A. Introduction

On 11 March 2010, CEBS has opened a consultation on its implementation guidelines on article 106 (2) (c) and (d) of Directive 2006/48/EC recast (CP38).

CEBS has asked to comment until 6 May 2010. Deutsche Börse Group wants to contribute to this discussion.

Deutsche Börse Group (DBG) is operating in the area of financial markets and operates along the complete chain of trading, clearing, settlement and custody for securities, derivatives and other financial instruments. Among others, two companies offering (I)CSD[1] services are classified as credit institutions and are therefore within the scope of the Capital Requirements Directive (CRD). Furthermore, Eurex Clearing AG as the leading European Central Counterparty (CCP) is also affected by the CRD implicitly as within the current German law it is treated as a credit institution and therefore it is within the full scope of CRD.

Despite being in general within the scope of the CRD rules, the business of the credit institutions within DBG is quite different from that of most other banks. DBG companies are just acting in specific corners of the financial industry and the banking business and their customer basis is focused on other banks and financial institutions only.

Due to the specific kind of business which is done mainly as an inter-bank activity, the tightened large exposures rules within the CRD II (Directive 2009/111/EC) turned out to be a major threat to our business and in turn to the whole financial market.

B. Business Background

Based on our business model for (I)CSD services, which is common in the area of securities settlement, our clients either draw short term (mainly intraday) on specific settlement lines granted or leave substantial amounts of cash with us in order to facilitate settlement and custody activities in an efficient and effective way. Payment in- and outflows cannot be predicted in a sufficient manner and liquidity for even substantial payments to be paid out also late in the day need to be available. Even if cash inflows are supposed to be pre-advised, this is not always the case and pre-advised funds might also not materialise. This is similarly true for cash outflows. Therefore, exposures resulting from client transactions towards the clients itself or towards cash correspondent banks on a single counterparty or a group of connected counterparties basis during the day or even at day end might exceed the 25 % threshold as defined in article 111 of the directive.

Diversification of the funds is done to the extent possible with highly credit worthy counterparties which are checked for the creditworthiness on a regular basis. As relationships with cash correspondent banks and the global custody network need to

[1] (International) Central Securities Depository

be reliable for operational purposes as well, also the capability of our network regarding continuous operations and reliability of IT systems, operations know how and proper position management of our clients' assets is monitored on an ongoing basis. Taking into account the number of markets and currencies we are operating in, (more than 40 markets and around 100 denomination currencies), diversification is nevertheless limited to a certain extent.

Current discussion on CCPs, including the intended EU wide harmonized regulation on the basis of the EMIL initiative, show that CCPs need to collateralize the positions held with them based on a well defined margining concept and sufficiently high confidence levels. As a consequence, a CCP needs to accept a broad range of highly liquid collateral and cash is in this regard highly welcomed. In turn, cash collateral received from clients need to be kept somewhere. Due to differing deadlines for settlement in securities and cash, intraday margin calls can just be fulfilled in cash from a certain point in time during the day. Furthermore, in order to give the financial community sufficient flexibility, an exchange of collateral (security against security or cash against security / security against cash) is feasible during the day. Finally, in times of high market volatility the likelihood and magnitude of intraday margin calls increases. This can happen also late in the day as clearing is done by Eurex Clearing currently up until 10:30 p.m. Due to market practice, cash is thereby delivered in currencies of markets which are still open for cash processing at that point of the day (i.e. USD). Clearing members of CCPs therefore need to manage their relationship with CCPs related to the large exposure regime. Even the fact, that CCPs are treated equally to credit institution (article 30 (4) of Directive 2006/49/EC as amended by CRD II), does not change the issue as such.

Both, cash received from clients / clients' overdrafts and cash collateral received can be withdrawn/repaid at any time (for collateral through replacement in securities collateral of the same collateral amount after taking haircuts into account). Their original maturity is therefore not lasting longer than the following business day.

As the amount of cash available is depending only on the behaviour of the clients, we are also not in the position to influence the duration of the possible holdings on our cash correspondent accounts. In order to avoid or at least reduce concentration risk, bigger amounts are placed out to treasury counterparts of high credit worthiness if possible on a collateralized basis. Any expected cash residuum is placed over a still reasonable short period but exceeding one business day (and is therefore not in the scope of the exemptions of article 106).

