

Mr. Stefan Ingves
Chairman, Basel Committee on Banking Supervision

Mr. Mark Carney
Chairman, Financial Stability Board

Mr. Paul Tucker
Chairman, Committee on Payment and Settlement Systems

Mr. Greg Medcraft
Chairman, International Organization of Securities Commissions

Re: Basel Committee on Banking Supervision - Supervisory Framework for Measuring and Controlling Large Exposures

Dear Sirs:

The CCP-12 is a global association of 31 major central counterparty organizations in Europe, Asia and the Americas.¹ This letter focuses on Comment 14 from page 27 of the Basel Committee on Banking Supervision's ("Committee") Consultative Document entitled *Supervisory framework for measuring and controlling large exposures*, which states that "[t]he Committee welcomes views on the options for treatment of banks' exposures to CCPs."²

As a reaction to some of the lack of clarity in bilateral trades during the financial crisis and the relative success of central counterparties ("CCPs"), the G-20 countries committed to increasing the amount of standardized over-the-counter ("OTC") contracts cleared centrally. CCP12 is of unanimous view that introducing a hard limit for controlling bank exposures to Qualifying central counterparties ("QCCPs")³ would risk compromising these commitments.

While it has been argued that increasing the amount of clearing increases the systemic risk of CCPs, this fails to take into account the other new measures introduced by local regulators and international standard-setting bodies to reduce CCP risk. CCPs serve to reduce systemic risk and have always managed their risk to high standards. Such standards have been raised further over the past months, not least due to new regulations on own capital, on Default Fund sizes and on default management procedures, all designed to address large exposure risk. Failing to take into account the unique nature of CCP exposures and seeking to set hard limits for such exposures could result in significant unintended consequences including an increase in overall systemic risk, a frustration of the G-20 central clearing commitments and an increase in costs to end users.

I. CCPs reduce overall systemic risk

Central clearing promotes financial stability, in part by reducing net credit exposure across the financial system. Moreover, CCPs are less susceptible to "runs" than other counterparties.⁴ During the recent financial crisis, troubled

¹ CCP-12 was formed to share information, develop analyses and develop policy standards for common areas of concern. The CCP-12 members work toward the common purpose of creating conditions in which a global CCP solution can emerge to meet the needs of the marketplace. The member list of the CCP-12 is included in Annex 1 to this letter.

² Basel Comm. Banking Supervision, *Consultative Document: Supervisory Framework for Measuring and Controlling Large Exposures* [hereafter *Supervisory Framework*]27 (March 2013).

⁴ The Committee's interim rules on capital requirements for bank exposures to central counterparties state that *a qualifying central counterparty (QCCP) is an entity that is licensed to operate as a CCP (including a license granted by way of confirming an exemption), and is permitted by the appropriate regulator/overseer to operate as such with respect to the products offered. This is subject to the provision that the CCP is based and prudentially supervised in a jurisdiction where the relevant*

financial institutions such as Lehman Brothers experienced precipitous withdrawals of funding and a sudden unwillingness of their trading partners to continue trading with them. In contrast, CCPs did not face similar runs on their funding or unwillingness by market participants to clear with them. Once begun, such runs became self-perpetuating and contributed to the failures or near-failures of several large firms. CCPs face significantly lower risk of counterparty runs, primarily because, as discussed below, the failure of a single clearing member does not threaten a CCP's ability to meet its obligations.⁵ In addition, the transparency and potential for portability embedded in best practices for central clearing obviates the risk that exposure opacity or credit concerns would cause a similar event at a CCP.

A. *Background on the role of a clearing house*

A CCP is a clearing house that interposes itself between counterparties, becoming the buyer to every seller and vice versa. Through counterparty substitution, a CCP effectively guarantees performance of the financial instruments that it clears. CCPs operate in a wide variety of securities and derivatives markets, both exchange-traded and OTC.

