, the other a risk-weighted exposure amount.

We believe the non-internal model method suggested within the consultation is an appropriate risk-based measure to base capital requirements. Therefore, we recommend the removal of the Cover* measure in favor of the NIMM as the basis for capital requirements against CCP DF contributions or to sensibly calibrate applied risk weights.

Q3. What risk weights / capital charges would best achieve, or appropriately balance, the objectives set out in Section II.C? In particular, how would possibly lower values ensure that clearing members are capable of absorbing losses in times of stress without the drawing down of the default funds threatening the viability of

the non-defaulting members who have contributed to them? How would the proposed 1250% risk weight affect incentives to use central counterparty clearing?

Each of the above sections of this response discuss why the application of a 1,250% RW (specifically to the Cover* measure) without consideration of the risk of CMs defaulting could render clearing uneconomical. Section III specifically contemplates two independent calibrations determining a risk weight between 20% and 50% based on exceedingly conservative estimates.

Q4. The Committee invites comments on this potential risk sensitive approach to capitalising trade exposures to CCPs.

We remain concerned about the appropriateness to apply a risk weight to trade exposures and if such capitalization has been contemplated, "… in a holistic way that recognizes how the different forms of exposure interrelate, and is therefore sensitive to the aggregate risk as well as to how it is distributed" (Section II.C(iii) of the consultation). Again, we do not see the rational to capitalize the trade exposures as the risk they bear is part of the counterparty credit risk that has been already capitalized via the waterfall framework. We understand that in extreme instances, the losses following a CM default might exceed the waterfall; however those losses result from the same CCR exposures facing the other CMs that have been capitalized. However, as previously stated by the BCBS[6], to recognize that CCP exposures are not risk free, a weighting such as 2% might be attributed to trade exposures but anything higher is not warranted.

Nonetheless, the consultation introduces a new method to determine the applicable risk weight that ranges from 2% to 20% that is primarily influenced by a CM's purported interest to over fund, in excess of requirements imposed by the CCP, contributions to the DF. We are concerned that the risk weight applied to trade exposures is implicitly dependent on DF contributions and further that the likely risk weight in foreseeable circumstances is, as described in the previous paragraph, overstated and lacks consideration to the overall capital requirements to support clearing.

We consider that all CCPs will endeavor to be a QCCP and therefore will size minimum pre-funded DF contributions to cover the two largest CM exposures. As there is likely little incentive for a CM to over-fund this minimum amount (for reasons supported throughout our response), we expect, based on the prescribed equation, that in most practical cases a 5% RW will apply to trade exposures. In light of the increased oversight and heightened risk management practices of a QCCP a 5% RW, or even the minimum 2% RW, is demonstrably conservative.

As mentioned in the introduction to this response, we are further concerned that the leverage ratio, as currently proposed, will place a floor considerably above the risk-based capital framework.

Q5. Do you consider it appropriate to treat initial margin, where a QCCP has legally enforceable rules that make initial margin a senior claim to variation margin in the event of losses in excess of default resources, differently from other trade exposures by retaining a fixed 2% risk weight on initial margin posted in a non-insolvency remote manner?

ISDA in its recent white paper publication "CCP Loss Allocation at the End of the Waterfall" has recommended a particular sequence of recovery measures that CCPs should implement through their recovery plans. According to these recommendations, which are primarily targeted at CCPs clearing derivatives, all residual risk would fall on trade exposures, either through the application of variation margin gains haircutting (VMGH) or through partial or full termination. The recommendations are deliberately designed to avoid initial margin collateral be put at risk throughout the recovery process. We therefore believe that it would be appropriate to assign a risk weight of 0% to initial margin collateral held by a CCP

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[6] Previously, in discussing counterparty risk management, the BCBS said, "Banks' mark-to-market and collateral exposures to a central counterparty (CCP) should be subject to a modest risk-weight, for example in the 1-3% range, so that banks remain cognizant that CCP exposures are not risk free". See http://www.bis.org/press/p100726/annex.pdf

that has implemented recovery plans which do not foresee the use of initial margin, irrespective of whether the initial margin collateral is held in a manner that is isolated from the CCP's insolvency.

