European Securities and Markets Authority

Date: 8 August 2012
ESMA/2012/516 Annex 1

ESMA CONTRIBUTION TO THE EBA'S DRAFT REGULATORY TECHNICAL STANDARDS ON CAPITAL REQUIREMENTS FOR CCPs

General comments

1. ESMA considers that it is particularly important to set the minimum capital requirements at an appropriate level to ensure that CCPs are safe and sound. Furthermore the level is important in view of the link with the draft RTS developed by ESMA on the default waterfall, where we are considering that the dedicated CCPs' own resources to be used in the default waterfall before the mutualised resources of the non-defaulting clearing members (so called "skin in the game") should be calculated as 50% of the minimum capital requirements.

2. ESMA notes that the general approach of the draft RTS on capital requirements starts from the fact that CCPs are exposed to the same kind of risks as credit institutions and therefore a similar approach as the one applied to the credit institutions should also apply to CCPs.

3. As you know, CCPs perform different activities and are exposed to different risks than banks. This is mainly due to the functions that CCPs perform, to the resources they use to cover the risks they are exposed to and to the strict limitations on the activity that CCPs can provide.

4. Our common objective is to ensure that CCPs are safe and sound. We are working closely together to achieve this objective. Therefore, we strongly support well capitalised CCPs. We should also recognise however that the minimum capital requirements for CCPs are only the very last line of defence for a CCP and they should not be treated as the main risk mitigation tool. We have to take into account, as stated in the introduction of the consultation paper, the fact that CCPs hold zero net financial exposures in their usual activity, that they rely on margin and default funds to cover their potential exposures and that, probably most importantly, EMIR only admits highly liquid resources to count as minimum capital requirements whereas under the CRD different resources are counted to meet the minimum capital requirements. These differences are key, in our view, for establishing a regime that does not build directly on the banking approach, since otherwise the result in terms of effective capital requirements would not be adapted to the specific risks that CCPs face and the requirements that they are subject to under EMIR.

5. We believe that the presumption that CCPs are exposed to similar risks as banks may have influenced the overall framework for the definition of minimum capital requirements for CCPs. Although we understand that from a legal perspective the wording of EMIR implies that the minimum capital requirements are calculated as the sum of the different components of risks faced by a CCP and not covered by specific financial resources, we believe that, as it is currently structured, the approach taken does not rightly distinguish the different risk components. This could lead to a risk of double counting and international inconsistency, with consequent serious effects for EU and also non-EU CCPs.

6. In particular, we believe that in line with CPSS-IOSCO Principles for Financial Market Infrastructures (FMIs), the general business risk faced by CCPs should be covered by the resources needed for the orderly winding-down or restructuring of the CCP activities. Therefore, in line with the assumption

that legal risk is part of operational risks as it is the case under capital requirements for banks, we believe that business risk should not be double counted.

7. Although recognising that capital requirements are a minimum and that competent authorities have the duty to ensure that capital is sufficient at all times, we think that including a specific concept through article 9 for additional capital requirements builds on risks that are already included in the requirements included in the previous articles of the draft technical standards. We think this provision could be eliminated without affecting the final effect of the rule.

8. As you know, the CPSS-IOSCO Principles for FMIs explicitly mention capital requirements under Principle 15 for general business risk and set them at a level equal to six months of current operational expenses. We noticed that the draft RTS by EBA set the capital requirements for orderly winding-down or restructuring at 12 months of the on-going annual gross expenses and we have not found a clear justification for such a significant departure from international adopted principles.

9. We believe that although the "sum approach" is a significant departure from the internationally adopted principles, it could be justified and considered compatible with CPSS-IOSCO if differently structured (see proposal below). However, the requirement according to which the operational expenses to calculate an orderly winding down should be equal to 12 months instead of 6 months, as prescribed by CPSS-IOSCO, might result in a disproportionate overall minimum capital requirement and would create a serious issue in terms of international consistency. If implemented, it could also potentially hamper the recognition process of non-EU CCPs under EMIR.