From the perspective of a clearing member, central clearing has three principal advantages:⁶

- i. *Decreased exposure to counterparty credit risk.* By consolidating bilateral trades with many counterparties into a single counterparty, a CCP enables each clearing member to offset credit exposures across counterparties. Through multilateral netting, a clearing member can reduce its net exposure by more than ninety percent.⁷ CCPs also absorb and, if necessary, mutualize losses associated with counterparty default, substantially insulating clearing members from credit risk of other members. While each clearing member faces an even more concentrated exposure to the CCP itself, the structure and regulation of CCPs, described below, ensure low residual risk to clearing members. Central clearing is based on the premise that one concentrated exposure to a CCP entails less credit risk than many bilateral exposures to other financial firms.
- ii. *Increased capital efficiency.* By decreasing clearing members' exposure to counterparty credit risk, multilateral netting also reduces the amount of margin (i.e., collateral) necessary to cover the same number of open trades.
- iii. *Decreased monitoring costs.* Central clearing eliminates the need for clearing members to evaluate and monitor the creditworthiness of parties on the opposite side of cleared transactions. Instead, the clearing member faces the CCP.

B. *Risk Management Best Practices of QCCPs*

A CCP's effectiveness in reducing counterparty credit risk depends on the adequacy of its risk management practices and financial resources to withstand financial market stress. For example, clearing members must post initial margin, proportionate to their relationships with the CCP, to cover additional costs the

regulator/overseer has established, and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the CPSS-IOSCO Principles for Financial Market Infrastructures.

Basel Comm. Banking Supervision. *Capital Requirements for Bank Exposures to Central Counterparties* 1 (July 2012).

⁴ See, e.g., William C. Dudley, President and CEO, Federal Reserve Bank of New York, Remarks at the Harvard Law School's Symposium on Building the Financial System of the 21st Century, March 22, 2012, available

at <http://www.newyorkfed.org/newsevents/speeches/2012/dud120322.html>; Darrell Duffie, Ada Li & Theo Lubke, *Policy Perspectives on OTC Derivatives Market Infrastructure*, Fed. Res. Bank of New York Staff Rpt. 11–12 (March 2010), available at http://www.newyorkfed.org/research/staff_reports/sr424.html.

⁵ Another systemic benefit of central clearing is a reduction in default-induced fire sales of open derivative positions and collateral, which might otherwise disrupt markets.

⁶ These advantages equally apply to customers that clear trades indirectly through clearing members.

⁷ Douglas D. Evanoff, Daniela Russo & Robert S. Steigerwald, *Policymakers, Researchers, and Practitioners Discuss the Role of Central Counterparties in THE ROLE OF CENTRAL COUNTERPARTIES*, (ed. Fed. Res. Bank of Chicago & Euro. Cent. Bank 7 (July 2007), available at <http://www.ecb.int/pub/pdf/other/rolecentralcounterparties200707en.pdf>.

CCP might incur in replacing trades should they default.⁸ QCCPs also must mark their positions to market and collect/pay variation margin on at least a daily basis to eliminate debt from its markets. Clearing members of QCCPs must contribute proportionately to the CCP's guaranty fund, which is designed to mutualize extraordinary losses caused by defaults of other clearing members. Finally, QCCPs will generally rely on a combination of contributed capital, assessments and other resources should the risk waterfall described above prove to be inadequate to cure a clearing member default. Positions, variation margin, and initial margin posted by a non-defaulting clearing member to a QCCP is bankruptcy remote from the estate of an insolvent CCP and would rarely, if ever, be impacted by the default of a fellow clearing member.

