

Industry Response to the European Banking Authority Discussion Paper On Draft Regulatory Technical Standards on the Capital Requirements for CCPs under the draft Regulation on OTC derivatives, CCPs and Trade Repositories (EBA/DP/2012/1)

A. Introduction

The International Swaps and Derivatives Association (“ISDA”) together with members of the Financial Services Industry (“The Industry”) welcome the opportunity to comment on the above Discussion Paper (“the Paper”). The Industry is supportive of the Paper’s aims and objectives and understands the desire expressed by the G20 nations to ensure that Central Counterparties (“CCPs”) are subject to robust prudential and organizational controls in respect of their non-clearing activities.

In particular we agree with the concepts of treating the investment risk of CCPs in a similar manner to that of other asset managers.

The Industry believes that in crafting legislation to reduce systemic risk, regulators must strive to strike the right balance between the desire for financial stability while seeking to maintain financial innovation and prudent risk-taking supported by sound business practice and encouraging economic expansion.

Principal matters where The Industry believes that further dialogue would be beneficial:

- I. CCPs, in respect of their non-investment activities, can be compared to asset managers particularly in respect of the risks arising from investing and managing their own capital. It therefore makes sense to apply a regime similar to that applied to regulated entities under CRD IV¹. However, the economic function of a CCP is to minimise risk whereas that of a regulated entity is to balance risk and reward. In consequence their capital structures are different and not all of the CRD IV proposals will be relevant to CCPs. Further, there are additional areas such as investment policies and concentration² risk which require to be addressed.
- II. The meaning of the term “Capital” is taken to mean resources available to the CCP which is used to support its day to day operations. Under the “waterfall”³ certain CCP resources must⁴ be available to meet the obligations of the CCP to non-defaulting members (“skin in the game”). With this exception Capital is not available to Clearing Members. Capital requirements under Article 12 of EMIR will therefore cover the credit, market and operational risks of the CCP’s non-clearing activities.

¹ Capital Requirements Directive

² For example a CCP which invested significant surplus liquidity with its clearing members may face additional risks.

³ Waterfall is a term used to describe the priorities of various claims on an entity and sets out the order in which providers of capital or liquidity are called upon to contribute and the sequence in which they may be repaid.

⁴ Pursuant to Article 42 of EMIR

- III. The meaning of the term “Other Activities”: These activities refer to the investment activities that a CCP undertakes in relation to its own capital and surplus liquidity arising from Initial Margin (“IM”) or other collateral that it collects from Clearing Members.
- IV. The investment policies for investing surplus funds need to be carefully assessed. The Industry understands that these are mostly limited to overnight Repurchase (“Repo”) and Reverse Repurchase (“Reverse Repo”) transactions. Further, the potential concentration issues that arise from these activities need to be monitored and controlled.
- V. The term Non-Clearing Activities is understood also to encompass activities ancillary to clearing such as the collection and dissemination of data. The Industry believes that the range of permissible Non-Clearing Activities should be narrowly defined.
- VI. There will be a very significant difference in the perceived credit worthiness between CCPs which have Central Banks as lenders of last resort and those which do not. The Industry understands that the distinction may well lie in perception rather than a legally binding agreement. In addition, CCPs which are constituted as banks may have more ready access to Central Bank discount facilities which may significantly affect the perception of their credit and/or liquidity position. CCPs constituted as non-banks may also have access to such facilities in certain circumstances.
- VII. The Moral Hazard argument is well understood whereby any institution which has access to backstop credit and liquidity facilities may be incentivized to compete for market share by lowering prudential standards or costs. The “skin in the game” argument provides some counter balance but the imposition of common minimum standards must be paramount.
- VIII. No regulation should be introduced which would have the effect of preventing a CCP whether or not it is a Bank obtain facilities from a Central Bank.
- IX. The Current Exposure Method (“CEM”) is inappropriate for the calculation of the riskiness of Clearing Members’ exposure to CCP default funds. It is unsophisticated, not risk sensitive and cannot be properly calibrated for large OTC derivatives portfolios⁵.

CCPS-IOSCO Principles for Financial Markets Infrastructure (PFMIs)

Q1. Do you support this approach to Capital Requirements?

The Industry broadly supports the capital requirement approach which will be at least equal to that presented by the CPSS-IOSCO principles.

Q2. Do you consider there to be any alternative approach which is more appropriate that would be consistent with Article 12 of the Regulation?

No.

⁵ ISDA Research Paper on the impossibility of correctly calibrating the Current Exposure Method for large portfolios of OTC derivatives, June 2011.

Operational expenses for winding-down or restructuring

Q3. Which criteria do you take into account for estimating the appropriate time span for orderly winding down or restructuring of the CCP's activities?

This is a matter to be addressed bilaterally between regulators and CCPs.

Q4. What is your estimation for the number of months necessary to ensure an orderly winding-down or restructuring of the CCP's activities?