10. We understand that the CFTC is also proposing 12 months operational expenses as the minimum capital requirement. However, according to CFTC rules[1] only 6 months of operational expenses should be held in liquid assets. Up to 6 months of the 12 months operating costs can be covered with a committed line of credit or similar facility. As you know, under EMIR only liquid assets will count as capital to fulfil the minimum capital requirements.

11. In addition, for the CFTC, the 12 months operational expenses is the only capital requirement applicable to CCPs, whereas under the EBA approach this is only one component. Therefore, given that such component covers business risk as defined by CPSS-IOSCO and calculated in a similar manner, we suggest avoiding departing from the international standard. Otherwise, the requirements for European CCPs will always be significantly higher than the ones in the US and other countries.

12. To summarise, on the general approach for the minimum capital requirements, we believe that the following three components could be considered and added-up:

    1) the capital requirement to cover business risk, which would ensure that the CCP has at all times sufficient resources to withstand an orderly winding-down or restructuring of its activity over an appropriate time span. This component of the capital requirements should be calculated as six months of the operational expenses;
    2) the capital requirements to cover operational risks, as currently structured;
    3) the capital requirements for non-covered activities, as currently structured, but with the clarifications included below.

[1] see section § 39.11 Financial resources of the DCO Core Principles available at: http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-27536a.pdf

13. Although the components reported under points 2) and 3) above are not explicitly mentioned in the CPSS-IOSCO Principles and would already imply a departure from these international standards, those components can be justified by the fact that CPSS-IOSCO Principles require CCPs to maintain adequate resources to withstand all the risks CCPs can face (including operational risks and risks not covered by specific financial resources) without specifying the form that these resources should take. It could, therefore, be argued that the appropriate resources to cover the risks under points 2) and 3) should be in the form of minimum capital requirements.

14. In addition to the comments above on the general approach to the minimum capital requirements, we have some concerns on the level of the notification threshold. Although we agree with the principle of a notification threshold, we believe that 125% is very high level for such purpose. Although we understand that the purpose of it is not to impose an additional 25% capital requirement, we believe that if the threshold is too high many CCPs will stay in a range of capital between 100% and 125% and the notification threshold might lose its purpose. We, therefore, suggest to set the notification threshold at a lower level, like 105%, for it to be an effective tool.

15. Finally, the capital requirements for non-covered activities implies that CCPs can perform activities such as margin lending transactions and investing in derivatives which are not allowed under EMIR and the draft technical standards developed by ESMA. Please refer to the following section for specific comments on the points we raised.

Specific comments

16. In the background and rationale section of the EBA consultation paper (page 6) it is reported that under Article 41 and 44 "no additional capital requirement is required to mitigate the CCP's credit exposure or market risk of the collateral collected". We want to raise to your attention that EMIR and the draft technical standards developed by ESMA consider that credit and market risk associated with the collateral collected should be covered with adequate haircuts. We therefore believe that it would not be appropriate to require, on top of that, capital requirements for that purpose.

17. Recitals 4, 6 and 7 give the impression that CCPs are exposed to the same risks as banks or that they perform similar activities. As for recital 4, we believe that there is no link between the clearing obligation and the fact that CCPs should be subject to similar capital requirements as banks. As for recital 6, we see first a weak justification to apply the operational risk framework of the CRR (the reference is simply to an appropriate framework); second, the financial instruments cleared by CCPs are not necessarily the same as those used by credit institutions or investment firms, but possibly only a subset of them. In addition, the operational risks faced by CCPs in clearing certain financial instruments are of a completely different nature than the ones faced by credit institutions or investment firms in trading and possibly clearing the same financial instruments. Recital 7, again, states that similar risks are faced by credit institutions or investment firms and CCPs on the non-covered activities, justifying a similar treatment.

