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Re: Consultation Paper on Draft Regulatory Technical Standards on Capital Requirements for CCPs (EBA/CP/2012/08)

Dear Sir/Madam,

UBS would like to thank EBA for the opportunity to comment on the Consultation Paper on Draft Regulatory Technical Standards on Capital Requirements for CCPs. Please find attached our response to the paper.

We would be happy to discuss with you, in further detail, any comments you may have. Please do not hesitate to contact Gabriele Holstein on +41 44 234 4486.

Yours sincerely,
UBS AG

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UBS Response to the EBA Consultation paper on
Draft Regulatory Technical Standards on Capital Requirements for CCPs

INTRODUCTION

UBS would like to thank EBA for the opportunity to comment on the consultation paper. Please find below our response to the overall content, as well as the specific questions set out in the Paper.

We consider that sufficient flexibility should be allowed for a market solution to be found in circumstances where the losses incurred following a clearing member's default are greater than the resources available in the default waterfall. Such a solution could potentially involve non-defaulting clearing members making additional contributions to cover any residual losses, including via the use of variation margin, and we do not believe the EBA should seek to place restrictions on such an approach.

We consider it important that additional clarity is provided by the EBA as to the interaction of i) the minimum capital requirement set out in Article 3, ii) the potential additional capital requirement imposed by a competent authority and iii) the notification threshold set out in Article 4.

With regard to the appropriate methodology for a CCP to calculate its market, credit and counterparty credit risk capital requirements, we question whether CCPs would typically be equipped to model these risks in a robust manner at present. However, we are of the view that CCPs could develop the necessary expertise and infrastructure over time. Consequently, we do not consider that the technical standards should preclude the use of advanced modelling approaches but stress that use of internal models should be subject to the achievement of robust modelling standards and competent authority approval.

CAPITAL REQUIREMENTS FOR CCPS

EMIR Article 16, 1. states that a CCP shall have a permanent and available initial capital of at least EUR 7,5 million to be authorised pursuant to Article 14. EMIR Article 16, 2. states that capital, including retained earnings and reserves, of a CCP shall be proportional to the risk stemming from the activities of the CCP. It shall at all times be sufficient to ensure an orderly winding-down or restructuring of the activities over an appropriate time span and that the CCP is adequately protected against credit, counterparty, market, operational, legal and business risks which are not already covered by specific financial resources as referred to in Articles 41 to 44.

EBA considers that, in order to ensure that the capital will be available when needed, a CCP has to hold the sum of the resources necessary to cover each of the risks that have been identified in EMIR Article 16, 2.

Q1: Do you support this approach to capital requirements?

Losses exceeding the default waterfall financial resources

EMIR Article 45 sets out the default waterfall which determines how losses resulting from the default of a clearing member will allocated between a CCP and its clearing members. However, EMIR, the RTS proposed by EBA and the 'Draft technical standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories' currently being consulted on by ESMA do not address the allocation of losses, or process to be followed, in a scenario where the losses resulting from the default of a clearing member exceed the amount of financial resources available within the default waterfall.

In such a scenario we expect that there would be several options available, broadly including i) the CCP absorbing the residual losses using any excess capital it may have, ii) the CCP being recapitalised by its owners, iii) the losses being absorbed by additional contributions from the non-defaulting clearing members and iv) the CCP being wound-up. We would expect the specific approach to be followed in any given case to be the result of a dialogue and potentially a joint decision between the CCP and its clearing members. In this context, we note that on page 6 of the CP, it is stated that "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 question whether this statement is appropriate, given that, should the non-defaulting clearing members agree to assume at least some of the residual losses, one means of achieving this would be through the use of variation margin. Given that this could be beneficial from a financial stability perspective, we consider that more analysis should be undertaken by EBA and ESMA before any requirements are introduced that could restrict the flexibility available to absorb losses that exceed the resources in the waterfall.

Accounting for wind-down and restructuring costs

We note that RTS Article 6, 2. includes a requirement that "The CCP shall also include additional costs that may occur in the case of winding-down or restructuring its activities".

We support this requirement as the litigation risk faced by a CCP when going through a wind-down or restructuring is likely to be significantly higher when compared to legal risks as part of day-to-day operations. In addition, during a wind-down, there will be additional costs relating to issues such as decommissioning of systems, termination of contracts and professional fees required to execute the winding down. Therefore, the capital framework should recognise this difference and ensure appropriate amounts of capital are in place.

Q2. Do you have any other option to suggest that is not covered in this draft RTS?

Please see our response to Q3.

Q3. Do you consider there to be any alternative approach which is more appropriate that would be consistent with Article 16 of the Regulation?

