

**To the European Banking Authority (“EBA”) from the Banking Stakeholder Group (“BSG”) –
Comments on Draft Regulatory Technical Standards on Capital Requirements for CCPs**

Key points

The bullet points below set out feedback of the BSG in relation to the EBA’s consultation on Draft Regulatory Technical Standards on Capital Requirements for CCPs (the “**Draft Standards**”) and, in particular, the EBA’s consultation paper on the Draft Standards dated 15 June 2012.

- **Differentiation from regulatory capital regime for credit institutions** – Whilst we agree (as noted in recital 7 of the Draft Standards) that some aspects of the regulatory capital regime for credit institutions may serve as a useful benchmark for CCPs, it will be important to ensure that the regulatory capital regime for banks is not applied wholesale to CCPs. In this context, we note that some CCPs (such as Eurex Clearing AG) are regulated in their home jurisdiction as credit institutions. In our view, the business and risk profiles of CCPs are substantially different to that of banks and it is important that the regulatory capital regime applied to CCPs is designed with this in mind and appropriately calibrated. Furthermore, the fact that CCPs benefit from default backing from clearing members, who (in practice) are mostly banks that will be required to hold capital against their potential default backing contributions should be considered in designing capital requirements for the CCPs themselves; as noted by ICE on page 4 of its response to the draft CPSS-IOSCO principles for financial market infrastructures (the “**FMI Principles**”), “*capital rules relating to banks will inevitably serve in many cases to create pressure for CCPs to adopt no greater than the specified minimum requirements.*”

This touches on a more general point, namely whether CCPs should retain the freedom to carry on non-clearing related activities (i.e. rather than being “pure” CCPs) and, if so, the capital requirements that should apply to their “non-covered” activities. This is discussed further in the final bullet.

- **Need for CCP capital requirements to be sensitive to CCPs’ individual risk models** – Article 16(2) of the European Market Infrastructure Regulation (“**EMIR**”), which the Draft Standards are intended to implement, provides that CCPs should hold capital to protect against risks “*which are not already covered by specific financial resources as referred to in Articles 41 to 44*”, i.e. margin requirements (Article 41), the CCP’s default fund (Article 42), other financial resources (Article 43) and liquidity risk controls (Article 44). In other words, Article 16(2) only requires CCPs to hold prescribed capital to the extent that risks are not already adequately covered by other financial resources in Articles 41 – 44. The Draft Standards should therefore be tailored with sufficient flexibility to ensure that individual CCPs’ capital requirements are sensitive to the default backing arrangements that CCP has in place and whatever other financial resources the CCP has access to. The possibility of CCP losses being written off against capital should be seen as merely one tool to ensure CCP stability that may be utilised in a CCP’s prudential model, rather than a necessary consequence of any clearing member default. Subject to Article 45 (*Default waterfall*) (on which, see further below), it should be permissible for CCPs with broader default backing arrangements and access to wider financial resources to hold a smaller amount of risk-adjusted capital. With this in mind, we would recommend including similar qualifications on CCPs’ obligations to maintain capital as set out in Article 3 of the Draft Standards as are set out in Article 16(2) itself, in particular including recognition that potential losses may be covered by risk mitigants other than capital, if available.
- **Capital charges for operational risk** – Operational risk is a crucial risk type for the CCPs. The proposed basic indicator approach seems to be a possible starting point. Nevertheless, it is questionable whether the 15% multiplier is justified. If the CCP calculated the operational risk capital requirement by the standardised approach, most of its income would be mapped to business lines where the relevant percentage (β factor) is 18 per cent. All the more, because as it is mentioned in the draft as well, in the case of low revenue CCPs the BIA might understate the operational risk capital charge. It could be also considered that an alternative simple approach based on the total number and value of the transactions would not be a better basis for the

operational risk capital charge than the revenue based approach. We agree with the proposal that the CCPs should be allowed to use the Advanced Measurement Approach in order to incentivise them to increase their operational risk management, which is their main risk beyond the one (counterparty risk) covered by “the other financial resources”. The use of such approach should however be subject to a strict validation by an appropriate Authority, i.e. with the expected expertise and probably a banking supervisory Authority. The explicit reference to floor would probably be discouraging and therefore not advisable.

