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July 31, 2012

European Banking Authority ("EBA")

Sent by email to: EBA–CP–2012-08@eba.europa.eu

EBA Consultation Paper on Draft Regulatory Technical Standards ("RTS") on Capital Requirements for Central Counterparties ("CCPs")

This letter contains the response of the International Swaps and Derivatives Association, Inc. ("ISDA") to the EBA's Consultation Paper on draft RTS on capital requirements for CCPs dated 15 June 2012 (the "Consultation Paper"). Since 1985, ISDA[1] has worked to make global over-the-counter ("OTC") derivatives markets safer and more efficient. Accordingly, this response focuses on the draft RTS' application to OTC derivatives markets, and in particular the proposals' suitability for OTC derivatives CCPs.

ISDA commends the EBA for its consideration of the issues raised in the Consultation Paper. We have a number of comments, welcome the opportunity to share these and look forward to assisting the EBA in implementing appropriate capital requirements for CCPs with a view to enhancing market liquidity, reducing risk and fostering financial stability.

Implications of a 50% deduction

The EBA RTS, together with the European Securities and Markets Authority's ("ESMA") proposed RTS of 25 June 2012, requires a CCP to deduct at least 50% of its regulatory capital requirements, as calculated under the EBA proposals, from its regulatory capital resources (i.e. share capital and reserves).

While the principle of including the "dedicated own resources" (or "skin in the game") in the calculation is consistent with the current position under Basel CRD for CCPs (i.e., the dedicated own resources are a "pillar 2" requirement) the quantum now proposed by ESMA is 50% of the requirement, which is a substantial increase for a CCP compared with the typical percentage of a CCP's own resources in the default waterfall today.

We recognise that the quantum is ESMA's, and not EBA's, jurisdiction. However, we are uncertain as to whether the 50% quantum is suitable and we urge EBA to collaborate with ESMA to ensure a consistent, rational rule set. To assist with that collaboration, we summarise here the position we intend to put to ESMA on this issue:

- We are uncertain that the 50% quantum strikes the correct balance between the goal of ensuring CCPs have "skin in the game" and the goal of ensuring that CMs have incentives to

[1] ISDA is one of the world's largest global financial trade associations, with over 800 member institutions from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the association's web site: www.isda.org.

International Swaps and Derivatives Association, Inc.
One Bishops Square
London E1 6AD, United Kingdom
P 44 (0) 20 3088 3550 **F** 44 (0) 20 3088 3555
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

bid in an auction of a defaulting CM's portfolio (and the systemic risk associated with member-owned CCPs, where a large CM default could either bring down the CCP or require its capitalisation in difficult funding conditions).

- We urge that before accepting proposals on the skin in the game quantum, ESMA, in conjunction with EBA and any other relevant supervisory body, thoroughly test them against the regulatory objectives via a well-designed quantitative impact study conducted in collaboration with industry participants.

- We consider that the balance would be better struck by requiring a CCP to hold 50% of its regulatory capital in a segregated deposit account, but subject to a cap (set at the level of a 75th percentile CM's default fund contribution for the relevant class of product) and a minimum amount (set at USD50 million).

- In our view, when determined this skin in the game amount should be placed ahead of the non-defaulting members' contribution. In our view this would safeguard both the CCP's incentive to reduce the chances of these assets being called upon (through margin calibration and risk management) and non-defaulting CMs' auction incentives

- A second tranche should follow the non-defaulting members' default fund contributions. The potential for additional CCP resources to be called upon if the default fund were exhausted would create the incentive for the CCP to ensure the total size of the default fund is adequate.

CCP capital requirements

In summary, the Consultation Paper notes[2]:

> The EBA's view is that according to the Regulation the capital of a CCP, including retained earnings and reserves, should be at all times at least equal to the sum of:
>
> i. the CCP's operational expenses during an appropriate time span for winding-down or restructuring its activities;
>
> ii. the capital necessary to cover the overall operational - including legal - risk born by the CCP; and,
>
> iii. the capital necessary to cover credit, counterparty credit and market risks stemming from "non-covered activities" that the CCP carries out.
>
> Other business and legal risks, borne by the CCP might lead its competent authority to require additional capital, similarly to banks which may be subject to extra capital charge.

We understand the logic for a CCP's capital requirement being the *sum* of the expenses-based winding-down requirement and the risk-based requirement, as opposed to the higher of the requirements, which was envisaged in the EBA's first consultation. However, we query the benefit of layering capital requirements without a greater appreciation of the relative probabilities of the two states manifesting, to inform an analysis as to whether a CCP requires full capital for both the 'business-as-usual' state and the 'winding-down' state.

[2] EBA Consultation Paper 'Draft Regulatory Technical Standards on Capital Requirements for CCPs', June 2012, page 4 and 5.

Further, the Consultation Paper asserts that a CCP's wind-down expenses are equivalent to its operational expenses for an appropriate time span for winding-down. This may be inappropriate as, in the wind-down state, there are numerous business-as-usual activities and discretionary activities that a CCP would not be carrying out, for example marketing and there may be additional costs relating to issues such as decommissioning of systems, termination of contracts and professional fees required to execute the winding down. We consider that a detailed analysis of these costs would be beneficial in determining the capital risks a CCP would actually run in the wind-down state, with final expenses calculated accordingly. In our view, such an analysis is required in order to ensure that the ultimate capital rules for CCPs are efficient.

