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The European Commission

By email: sebastijan.hrovatin@ec.europa.eu

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

Dear Mr Hrovatin

Thank you for your willingness to meet with us and discuss the EC compromise draft on capital requirements for bank exposures to CCPs in the Draft CRR Text.

In particular, we were grateful to learn that the omission of the scalar in method 2 to convert risk-weighted assets to capital was unintended, and would be corrected in the next draft by applying the 8* risk weight to the right side of the term.

We also learned that the omission of the 4% capitalisation category was an oversight, brought about by the short time available to produce the wording. We would also like to point out that the US Joint Agencies[1]

> believe that omnibus accounts (that is, accounts that are generally set up by clearing entities for non-clearing members) in the United States would satisfy these requirements […necessary for a 2% risk-weight]… because of the protections afforded client accounts under certain regulations of the SEC [See 15 U.S.C 78aaa – 78lll and 17 CFR part 300] and CFTC [See 17 CFR part 190]. If the criteria above are not met, a banking organization that is [a] clearing member client would apply a risk weight of 4 percent to the trade exposure amount.

We consider that if trialogues took a consistent approach to omnibus accounts in Europe, where comparable protections afforded to client omnibus accounts may also exist, many additional issues with the cross-implication of regulatory reform would fall away, including in relation to the implementation of EU to US indirect clearing arrangements.

However, we strongly disagreed with two of the intentional 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 ("BCBS 227"). We also wish

[1] http://occ.gov/news-issuances/news-releases/2012/nr-ia-2012-88b.pdf

to emphasize that Basel should be implemented without deviation, especially if the maths of any deviation is not sound. We wish to address two matters:

1. **Ability to choose between methods 1 & 2**

We understand that the EC seeks to avoid arbitrage between the two methods and a regime where firms select the approach that gives them the lowest capital requirement; the ability to cherry pick irrespective of risk. You did advise of appetite to allow ESMA/EBA to determine which method should be used for each CCP if some "criteria" other that regulatory capital reduction is proposed.

However, we do not consider that further criteria are necessary, given that method 2 takes an extreme approach for estimating a very conservative regulatory capital requirement against the risk of members experiencing losses on a Qualifying CCP ("QCCP")'s default fund ("DF"). QCCPs that are either authorised or recognised under EMIR "shall maintain pre-funded default funds that enable the CCP to withstand, under extreme but plausible market conditions, the default of the clearing member to which it has the largest exposures or of the second and third largest clearing members, if the sum of their exposures is larger" (Art. 42 of EMIR). In addition, a QCCP must maintain other pre-funded financial resources which shall at all times enable the CCP to withstand the default of at least the two clearing members to which it has the largest exposures under extreme but plausible market conditions in accordance with Art.43 of EMIR. By definition, the extreme but plausible market conditions which would lead to a first-Euro loss on non-defaulting members' default fund contributions has a probability of occurring of less than 1%, since QCCPs must collect margin from all of their clearing members that cover losses that result from at least 99% of exposure movements over an appropriate time horizon in accordance with Art. 41 of EMIR. Thus, the probability that a CCP's default fund will be needed to absorb any losses at all represents a remote risk, and the probability that the entire funded default fund might be depleted is extremely unlikely.

Applying a risk weight of 1250% to pre-funded DF contributions under method 2 implies that these contributions are highly likely to be lost in their entirety on a regular basis. Given how QCCPs must determine the size of their pre-funded financial resources, this would imply that extreme market conditions which lead to the simultaneous default of the two clearing members to which the CCP has the largest exposures must be fully backed by own funds of the clearing members. We find it difficult to imagine a more punitive regulatory capital treatment for default fund exposures. Therefore, it can be presumed that a bank who selects method 2 for any CCP would only ever select it where the CCP's hypothetical capital requirement as determined under method 1 would result in risk assessments that far exceed those of the CCP's regulatory approved margin model and the CCP's regulatory approved stress testing methodology for determining the required size of its pre-funded default fund. This is why the BCBS 227 text allowed 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. Put simply, the flat risk weight/method 2 is – very clearly – a choice no bank would be willing to make. A firm would only be compelled to employ Method 2 where, such as for IRS portfolios where there is no significant trade compression, the CEM does not reliably measure risk.

2. Committed but unfunded default fund

During our call you advised that the objective of the additional capital charge not proposed in BCBS 227 was to ensure prudential capitalisation of this risk arising from commitments. You mentioned frustration that this was not included in the recommendations for an international standard defined in BCBS 227 by the Basel Committee, despite raising the issue. We agreed that the risk of loss of an assessment was low given it would take place in a scenario where margin, CCP skin-in-the game and default fund had all been exhausted. However, our key argument is that a separate regulatory capital requirement against this risk is not needed, because it is already included in the regulatory capital requirement specified by the Basel Committee which covers clearing members' entire exposure to a CCP's default fund, i.e. not only the risk of loss on pre-funded contributions but also the risk of loss on contractually committed contributions.

Put simply, Method 1 calculates a theoretical regulatory capital amount that would be required by the CCP to cover the CCP's exposures to its clearing members. To the extent that this "hypothetical" capital requirement is smaller than the CCP's own financial resources in the default waterfall, clearing members' own fund requirements are a function of this shortfall. The formula that determines the own funds requirements for all clearing members collectively takes both pre-funded and unfunded contributions into account. While it does not apply risk weights to funded and unfunded DF contribution separately, the formula that determines each individual clearing member's own fund requirement clearly covers both types of exposures. In fact, under method 1, the sum of members' regulatory capital requirements is more than the "hypothetical capital" that a CCP would theoretically need. Capital charges for default fund exposures in addition to the capital requirement under method 1 therefore amount to a double counting of risk and their justification is based on a misunderstanding of the BCBS "hypothetical capital" construct. This is why the exposures were not separately addressed by BCBS during the 2 years the framework was in development.

As discussed in the previous section, method 2 is designed to provide a conservative estimate for clearing members' own funds requirements in case that the calculation of the hypothetical capital requirement under method 1 does not result in a satisfactory assessment of the CCP's risks. Since the own funds requirements calculated under method 1 already cover the risk of clearing members' entire risk from default fund exposures, it would be equally inappropriate to prescribe additional own funds requirements under method 2.

In addition, the treatment for contingent exposures is only applicable where DF*>K CCP (Article 298b(1)(b)of the Draft CRR Text) which in a case where method 2 is used would result in an additional 100% capital deduction. This charge bears no resemblance to the risk that of loss of the commitment.

Significant effort has been expended by BCBS-IOSCO and our members to ensure that there are not capital disincentives to banks being clearing members of CCPs. A situation where banks are discouraged from providing these services will not support EMIR and the G20 explicit commitments to encourage clearing and avoid regulatory arbitrage.

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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