C. Regulation of QCCPs

All QCCPs are subject to robust regulation in their home jurisdiction that at least meet the best practices set out in the Principles for Financial Market Infrastructures ("PFMIs") released in April 2012 by the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions ("CPSS-IOSCO"), including relevant financial resources, risk management, margin, governance, default and other standards.⁹ CPSS-IOSCO has further advised that compliance with the PFMIs should be determined by the CCP's home regulator in accordance with the PFI: Disclosure framework and Assessment methodology released in December 2012. Among other things, the PFMIs require CCPs to collateralize credit exposures to all clearing members fully with a high degree of confidence¹⁰ and, where applicable, conduct rigorous stress testing of initial margin levels, mark to market exposures through daily settlement cycles and maintain minimum guaranty fund levels. The minimum guaranty fund requirement for CCPs depends on the size and complexity of their clearing operations. Under the PFMIs, most CCPs will be required to maintain "additional financial resources sufficient to cover a wide range of potential stress scenarios involving extreme but plausible market conditions."¹¹ In addition, a CCP that is involved in activities with a more complex risk profile or that is systemically important in multiple jurisdictions will be required to maintain sufficient financial resources to absorb simultaneous defaults by its two largest clearing members in extreme but plausible market conditions (a "cover two" standard).¹² Relevant regulatory authorities in developed financial markets throughout the world are expected to incorporate the PFMIs in their legal and regulatory frameworks by year-end 2013.

II. Unintended consequences of applying large exposure limits to CCPs

A. Frustration of G-20 Commitments

Applying large exposures limits to CCP exposures is inconsistent with the spirit of the G-20 commitment to centrally clear standardized OTC contracts. By way of background, following the recent global financial crisis, the G-20 leaders made the following commitment at their meeting in September 2009 in Pittsburgh: "[a]ll standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end 2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements."¹³ The G-20 commitments represent a global decision to promote the benefits of central clearing.

This commitment was reaffirmed by the G-20 leaders at the June 2010 summit in Toronto, where they committed to "strengthen financial market infrastructure by accelerating the implementation of strong measures to improve transparency and regulatory oversight of hedge funds, credit rating agencies and over-the-counter

⁸Clearing members that serve as intermediaries between customers and a CCP collect initial and variation margin from customers, passing through customer funds to the CCP as appropriate.

⁹Comm. Payment and Settlement Systems & Technical Comm. Int'l. Org. Securities Comms.(CPSS-IOSCO), *Principles for Financial Market Infrastructures* [hereafter *CPSS-IOSCO Principles*] (April 2012), available at <http://www.bis.org/publ/cpss101a.pdf>.

¹⁰ For example, CCPs must calibrate initial margin requirements using a confidence interval of at least 99 percent. See *id.* at 43.

¹¹*Id.*

¹²See *id.* at 1.

¹³Fin. Stability Bd. Press Release, Financial Stability Board Releases Report on Improving OTC Derivatives Markets 2 (Oct. 25, 2010), available at http://www.financialstabilityboard.org/press/pr_101025.pdf.

derivatives in an internationally consistent and non-discriminatory way.”¹⁴ More recently, the FSB has affirmed that national authorities should, pursuant to this commitment, “incentivise greater use of central clearing.”¹⁵

The proposed large exposure framework could limit the potential benefits of central clearing by effectively forcing certain large counterparties to clear trades through multiple CCPs. As Federal Reserve Bank of New York President William C. Dudley recently stated, in an overly fragmented CCP system, “many of the risk-reducing benefits from CCPs could be lost or severely attenuated. That is because fewer offsetting positions would likely be cleared through any particular CCP and this would reduce the scope for reducing large gross exposures into much smaller net positions.”¹⁶

The use of a gross notional exposure calculation that does not account for the structure of CCP exposures could also frustrate G-20 commitments due to its lack of differentiation between customer positions and proprietary positions of a clearing member. Including customer positions in the exposure calculation may result in clearing members only having capacity to clear their own proprietary activity and not client activity. The lack of bandwidth for client clearing could deny clients access to a central clearing facility based on an exposure methodology that is inappropriate for the calculation of CCP exposures. In addition to the calculation issues, increased costs due to liquidity fragmentation (as described in more detail below), could further limit the ability of clearing members to provide clearing services to all clients. In conjunction, the above issues could materially impinge on the ability of jurisdictions to comply with their G-20 central clearing commitments.