In addition, while not within scope of the Consultation Paper, we urge the EBA to consider CCP liquidity as important as capital given that capital is intended to fund fixed assets and absorb P&L losses, not finance short-term assets. Capital cannot meet immediate cash expenditure, only liquid assets can, and a CCP with a very strong capital position could still fail if it ran out of cash. Consequently, in the supervision of CCPs, we believe that a competent authority should place as much emphasis on a CCP's liquidity position and compliance with the liquidity risk requirements in EMIR Article 44 as it does on the CCP's capital position.

Finally, we query how the credit-related risks arising from "non-covered activities" can be determined separate from the credit exposures to clearing members. For example, if a clearing member is also a settlement bank, sub custodian or liquidity provider to a CCP, how can these credit risks can be allocated capital separate from the exposure taken to the clearing member with respect to clearing? The increased role of CCPs contains new forms of systemic risk. It is important that the approach to the regulation of such new forms of risk not be based on the assumption that what is necessary is the simple extension of existing capital requirements for banks. Rather, we suggest that a comprehensive and integrated analysis should be carried out. This analysis should include an open consideration of the best ways of addressing such risks, both via capital requirements on CCPs and clearing members as well as through other design elements.

CCPs should be allowed to develop internal models for market and counterparty risk

The approach proposed in the Consultation Paper for credit and counterparty risk related to non-covered activities is not risk-sensitive. A more risk-sensitive approach (as is seen in Basel II IRB combined with IMM) would assign credit risk weights that depend on the counterparty and exposure that reflect the possible market values of an OTC trade. Such an approach would require the CCP to develop and operate internal models (CCPs have modelling capacity in order to set their margin requirements). The lack of risk-sensitivity can create undesirable incentives. We urge the EBA to allow CCPs to develop internal models for measuring market and counterparty risk (subject to regulatory approval).

We note that the proposed approach to market risk related to non-covered activities also lacks risk sensitivity.

125% "notification threshold"

We do not object to the 125% "notification threshold", since it helps regulators to spot potential problems early. However, we would appreciate more clarity in the RTS on what actions regulators would be empowered to take once notified and before a CCP's capital falls below the minimum requirement.

In addition, we note that page 5 of the Consultation Paper contemplates that a competent authority could require a CCP to hold additional capital to cover other business and legal risks (similar to Pillar

2 for banks). We therefore consider it necessary to clarify what the notification threshold would be in circumstances where the CCP had such an additional capital requirement. Specifically, would the notification threshold be i) 125% of the requirement calculated under Article 3 or ii) 125% of the sum of the Article 3 requirement and the additional component authority imposed requirement? We consider that it should be the former and that this should be made explicit in the text.

The floor of 80% for AMA versus BIA should be lowered (or removed)

The Consultation Paper provides that CCPs should be allowed, subject to the same strict organisational and quantitative standards as banks and to the permission of the competent authority, to use the Advanced Measurement Approaches ("AMA") to incentivise them to increase their operational risk management. To ensure a proper capitalisation of operational risk, the CCPs using the AMA should respect a floor of 80% of the capital requirements calculated on the basis of the Basic Indicator Approach. We consider that the floor of 80% for AMA versus BIA should be lowered (or removed), again to increase incentives for CCPs to use models of increased sophistication and risk sensitivity.

Losses exceeding the default waterfall financial resources

Page 6 of the Consultation Paper states, "Under no circumstances will a CCP use margins posted by non-defaulting clearing members to cover its losses resulting from the default of another clearing member."

We assume the reference to "margins" means Initial Margin. Otherwise, this would clash with CPSS-IOSCO Financial Market Infrastructure Principle ("PFMI") 3.4.25, which states[3]:

> In certain extreme circumstances, the post-liquidation value of the collateral and other financial resources that secure an FMI's credit exposures may not be sufficient to cover credit losses resulting from those exposures fully. An FMI should analyse and plan for how it would address any uncovered credit losses. An FMI should establish explicit rules and procedures that address fully any credit losses it may face as a result of any individual or combined default among its participants with respect to any of their obligations to the FMI. These rules and procedures should address how potentially uncovered credit losses would be allocated, including the repayment of any funds an FMI may borrow from liquidity providers.

Footnote 61 to PFMI 3.4.25 states[4]:

> For instance, an FMI's rules and procedures might provide the possibility to allocate uncovered credit losses by writing down potentially unrealised gains by non-defaulting participants and the possibility of calling for additional contributions from participants based on the relative size and risk of their portfolios.

Importantly, if non-defaulting clearing members agree to assume some of the residual losses through the use of their variation margin, then as this could be beneficial from a financial stability perspective,

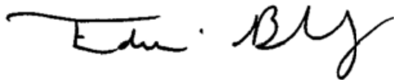
[3] Committee on Payment and Settlement Systems and Technical Committee of the International Organisation of Securities Commissions 'Principles for financial market infrastructures', April 2012, page 45.

[4] *Ibid.*

we urge EBA (and ESMA as the case may be) to ensure CCP capital requirements do not restrict arrangements available to absorb losses that exceed the resources in the waterfall.

We appreciate the opportunity to provide these comments. Should you require further information, please do not hesitate to contact the undersigned.

Yours sincerely,



Edwin Budding
Assistant Director, Risk and Research
ISDA