See response to question 3.

Q5. Do you think that a minimum list of items to be included in the operational expenses could be useful, such as the IAS 7?

The Industry's views on the Operation Risk of CCPs are as follows:

- I. CCPs which are not banks are not subject directly to the Basel III Proposals⁶. However, a standardized approach based on the Basic Indicator Approach may be appropriate for less sophisticated CCPs.
- II. The Industry has a strong preference to permit CCPs to utilize a models based approach.
- III. Given the somewhat specialized nature of CCPs' businesses, models would need to take into account a number of factors including the time period for liquidation and/or resolution and the feasibility of transferring Clearing Member positions to other CCP's (portability).
- IV. CCPs occupy a systemically important position. Given the linkages between Clearing Member default and risks to the CCP's capital an Advanced Measurement Approach ("AMA") is justified.

Q6. How do you currently measure and capitalise for operational risk?

This is a matter to be addressed bilaterally between regulators and CCP's.

Q7. Do you think that the banking framework is the most appropriate method for calculating a CCP's capital requirements for operational risk? If not, which approach would be more suitable for a CCP?

Conceptually The Industry agrees with this approach although the unique business model and systemic importance of CCPs will require certain modifications to a "plain vanilla" CRD IV approach.

Q8. What would be the cost of employing the basic indicator approach set out for banks for the calculation of your capital requirements for operational risk?

This is a matter to be addressed bilaterally between regulators and CCPs.

⁶ Basel III; A global regulatory framework for more resilient banks and banking systems, December 2010 (Revised June 2011)

Q9. Do you think that the Basic Indicator Approach set out for banks is appropriate for CCPs?

Systematically important CCPs ought to be encouraged to adopt the SA approach because of the additional requirements to implement OR management processes and reporting. Clearly, setting a BIA Alpha to 18% will not result in any capital savings from BIA.

Q10. In your view, which alternative indicator should the EBA consider for the Basic Indicator Approach? (Please elaborate why such indicator would be more appropriate for CCPs)

This is a matter to be addressed bilaterally between regulators and CCPs.

Q11. In your view, with regard to the Standardised Approach, which different lines of business or type of products can be relevant for CCPs' operational risk?

This is a matter to be addressed bilaterally between regulators and CCPs.

Q12. Do you think CCPs should be allowed to calculate the capital requirements for operational risk with an internal model, as in the advanced measurement approach?

Yes, this should be encouraged as the approach is sophisticated, risk-based and engages the entire organization, up to and including the Board. However, the same standards and scrutiny needs to be applied to a CCP as is applied to Banks

Similar to the AMA requirements for banks, there ought to be floors placed on the amount of capital required for AMA CCPs in the 3 years following approval, vis-à-vis BIA/SA.

Q13. Which other approaches should the EBA consider for operational risk measurement?

This is a matter to be addressed bilaterally between regulators and CCPs.

Q14. How do you currently measure and capitalise for credit, counterparty credit and market risk stemming from "non-clearing activities"?

This is a matter to be addressed bilaterally between regulators and CCPs.

Q15. Do you think that the banking framework is the most appropriate method of calculating a CCP's capital requirements for credit, counterparty credit and market risk stemming from "non-clearing activities"? If not, which method would be more suitable for a CCP?

Yes

Q16. What would be the cost of employing Standardised Approach methods for the calculation of your capital requirements for credit, counterparty credit¹² and market risk stemming from "non-clearing activities"?

This is a matter to be addressed bilaterally between regulators and CCP's.

Q17. In your view, are the Standardised Approach methods appropriate for the calculation of credit, counterparty credit and market risk a CCP faces stemming from “non-clearing activities”?

As stated, there should be a range of methodologies available depending on the level of sophistication of the CCP subject to supervisory approval.

Q18. Do you think that CCPs, which concentrate risks stemming from derivatives, should be allowed to calculate their capital requirements for credit, counterparty credit and market risk using internal models?

Yes

Q19. In your view, which assets held by a CCP should be better capitalized with a market risk treatment?

Those which, in a firm subject to the Basel III proposals would be eligible for Trading Book treatment.

Q20. In your view, which other approaches should the EBA consider for credit, counterparty credit and market risk measurement?

None

Q21. What is your view on the notification threshold? At which level should it be set?

The level should not be below 110% which is the level set for firms authorised by the UK Financial Services Authority (“FSA”) although should be given as to whether, given the unique business model of CCP’s, a fixed or higher percentage is appropriate.

CCP’s should be required to have procedures in place, approved by regulators, as to the steps to be taken in the case that the notification limit is breached. The Industry fully understands the effects on the industry that the “leaking” of such information may trigger.

Q22. In your view, in which case should restriction measures be taken by the competent authority once the notification threshold is breached?

This is a matter to be addressed bilaterally between regulators and CCPs.

Cost-benefit Analysis

Questions 23 to 27 will be envisaged on a bilateral basis by the CCPs.