B. Increased costs due to liquidity fragmentation

Duffie and Zhu note that each counterparty has a higher expected counterparty exposure in an environment with multiple CCPs rather than one with a single CCP.¹⁷ An overly fragmented CCP system also entails higher operational costs and risks, since it could force some institutions to acquire memberships in additional CCPs (including foreign CCPs) and thereby incur higher costs from, among other things, additional guaranty fund contributions and decreased margin efficiencies. Too much fragmentation could also prevent market participants from employing their capital in an efficient manner due to the lack of margin offsets between correlated products at the same CCP and higher capital charges that may apply to multiple guaranty fund deposits and non-QCCP exposures. The increased costs could prevent clearing members from either joining additional CCPs or providing client clearing services at those CCPs. In short, inclusion of CCP exposures in the large exposures limit would significantly influence the shape of the CCP industry, but in a rather haphazard way—effectively short-circuiting a more fulsome consideration of the costs and benefits of CCP consolidation. We do not believe the large exposures limit presents the proper vehicle to determine the optimal level of consolidation in the CCP industry.

C. Reduction in available liquidity to CCPs

The large exposures framework proposes the credit conversion factor be set to 100% for secured credit facilities to assume the counterparty would draw on any funds available to it in order to prolong its existence as a going concern.

PFMI 7, *Liquidity risk* states that

*“[a]n FMI should effectively measure, monitor, and manage its liquidity risk. An FMI should maintain sufficient liquid resources in all relevant currencies to effect same-day and, where appropriate, intraday and multiday settlement of payment obligations with a high degree of confidence under a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would generate the largest aggregate liquidity obligation for the FMI in extreme but plausible market conditions.”*¹⁸

¹⁴ See White House Press Release, The G-20 Toronto Summit Declaration ¶ 19 (June 27, 2010), available at <http://www.whitehouse.gov/the-press-office/g-20-toronto-summit-declaration>.

¹⁵ Fin. Stability Bd., *Implementing OTC Derivatives Market Reforms* (Oct. 25, 2010), available at http://www.financialstabilityboard.org/publications/r_101025.pdf.

¹⁶ See Dudley, *supra* note 3; see also Darrell Duffie & Haoxiang Zhu, *Does a Central Clearing Counterparty Reduce Counterparty Risk?*, 1(1) REV. ASSET PRICING STUDIES 75 (2011) (“...counterparty risk is always reduced by merging the clearing activities of multiple CCPs into a single CCP”), available at <http://raps.oxfordjournals.org/content/1/1/74.full.pdf+html>.

¹⁷ Duffie & Zhu, *supra* note 22 at 89.

Liquid resources are defined as cash at the central bank of issue and at creditworthy commercial banks, committed lines of credit, committed foreign exchange swaps, and committed repos, as well as highly marketable collateral held in custody and investments that are readily available and convertible into cash with prearranged and highly reliable funding arrangements, even in extreme but plausible market conditions. *Limits on exposures to CCPs could also result in clearing members no longer providing liquidity resources to CCPs such as commitment to secured credit facilities.* CCPs that employ committed liquidity facilities do so for use in the event of a clearing member default, not in the event potential default of the CCP. Additionally, draws on the facilities are typically secured by overcollateralization and the bank participants are entitled to the collateral in the event the CCP does not repay the borrowings.

D. Proposed framework disregards CCP operations and safeguards

(i) Including exposures to CCPs in the framework may result in several other unintended consequences. The Committee proposes to quantify banking book and trading book OTC derivatives exposures using CEM or its successor. CEM is an inappropriate measuring exposure as it is based on notionals. Initial estimates are that under CEM, many counterparties would already have exposures to some CCPs that were in excess of 25% of capital, even before clearing is mandated. If the CEM successor is used to monitor exposures, it must be a risk-sensitive measure. Simply increasing the amount of exposure netting allowed within a portfolio is unlikely to be sufficient.