We would also argue that a 2% risk weight would be appropriate in cases where the recovery plans of a CCP place initial margin in a senior position to variation margin haircuts on trade exposures, even if those recovery plans were not legally enforceable (by CCP participants). The reason is that CCPs may not want their recovery plans to be "legally enforceable". In fact, the CPSS and IOSCO Committees in their recent consultation on CCP recovery plans recommend that CCPs should maintain flexibility with respect to the choice and the order in which a number of possible recovery tools could be applied, including haircuts on initial margin. For this reason we fear that CCPs may be reluctant to commit to legally enforceable rules which would compromise their flexibility, even if the CCP did not have the intention to use haircuts on initial margin throughout the recovery process.

As argued in the answer to question 4, we think that a 2% risk weight on trade exposures to CCPs that meet the PFMI standards for QCCPs would be conservative, but acceptable. Consequently, we think that the the 2% risk weight should also apply to initial margin, if the CCP is a QCCP.

Q6. Do the proposed approaches to capture commitments to top up default funds in the capital treatment of exposures to QCCPs satisfy the objectives which the capital treatment seeks to achieve? Are there ways in which the proposed capital treatment of commitments could be improved? Is the proposed (alpha) value of 0.5 appropriate?

As described in Section IV of this response, we believe any requirement to hold additional regulatory capital for "top-up commitments" to a CCP's DF over and above the requirement under the Basel framework, which already covers banks' entire exposure (trade exposure and DF exposure), would imply a double-counting of risk and lead to excessive capital requirements.

VII.   Text within the consultation that merits clarification

The definition of c_1 in paragraph 37 should be corrected to 1.6% from 16% to be consistent with the interim rules. In a scenario where pre-funded resources of the DF exceed the hypothetical capital amount, the excess would be <u>capitalized at 16%</u> assuming the factor is not adjusted. However, the maximum capital charge for the excess under the <u>interim rules is 1.6%</u> and can be further lowered to 0.016%. The 1.6% stated in the interim rules is equivalent to the 20% risk weighting (consistent with bilateral broker-dealer exposure under the Standard rules). The third bullet of Paragraph 38 states that c_1 represents a simplified alternative to the equivalent parameter used in the capital requirements formula under the interim rules, however without mention of any recalibration to 10x the interim rules. Further the reference to a "16% risk weight" instead of a 200% risk weight that equates to a 16% capital charge suggests that these terms require modification.

The RW in paragraph 63 requires clarification as to whether it is to be consistent with the RW defined in paragraph 46.

Appendix A: Incremental Default Risk Charge Risk Weight Calibration

ISDA proposed an incremental default risk charge (IDRC) method to assess capital requirements for CM's contributions to a CCP DF. The method is fully described within the *Risk Sensitive Capital Treatment for Clearing Member Exposure to Central Counterparty Default Funds* paper[7] published by ISDA in March 2013 (IDRC Paper).

The method is based on the capital add-on to VaR required to capture default and migration risk of debt instruments and CDS held on the trading book, known as IRC, incremental risk charge. IDRC is a forerunner of IRC which captures only default risk and is the relevant concept for DF capital.

For DFs, the IDRC model treats the risk of CM default like a pool of bonds issued by the CMs with probability of default and default correlation calibrated to conservative values typical of that used for trading book calibration and based on publicly available date. LGD (loss given default) was based on limited data available to us from CCPs, HDM (historical drawdown measure) and stressed losses in excess of IM and DF contributions made by the defaulter. This latter data is that actually used to assess the size of the DF under the cover 2 approach.