Cash flows in and out on our cash correspondent and client accounts are highly frequent and are usually not taking into consideration when deriving credit or regulatory figures. As the accounts with both clients and cash correspondent banks are maintained on a current basis, cash flows are netted legally at the moment, where they affect the account. It is therefore neither legally possible nor practically feasible to find out when positions once opened are closed again.

Our business model as described above was one – if not the major – reason to introduce article 106 (2) (c) with CRD II. It needs to be taken into account that article 106 (2) (b) is already offering some exemptions related to our business and this is reflecting to a five days period. We also want to point out, that especially collateral given and received might be withdrawn at any time in case collateralization is secured by other means. But, in order to fulfil its role, the likelihood for a substantial part to be rolled over is inherent to the purpose of the collateral. In the light of this fact, recital 22 of CRD II nevertheless clearly states, that collateral given and received is included in the exemption.

C. Comments in detail

Paragraph 21:

The current wording of paragraph 21 is in our view focussing too much on late incoming funds. As described above, the value of the exposure at the end of the day is determined by various flows and even by expected but finally not materialized payments.

In order to reflect the client behaviour as described above, it is to our mind not sufficient to reflect to the difficulties to predict external inflows. It also need to be taken into account, that inflows can come out of settlement or custody business (internal inflows) and outflows both externally (cash withdrawals) and internally (securities purchases or custody payments) can occur. Also the possibilities to predict cash flows and in consequence cash positions out of those activities are fairly limited.

In order to describe this in a more comprehensive manner, we kindly ask to widen the description accordingly.

This is also true with respect to collaterals. Collaterals given and received are explicitly mentioned in recital 22. As the process for collateral is different from other exempted client related business, we also would like to see this item described in the background part of the guidelines.

Paragraph 22:

We clearly share the description of the three conditions to be met in general. Nevertheless, we see some need for changes at various places.

a) Based on the wording of article 106 CRD II we feel that the term "services" is a better description for the content of part A and we therefore suggest referring A as "Types of services". In the consequence, the wording of the subsequent text needs to be adopted accordingly.
b) The exposures exempted are according to the text of article 106 either "delayed receipt in funding" **or** "other exposures". In this sense our understanding of the text – especially when read in conjunction with recital 22 –

does not show any limitation to "delayed receipts in funding". This is underlined by the expression in recital 22: "The related exposures include exposures which might not be foreseeable and are therefore not under full control of the credit institution, …". The last paragraph of A as proposed by CEBS is therefore to our understanding going far beyond the text of CRD II. Based on our understanding of the text and taking into account the aim behind the article as expressed in recital 22, the "delayed receipt in funding" is to be read more like "such as …".

c) Like the requirement of article 106 to exempt exposures only, when they are arising from client activity, we see the different exposures types as being more a question of "origin" and suggest therefore bundling the exposure types with the client relation to a revised criterion B "Origin of the exposure".
This revised criterion B should contain in our mind the relation to client activities as currently and in addition some additional descriptions of the exempted kinds of exposures.
The text of the article as explained above (see b) covers in principle all possible kind of exposures (as long they are related to the exempted services, are arising of client relations and are in principle not lasting longer than the following business day). Nevertheless, the intention of the exemption is clearly putting some focus on such exposures which are not under full control of the credit institution. We therefore propose to include a caption in section "B", describing exposures which are not under full control of credit institutions (e.g. late incoming payments, not materialized expected in- and outflows and exposures which due to technical or external constraints can not be reduced with reasonable effort before the end of the business day). Those exposures might therefore add to other (not exempted) exposures and in consequence the total exposure towards one counterparty might lead to breaches of LE limits. From a wording perspective, it is potentially not the single exposure that breaches the LE limits but the total exposures towards a single client or a group of connected clients.
As the CEBS is already indicating in including the list of exemptions stated in recital 22 in its consultation proposal, the items listed above are to be seen as examples. Therefore, even taking into account the largest possible framework of common understanding, there is still the need to leave some room for interpretation in the day to day supervision. This also takes care for specific exposures which might arise in the future due to changes in market conditions which are not foreseeable currently but are covered within the faith of the exemption granted in article 106 (2) lit. c..

d) Based on our comment c) above, the items so far listed as "other exposures" by CEBS in criterion A should be moved in the light of our proposals above as additional guidance into criterion B.