PFMI 4, *Credit risk* requires CCPs to mitigate the credit risk or debt in the market by collecting or paying variation margin on at least a daily basis based on the mark-to-market value of the positions they clear. The payment and collection of variation margin resets the value of the open positions to zero and the exposure of clearing members and CCPs to each other is equal to the “difference between the current (that is, at the moment) value of open positions and the value of the positions when the CCP last marked them to market for the purposes of collection variation margin.”¹⁹ The combination of initial margin collected by a CCP²⁰ and the variation margin that is paid and collected on at least a daily basis results in exposures that are significantly lower than the outstanding notional value of the contracts cleared. Additionally, CCPs are required by PFMI 4 to perform stress testing to cover potential future exposures and have sufficiency in their financial resources in the event of default(s) in extreme but plausible market conditions. Under PFMI 6, *Margin*, CCPs must have the authority to collect and pay margin on an intraday basis, scheduled and unscheduled, which further reduces the exposure between the CCP and its clearing members. The worst case scenario should be to calculate CCP exposures based on the change in market value from the last payment or collection of variation margin since that would be the only current exposure between a clearing member and a CCP.

(ii) Additionally, the large exposures framework proposes that physical collateral should generally not be permitted to reduce exposure values for large exposures purposes because eligible collateral can mitigate the risk posed by the sudden failure of a counterparty only if it is immediately available and liquid, a condition that physical collateral is unlikely to fulfill. Collateral posted to meet initial margin requirements at a CCP is one of the fundamental tools employed to mitigate risk in the event of default by the clearing member. Physical collateral accepted pursuant to appropriate haircut and limit policies can allow for more diversity in the types of collateral posted by market participants. This diversity can be especially important in an environment where significantly more instruments will be subject to a central clearing requirement. Historically, the acceptance of physical collateral has not impacted the ability of CCPs to effectively manage a clearing member default. Further, such physical collateral may be pledged against credit facilities that can provide immediate liquidity as needed. As such, we do not agree with the view that physical collateral should not be available to mitigate credit risk to a CCP.

¹⁹See Principle 4, Art. 3.4.13, *CPSS-IOSCO Principles* at 41.

²⁰ Principle 6 requires QCCP initial margin models to “use a conservative estimate of the time horizons for the effective hedging or close out of the particular types of products cleared by the CCP (including in stressed conditions....” See Principle 6, *CPSS-IOSCO Principles* at 50.

III. Dissimilarity of CCP exposure to single exposure

Exposures to CCPs should not be treated as a single exposure because they are diversified by their nature due to the loss-mutualization effects of the financial safeguards waterfalls utilized by CCPs. In contrast to other exposures, the natural buffer that the waterfall provides before potentially impacting a CCP's capital in times of market stress diversifies the risk of a CCP default by placing third-party resources in front of those of the CCP where there is a clearing member default.²¹ By design, a CCP insulates each clearing member and clearing member customer from the risks associated with default of an individual counterparty. As noted by the Committee, "CCPs mitigate counterparty credit risk because the impact of the failure of a major counterparty is absorbed by the CCP's default protection schemes."²² Similarly, the U.K. Financial Services Authority has observed that a CCP acts as a "circuit breaker to systemic risk on a major participant's failure."²³ As noted above, non-defaulting clearing members' positions and margins, and those of their customers, are insulated from the default of other clearing members and clearing member customers and in no event would be used to cure such a default. By clearing through a CCP, a bank effectively diversifies its credit risk exposure to its indirect counterparties (i.e., the clearing members taking or guaranteeing the other side of its trades). Several of the largest clearing members would have to fail at or around the same time for a non-defaulting member potentially to suffer losses beyond its guaranty fund contribution. By treating CCP trade exposures as credit exposures to "a single counterparty" the large exposures framework overlooks these structural aspects of CCPs— aspects which are fundamental to the way CCPs mitigate counterparty credit risk and systemic risk.