In summary we used the average of one year PDs available from Moody's, S+P and Fitch for banks for each major credit rating:

AAA	0.00%
AA	0.03%
A	0.08%
BBB	0.25%
BB	1.48%
B	3.92%
CCC	23.98%

Asset price correlation typically used in IRC models is based on CDS and bond spread correlation data. For our exercise we assumed 79% asset price correlation which for two single A obligors translates into a default correlation of around 5%.

Based on the data provided by CCPs we found that on only 30% of occasions when a CM defaulted were other CMs expected to suffer a loss through DF exposures and that the loss would likely fall in the range of 2%-20% of their DF contribution.

The IDRC model works by simulating default events based on the parameter outlined above over some simulation horizon. For this application to DF exposure we simulated over a 1-year horizon to be consistent with both banking book and trading book IRC capital standards and observed the 99.9[th] percentile loss. Our proposal was that this would be the capital requirement for DF exposure. One nice feature of the IDRC simulation is that since it looks through the CCP to the underlying pool of CM exposures it can also consider multiple CCPs simultaneously and capture risks due to the same CM defaulting on several CCPs at the same time. It also properly takes into account that CCPs will not all default simultaneously so there is rightly a diversification benefit which comes from being a member of many CCPs, in that banks should not be required to capitalise their exposure to each on a standalone basis.

From Table 4 and 5 within the IDRC Paper it can be seen that on a diversified basis capital requirements turn out to be around 10% of the funded contributions of a DF in our main case assumption. However, to be conservative, and in line with stress test results that suggest a 20% DF loss could occur per default, assume here that 20% of the DF is a conservative capital requirement.

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[7] *Risk Sensitive Capital Treatment for Clearing Member Exposure to Central Counterparty Default Funds*, ISDA March 2013, available at:
http://www2.isda.org/attachment/NTQ1Ng==/Capital%20Treatment%20for%20Exposure%20to%20CCP%20Default%20Funds.pdf

So from IDRC we would estimate conservatively that capital for DF exposure should be around 20% of the funded DF contribution. On the other hand, NIMM calculations imply an EAD of 98% of DF, not quite 100% because of contributions from the CCP and other factors.

Assuming capital is 8% x RW x EAD then we have a simple equation that can be solved for RW (risk weight) as follows:

20% x DF=8% x RW x 98% x DF

So RW = 20% / (8% x 98%) = 255%.

For CMs exposed to multiple CCPs this might reasonably be reduced to 125% because of the diversification benefit discussed above. Note also that this figure corresponds to a 1-year capital horizon. We can calculate IDRC over shorter horizons but then many more assumptions about scaling PDs, which are only publicly available, annualised, come under scrutiny. We consider the NIMM approach and thereby scale by the square root of time to a 10-day MPOR (the applicable MPOR for margined exposures). These results indicate a RW for the DF ranging from 25%-51% (scaling 125% and 255% by 1/5, respectively) which we believe broadly in line with those that would apply based on a direct look through to the underlying CMs.

Appendix B: Description of the Associations

International Swaps and Derivatives Association (ISDA)

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

Institute of International Finance, Inc. (IIF)

The IIF is a global association created in 1983 in response to the international debt crisis. The IIF has evolved to meet the changing needs of the international financial community. The IIF's purpose is to support the financial industry in prudently managing risks, including sovereign risk; in disseminating sound practices and standards; and in advocating regulatory, financial, and economic policies in the broad interest of members and foster global financial stability. Members include the world's largest commercial banks and investment banks, as well as a growing number of insurance companies and investment management firms. Among the IIF's Associate members are multinational corporations, consultancies and law firms, trading companies, export credit agencies, and multilateral agencies. All of the major markets are represented and participation from the leading financial institutions in emerging market countries is also increasing steadily. Today the IIF has more than 450 members headquartered in more than 70 countries. For more information, please visit www.iif.com.

Global Financial Markets Association (GFMA)

The Global Financial Markets Association brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, please visit www.gfma.org.