We note that clearing houses are not deposit taking or lending institutions and their financial risk is more akin to a corporate than a bank. The margining requirements are intended to mitigate the risk from financial operations. The risk to the corporate entity is more cash flow than capital related. The focus should hence be on EBITDA and liquidity rather than capital reserves.

Therefore, whilst not within scope of this paper, we emphasise that we consider CCP liquidity to be 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.

Q4. What is the incremental cost to your CCP for the implementation of this proposal?

It is up to CCPs to advise on the incremental costs of implementation.

Q5. What is the incremental benefit to your CCP for the implementation of this proposal?

It is up to CCPs to advise on the incremental benefits of implementation.

Q6. What is the incremental cost for the supervisors for the implementation of this proposal?

We have no comments to provide.

Q7. What is the incremental benefit for the supervisors for the implementation of this proposal?

We have no comments to provide.

NOTIFICATION THRESHOLD

According to EBA in the event that the amount of capital held by a CCP turns out to be lower than the threshold of 125% of the capital requirements ('notification threshold') set in Article 3, the CCP shall immediately notify the relevant competent authority. Notification shall be made in writing and shall contain the following elements: (i) the reasons for the CCP's capital being below the notification threshold and a description of the short-term perspective of the CCP's financial situation and (ii) a comprehensive description of measures the CCP intends to adopt to ensure ongoing compliance with the capital requirements.

On the basis of the information provided, the competent authority shall decide whether to set a more stringent frequency for the CCP's reporting on its capital position with respect to the notification threshold.

Q8. What is your view on the notification threshold? At which level should it be set?

We agree with the suggested 125% notification threshold.

Q9. In your view, in which case should restriction measures be taken by the competent authority once the notification threshold is breached?

We interpret the Article 4, 2.(b) requirement that the notification shall include "a comprehensive description of the measures the CCP intends to adopt to ensure the on-going compliance with the capital requirements" to relate to the CCP's approach to complying with the minimum capital requirement (i.e. 100% of the requirement calculated under Article 3, 1.) rather than a requirement to recapitalize back to the 125% notification threshold. We believe this should be made explicit, as were this not the case, the 125% notification threshold would become the de-facto minimum capital requirement.

In addition, we note that page 5 of the CP 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 compentent authority imposed requirement? We consider that it should be the former.

CCP WIND-DOWN OR RESTRUCTURING

Q10. Which criteria do you take into account for estimating the appropriate time span for orderly winding down or restructuring of the CCPs activities?

We have no comments to provide.

Q11. What is your estimation for the number of months necessary to ensure an orderly winding-down or restructuring of the CCP's activities?

We have no comments to provide.

Q12. What is the incremental cost or benefit to your CCP of this proposal assuming that the time span for winding down or restructuring a CCP's activities is 12 months?

We have no comments to provide.

CAPITAL REQUIREMENTS FOR OPERATIONAL RISK

EBA identifies the following three potential approaches for operational risk measurement for banks under CRD and considers whether they should be available for CCPs:

Basic Indicator Approach ("BIA"): EBA considers the BIA a valid starting point for the calculation of the capital requirements to cover operational risk, but considers that the BIA may understate the real risks for CCPs with low revenues.

Standardized Approach: EBA considers that the Standardised Approach provided in the CRD framework for banks is not appropriate for CCPs since the business lines of this approach are not adapted to the activities carried out by CCPs.

Advanced Measurement Approach ("AMA"): EBA states that CCPs should be allowed, subject to the same strict organisational and quantitative standards as for banks and to the permission of the competent authority, to use the AMA in order 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 BIA.

Q13. How do you currently measure and capitalise for operational risk?

It is up to CCPs to advise how they currently measure and capitalise for operational risk.

Q14. Do you think that the banking framework is the most appropriate method for calculating a CCPs capital requirements for operational risk? If not, which approach would be more suitable for a CCP?

We reiterate our view provided in our response to the EBA DP that it is important that CCPs are adequately capitalised and have appropriate risk management arrangements given their vital importance in the market and the potentially systemic impact of CCP failure. CCPs should be encouraged to migrate towards more advanced approaches to operational risk management and calculation of operational risk capital requirements to optimise the protection of all market participants and the system as a whole.

Q15. Do you think that the Basic Indicator Approach set out for banks is appropriate for CCPs?

We agree with the view taken by EBA. The proposed Basic Indicator Approach ("BIA") seems to provide a practical starting point, but it is difficult to comment on whether the factors comprising the "relevant indicator" represent an appropriate proxy for a CCP's risks and whether the approach shares the limitations recognised in the BIA more generally.

Given that BIA was not originally intended for large, internationally active institutions, it may be questioned as to whether it is appropriate for systemically important institutions such as CCPs.

Q16. In your view, which alternative indicator should the EBA consider for the Basic Indicator Approach?