18. It should be noted that, contrary to credit institutions and investment firms, CCPs are subject to strict limits on the financial instruments in which they can invest and strict requirements on the highly secure arrangements for depositing financial instruments and maintaining cash. A risk based approach as the one proposed in the standards should be, therefore, expected to consider the lower risks that CCPs non-covered activities should entail compared to banks activities. These should be recognised and it could be stressed that the residual risks arising from the investment policy are of

similar nature as those faced by credit institutions or investment firms, so a similar calculation method could be justified. As mentioned above, it should also be noted, however, that the minimum capital requirements for CCPs only include the liquid financial resources invested in accordance with the investment policy standard, whereas for banks and investment firms the capital is counted irrespectively of how it is invested. This significant difference should also be taken into account when applying or adapting the banking framework.

19. Recital 8 and 9 do not provide justifications for setting the notification threshold 25% higher than the capital requirements or the operational expenses equal to 12 months, apart from the fact that it is desirable or that it is a conservative measure. As explained above, we believe that these requirements might be too high and in the absence of a strong justification for them we would suggest a revision and redrafting of the relevant recitals.

20. In Recital 10 and in Article 5(2) a reference is made to "the competent authority in line with Article 22 of EMIR", you might want to change the reference to "the competent authority designated in accordance with Article 22 of EMIR" or to "the CCP competent authority". The reference to "in line" would imply the reports (Recital 10) or the capital plan (Article 5(2)) are established under Article 22 of EMIR.

21. Recital 12 makes a reference to Pillar 2 of the CRD and to the need for competent authorities to apply additional capital requirements. For the reasons explained above, we believe that Article 9 of the draft RTS should be deleted and that Pillar 2 requirements are not compatible with a Regulation that ensures maximum harmonisation among CCPs from different Member States.

22. Article 1 states that the rules relating to capital requirements are for non-covered activities or operational risk. In line with our general comment, we believe that the reference should be to: business risk, operational risk and risk arising from non-covered activities. Otherwise the draft RTS would give the impression that different methods are used to cover the same risks, whereas the "sum" approach should imply that different risks requires different computations.

23. In line with our general comment, we are of the view that Article 3 should be redrafted and Article 9 could be deleted.

24. In Article 6(2) the last sentence refers to the additional costs that the CCP may incur in case of winding-down or restructuring. We believe that this makes the provision circular, given that the operational expenses are used to calculate the necessary resources to cover the orderly winding-down or restructuring of the CCP activities.

25. The explanatory part of Article 8 refers to "the prudential framework for banks but to take into account the concentration risk stemming from derivatives that the CCPs are exposed to". This explanation could be clarified. In addition, as you know, EMIR requires that CCPs can invest only on highly liquid financial instruments with minimum market and credit risks and the relevant draft RTS developed by ESMA allow the investment in derivatives only for default management purposes. This means that in the course of the general business CCPs are never exposed to derivatives, as the derivatives they clear are net by definition. Therefore, the only case in which a CCP can be exposed to derivatives is when it needs to liquidate them following a default and for that reason ESMA considered to authorise their use in such circumstance.

26. Against this background, we consider that the references in Article 8(5) to the mark-to-market method for derivatives transactions should be deleted as it would imply that the CCP can be exposed to derivatives, which is not the case. Article 8 paragraphs 2 and 5 make also references to margin lending transactions. These would imply that the CCP can extend credit in connection to a transaction which is not the case and the draft RTS should not give the impression that such activity is allowed. Article 8(5) also makes reference to "commodities lending" and "long settlement transactions". Given that according to EMIR, a CCP is not supposed to invest its resources in commodities and CCPs investments need to be liquidated rapidly, we believe that those transactions are incompatible with the operational possibilities allowed in EMIR. In case the reason for the inclusion of these references was due to the clearing activity of the CCP in commodity or other transactions, given that this would be covered by specific financial resources, it would not fall within the scope of the draft RTS.