e) Related to the limitation on exposure diversification with regard to "the same or higher credit quality" we cannot see this being covered in the CRD II. As in certain markets it is difficult to find counterparties which are close to the rating (being used here as the indicator for credit quality) of the CCB / custodian used, the proposed treatment in any case seems to be too restrictive. We

therefore propose to drop this requirement.
In case CEBS wants to urge usage of at least similar ratings and in turn wants to penalize usage of diversification towards lower rated counterparts, we propose to use credit quality in the sense of being the same credit quality step derived from the counterparty (credit institution) credit rating according to the rules based on Directive 2006/48/EC Annex VI paragraph 29.

f) The monitoring of exposures for credit purposes and the regulatory reporting is highly related to accounting data. Especially regulatory reporting tends to use account balances at end-of-day. In the specific cases of the services included in the exemption, most of the business is done using current accounts and transaction data is not kept for regulatory reporting purposes. As a consequence, the usage of data based on transactions flows for the purpose of Large Exposure reporting is more or less practically not feasible. Determination of the duration of specific flows of funds in the accounts of a credit institution is impossible. The fulfilment of the condition "do not last longer than the following business day" therefore needs to be based on the general content of the underlying flows, contractual relationships (maximum allowed duration of a loan restricted for the exempted business), general policies and guidelines in place and other means to demonstrate towards the supervisor that the condition is kept in a sufficient manner. We therefore propose to formulate criterion C along these principle based lines.

g) In addition to the principle based approach a solution for cash collateral – especially in the context of cash collateral towards CCPs is necessary. Cash collateral given has a tendency to persist over a certain period. As the cash collateral is the most liquid collateral, this was one of the main reasons to include this in recital 22. Cash collateral to a substantial degree will not demonstrate a turnover during its life cycle and also for practical reasons (to secure proper collateralization at all times) any process to sweep out the collateral once during the day is not an option. In order to exempt the collateral giver from large exposure requirements, which he potentially is not able to meet in the current set up, he might be required to buy securities to give them as collateral. This is changing its risk profile in an unintended way and putting also the collateral receiver in a less liquid position. The wording of article 106 (2) lit c here is not exactly covering the scope as indicated in the recital. We nevertheless believe that the intention of the article is to cover cash collateral under the following conditions:
    i. They are given / received in the course of services as listed under A in the (revised) CEBS guidelines;
    ii. They stem from client activity; or
    iii. They do not have a fixed term / minimum cancellation period of more than one business day.

   This exempts to our understanding totally in line with the article 106 (2) lit. c any intraday margin calls. We propose therefore to add the following text to the criterion C: ***"Cash collateral given is within the scope of the Article 106 (2) (c) CRD II exemption, if it is the consequence of intraday margin calls. Other cash collateral in the course of transactions as described in***

A are exempted, in case it is not requested to be held for a fixed or minimum period exceeding the next business day."
From a different point of view, daily margin calculation requires at least daily different collateral requirements. Therefore the cash collateral given is to be seen every day in combination with a new (revised) collateral requirement.

h) With regard to the client relationship and the fulfillment of the maximum duration period organizational requirements arise which the institution needs to follow. Alternatively to a description at various places, we could imagine to have an additional paragraph (22a) inserted, which puts the organizational requirements together at one place.

Based on the above mentioned aspects, we propose furthermore, to align the wording of paragraph 24 criterion A with the one of paragraph 22 ("Types of services" instead of "Transaction types").

Related to the questions raised by CEBS, we want to deliver our answers as follows:

1. We refer to our positions in detail above and explicitly want to repeat our understanding of "other exposures" covering all kinds of exposures arising from client activity for services as listed under A and which do not last longer than the following business day (as defined in our proposal above).
2. In our mind the definition related to client activity is in principle sufficiently clear. In our specific case a proper distinction seems to be feasible.
3. The practical problems to track transactions flows rather than end-of-the day accounting balances have been pointed out in our detailed remarks above. We therefore clearly prefer a principle based approach in this respect.
4. Beside our above mentioned proposal to change the wording to "Types of services" we feel the definition being appropriate.
5. Yes, this seems to us being the appropriate approach in this regard.
6. As the exempted exposure is potentially just one part of the total exposure towards a single client / group of connected clients, we propose to rephrase a little bit the wording. It should be made more clearly, that the "total" exposure shall be below the LE limits. Wording should be therefore more like "…, i.e. the reporting institution shall secure that any intraday excess exposures compared to the LE limit are brought below the 25 % LE limit before the end of the business day, taking into account other exposures with the same client / group of connected clients."

Frankfurt / Main

6 May 2010