IV. The PFMI's address concentration risk

The risk of large exposures or concentrations is properly addressed in the PFMI's rather than through strict limitations imposed as if CCP exposures are similar to those of other financial institutions. The PFMI's address potential concentration risks at CCPs in numerous different ways. For example, PFMI 3, *Framework for the comprehensive management of risks* requires CCPs to consider concentration risks as part of their comprehensive risk management framework. PFMI 4, *Credit risk* requires regular testing of the sufficiency of a CCP's financial resources and regular comprehensive analyses of "stress testing scenarios, models, and underlying parameters and assumptions."²⁴ These analyses must be performed more often where "the concentration of positions held by a CCP's participants increases significantly."²⁵ In addition, PFMI 5, *Collateral* requires CCPs to avoid "concentrated holdings of certain assets where this would significantly impair the ability to liquidate such assets quickly without significant adverse price effects."²⁶ It is suggested that such risks can be avoided by imposing concentration limits or concentration charges which must be periodically reviewed by the CCP. Limits impose ceilings on the ability of a participant to provide certain types of collateral assets while charges penalize participants for holding assets beyond a certain threshold level with a CCP. PFMI 6, *Collateral* also requires CCPs to consider the potential risk of position concentrations when determining the appropriate close out period in the initial margin models.²⁷ CCPs must also monitor and manage their concentration of credit and liquidity exposures to commercial settlement banks pursuant to PFMI 9, *Money settlements*.²⁸

All QCCPs must comply with the above-referenced PFMI's²⁹ on concentration or large exposure limits as well as any additional requirements on concentration or large exposures applied by their home regulators.³⁰ We believe that requirements imposed on QCCPs related to large exposures are comprehensive and properly tailored to the structure and business of CCPs. Since QCCPs are already subject to a myriad of regulations designed to deal with large exposure risk

²¹ Depending on the structure of a CCP's rulebook, it may or may not be required to make additional contributions to the resolution of a default.

²² Basel Comm. Banking Supervision, *Consultative Document: Capitalisation of Bank Exposures to Central Counterparties*, ¶ 9 (Nov. 25, 2011), available at <http://www.bis.org/publ/bcbs206.htm>.

²³ Fin. Servs. Auth. & HM Treasury, *Reforming OTC Derivative Markets: A UK Perspective*, ¶ 6.8 (Dec. 2009), available at http://www.fsa.gov.uk/pubs/other/reform_otc_derivatives.pdf.

²⁴ CPSS-IOSCO Principles, *supra* note 9 at 67.

²⁵ *Id.* at 56.

²⁶ *Id.* at 48.

²⁷ See *id.* at 53.

²⁸ See *id.* at 67.

²⁹ CCPs must also address concentration or large exposure risks in their investment of participant assets (where relevant) under the PFMI's.

³⁰ The PFMI's provide guidance on best practices in CCP regulations but do not prevent home regulators from imposing additional obligations on their local CCPs.

without potentially limiting the access of clearing members and their clients to central clearing, we do not believe that the blunt implementation of regulations designed for banks against uniquely structured CCPs is advisable.

Conclusion

QCCPs play a unique, risk mitigating, role in the financial system. They provide significant netting benefits, diversify and mitigate the exposures of their clearing members through their risk waterfalls and are subject to significant regulatory oversight. The importance of CCPs was demonstrated during the financial crisis by their resiliency in the face of significant turbulence in the global financial system. The resiliency of the CCP model led the G-20 to conclude that the expansion of central clearing to standardized OTC products would be beneficial to the marketplace.

The Committee's goal in developing a large exposures framework was to "contribute to the stability of the financial system."³¹ Unfortunately, the application of a framework designed for standardized single counterparties to entities with the unique, diversified exposure characteristics of CCPs undermines the stability sought by the Committee by increasing participant costs, fragmenting liquidity and potentially limiting access to central clearing. These factors, along with the risk that the application of large exposure limits to QCCPs could frustrate the goals of the G-20, clearly argue against the application of large exposure limits to QCCPs. Thus, we strongly advise the Committee against the application of a Pillar 1 hard limit to QCCPs.

Sincerely,

Siddhartha Roy
Chairman, CCP-12

Attachment: Annex 1 – List of CCP-12 Member Organizations

³¹See *Supervisory Framework*, *supra* note 2 at 2.