We refer to our response in Q15.

Q17. What would be the incremental cost of employing the basic indicator approach set out for banks for the calculation of your capital requirements for operational risk?

It is up to CCPs to advise on the incremental costs.

Q18. 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?

Referring to our earlier comments, given the systemic nature of CCPs, it would be prudent to encourage CCPs to migrate towards a more advanced approach to risk management and regulatory capital. The AMA approach is appropriate given that the internal model can be tailored to the nature and scale of the activities performed and the risk profile. We support the requirement that use of the AMA should be subject to the same strict organizational and quantitative standards as for banks and be subject to the permission of the competent authority. The use of an internal model is likely to encourage and incentivise management to focus on better management of operational risk within the CCP.

Q19. Which other approaches should the EBA consider for operational risk measurement?

Should a CCP adopt the AMA, it is our view that this should include stress testing of tail risk events and wind-down scenario planning.

Q20. What are the incremental costs and benefits to your CCP for the implementation of the advanced measurement approach for operational risk?

It is up to CCPs to advise on their incremental costs and benefits.

CAPITAL REQUIREMENTS FOR CREDIT, COUNTERPARTY CREDIT AND MARKET RISKS STEMMING FROM NON-COVERED ACTIVITIES

"Non-covered activities" carried out by a CCP means all activities which are not covered by the specific financial resources as set out in Article 41 to 44 of EMIR.

EBA considers that risk exposures stemming from non-covered activities should be calculated using approaches set out for banks by the CRR. As investment activities expose the CCPs to the same kind of credit risks typically faced by credit institutions, it is considered appropriate to refer to the prudential framework for banks taking into account the concentration of risks stemming from derivatives that CCPs are exposed to. For *credit risk*, it is the EBA's view that the CCPs should calculate its risk-weighted assets according to the Standardised Approach for credit risk. According to such method, the exposure value of an asset (i.e. its risk weighted value) is equal to the product of its accounting value and the specific risk weight associated. The risk weights range from 0% for to 150%. Capital requirements for credit risks would be equal to the 8% of the risk-weighted assets. EBA also considers that *market risk* should be calculated using the Standardised Approach for market risk set out for banks by CRD. According to such method, capital requirements for market risk are calculated using position risk adjustment factors applied to market values of the positions held by the CCP.

Q21. Do you think CCPs should be allowed to calculate the capital requirements for market, credit and counterparty credit risks with internal models?

We would reiterate our response provided to the EBA DP that, in the period immediately following EMIR's entry into force, CCPs are unlikely to have the credit and market risk modeling expertise and infrastructure to adopt more advanced approaches as they do not have a strong proprietary risk-taking history.

However, we accept that, over time, CCPs could develop this expertise and infrastructure, and we do not therefore consider that the EBA should preclude CCPs from using advanced modeling approaches for credit, counterparty and market risk. We believe CCPs could move towards the use of internal models by (i) buying more sophisticated tools off the shelf from credit rating agencies, (ii) building their own credit expertise, or (iii) relying on the credit expertise of clearing members. The use of internal rating models should not be permitted unless a clearing house could demonstrate that it meets minimum standards which should be subject to supervisory approval. We would emphasize that all credit models require qualitative input since models based on balance sheet numbers cannot capture for example, risk concentrations, or access to external support and liquidity.

Q22. How do CCPs currently measure and capitalise for credit, counterparty credit and market risk stemming from non-covered activities?

It is up to CCPs to advise how they currently measure and capitalise for credit, counterparty credit and market risk stemming from non-covered activities.

Q23. Do you think that the banking framework is the most appropriate method of calculating a CCPs capital requirements for credit, counterparty credit and market risk stemming from non-covered activities?

We believe that applying the banking framework is an acceptable approach**.**

Q24. What are the incremental costs or benefits to your CCP of this proposal assuming that for credit risk stemming from non-covered activities is computed with the approach required in Article 8?

It is up to CCPs to advise on their incremental costs or benefits.

Q25. What are the incremental costs or benefits to your CCP of this proposal assuming that for counterparty credit risk stemming from non-covered activities is computed with the approach required in Article 8?

It is up to CCPs to advise on their incremental costs or benefits.

Q26. What are the incremental costs or benefits to your CCP of this proposal assuming that for market risk stemming from non-covered activities is computed with the approach required in Article 8?

It is up to CCPs to advise on their incremental costs and benefits.

Q27. Do you think that CCPs, should be allowed to calculate their capital requirements for credit, counterparty credit and market risk using internal models?

Please see our response to Q21.

Q28. In your view, which other approaches should the EBA consider for credit, counterparty credit and market risk measurement?

We have no comments to provide.

Q29. What other risks should be considered in Article 9?

We have no comments to provide.