- **Estimating the wind-down period for operational risk charges** – Whilst, in our view, twelve months does not sound like an unreasonable default time period within which a CCP could theoretically be resolved and its positions transitioned, we would note that this time period may vary considerably depending upon the jurisdiction in which the CCP is established and the prudential risk model that it adopts. Therefore, this question should principally be for CCPs to assess in conjunction with their national regulator. In this context, we take some comfort from the provision in Article 6 of the Draft Standards that would base the capital charge for operational expenses on the CCP’s “*estimated winding-down or restructuring period*”, subject to the proposed twelve month floor (on which, see below), i.e. the twelve month figure is a back-stop rather than a default figure.
- **Whether a floor should be applied to the wind-down period for operational risk charges** – As a matter of interpretation, we do not think that an “*appropriate time span*” for orderly wind-down or restructuring of a CCP’s activities necessarily requires an explicit floor to be set in the Level 2 Technical Standards; there may be an argument for allowing CCPs to apply a shorter time period when they are able to evidence through their general capital plan that a shorter period for wind-down or restructuring is foreseeable. Assuming that the general capital plan, as set out in Article 5 of the Draft Standards, is appropriately scrutinised by the CCP’s competent regulator, then there should be flexibility to set a shorter time period for the purposes of setting a CCP’s capital charges for operational risk. With this in mind, we would not object to a shorter floor than twelve months, provided the likely resolution period continues to be estimated on a CCP-by-CCP basis. (One general point to note here is that it is not clear how these proposals will dovetail into the Commission’s forthcoming consultation on the resolution of CCPs. The general capital plan referred to in Article 5 appears to include a resolution and recovery plan under Article 5(1)(b), which begs the question of whether Draft Standards under EMIR are the correct instrument to achieve this, but also raises the question as to what the forthcoming Commission consultation on the resolution of CCPs will address. There is no reference whatsoever in the Draft Standards to the Commission’s ambitions or draft crisis management proposals and this needs clarifying.
- **The implications of CCP capital requirements for non-member ownership interests** – In considering what capital requirements to apply to CCPs, it is important not to lose sight of the potential impact on CCP’s ownership models. The practical consequences of requiring CCPs to hold additional capital will, in many cases, be that CCPs will be required to raise additional capital, either from their existing shareholders or other third parties. In the case of principally member-owned clearing houses (e.g. DTTC), this either raises the risk of increasing clearing members’ potential losses in the event of a CCP failure (i.e. by adding additional potential losses on CCP equity held by a clearing member on top of any contributions that clearing member may need to make to the CCP’s default fund) or else, if existing clearing members are reluctant to contribute the additional capital required, mandating capital raising from non-members. Raising equity capital from third parties may not be cost effective (particularly if a number of different CCPs are required to seek funding in the equity capital markets at the same time) and may also lead to non-stakeholders with a principally financial motivation having a considerable say in CCP governance. It has been noted by some commentators that opening up the membership of US CCPs to non-members would leave the CCPs’ practices open to scrutiny under US anti-trust laws, which do not apply to member-owned businesses; likewise, it will be necessary to consider the EU competition law implications of EU CCPs raising capital from persons other than clearing members.

- **Positioning of CCP resources and capital in the loss waterfall** – Article 45(4) (*Default waterfall*) of EMIR envisages that CCPs should use their dedicated own resources before using the default fund contributions of non-defaulting clearing members. This approach (known as “CCP skin-in-the-game”) was justified in the EMIR negotiations as incentivising responsible risk management by CCPs (see e.g. point 6 of the public comments from ISDA/AFME on the Hungarian Presidency compromise text of 17 March 2011). We note from Article 43(1) (*Other financial resources*) that such resources should not be used to meet the capital requirements required under Article 16, but there is no similar rule in relation to capital, the implication being that CCPs may call on default fund contributions from non-defaulting clearing members before writing off any further losses against capital. We also note that, under Article 45(5), responsibility lies with ESMA (rather than the EBA) to develop rules on the calculation and maintenance of CCPs’ own resources requirements. It is important that ESMA and the EBA work together closely on these issues due to the interrelationships between them; in particular, the amount of other resources that CCPs will be required to hold under the ESMA rules will have a direct impact on both the risk posed to default fund contributions from non-defaulting clearing members and the risk that a CCP will be required to recapitalise following the default of a clearing member (which, in turn, should factor into a CCP’s capital plan that will be required by Article 5(1) of the Draft Standards). In addition to this, it might be useful for the EBA to clarify what the “other financial resources” held by CCPs are likely to comprise in practice and confirm whether the intention of Article 43 is to carve such resources out of the definition of “capital” for the purposes of CCP capital adequacy requirements (or, if not, how the provision should be read). In this context, we note that, at the recent EBA open hearing on the draft RTS, the EBA representatives expressed the view that the “other financial resources” requirement, which sits higher up in the default waterfall than capital, is explicitly deducted from capital in Article 3 - potentially helping with the ambiguity on how such resources should be treated (and eliminating the risk of double-counting).
- **Capital charges for business risks and residual legal risks** – Whilst we would not object to competent authorities having the power to require CCPs to hold additional capital against business and legal risks (as envisaged in Article 9 of the Draft Standards), we believe that this should be discretionary and should take into account CCP’s overall prudential model, including its access to other financial resources and the extent to which such risks (in particular, legal risks) are already covered in the CCP’s default backing arrangements. We believe that this is consistent with the present draft of Article 9 and therefore have no changes to suggest to the current wording.
- **Capital charges for “non-covered” activities** – Article 8 of the Draft Standards imposes an additional capital charge for non-covered activities that appears to go beyond the intent of Article 16(2) of EMIR. Article 8 is geared towards the investment activities of CCPs, including the investment of its own financial resources and collateral received from clearing members (see Article 8(2)). However, it is not entirely clear that this additional capital charge is proportionate to the risks that these activities give rise to given the highly conservative investment policy of CCPs which is buttressed with quite detailed Level II standards being proposed by ESMA (confer Article 47 EMIR and Chapter XII of ESMA’s draft RTS on OTC Derivative, 25 June 2012). CCPs should not carry trading book positions (even if they may have open FX positions) or significant credit risk. This raises the issue as to whether or not prudentially regulated CCPs should be permitted to use internal models for other risks than operational ones;. A simple application of a standardised approach to risk to a broad range of activities would then be perfectly legitimate. CCPs should focus on their main role which is to make trade exchange safer and not to divert their attention towards other profit generating activities.
- **Capital requirement notification threshold** - We understand that the threshold set at 125% is not construed as being a capital buffer, which makes a lot of sense, but the contemplated sanction in case of breach of the minima is not clearly established and cannot only be a more stringent reporting