

EBA Discussion Paper: Draft Regulatory Technical Standards on the capital requirements for CCPs under the draft Regulation on OTC derivatives, CCPs and Trade Repositories (EBA / DP / 2012 / 1)

Response from ICE Clear Europe Ltd, 2 April 2012

This paper sets out ICE Clear Europe's response to the Discussion Paper entitled Draft Regulatory Technical Standards on the capital requirements for CCPs under the draft Regulation on OTC derivatives, CCPs and Trade Repositories (EBA / DP / 2012 / 1).

ICE Clear Europe is ICE's UK-based clearing house which was established in 2008 to provide clearing services for all exchange-traded and OTC derivatives contracts traded on the energy markets operated by ICE Futures Europe and ICE US OTC Commodity Markets, LLC. In July 2009, ICE Clear Europe launched clearing services for the OTC credit derivatives markets.

ICE Clear Europe is supervised in the UK by the Financial Services Authority ('FSA') as a UK Recognised Clearing House under Part XVIII of the Financial Services and Markets Act 2000; and is designated under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999. Further, ICE Clear Europe is recognised as an inter-bank payment system under the Banking Act 2009 and regulated by the Bank of England.

ICE Clear Europe seeks to enable the efficient development of new cleared markets to support the risk management needs of its global customers around-the-clock, with the capability to offer services to an expanded range of asset classes and other exchanges seeking clearing services. ICE Clear Europe guarantees contract performance by acting as an independent central counterparty to every derivatives contract traded on ICE Futures Europe and contracts on ICE OTC markets, including energy products and credit default swaps (CDS). This ensures the safety, security and market integrity that are vital to the exchange trading process. The availability of cleared OTC energy contracts reduces bilateral credit risk and provides significant capital efficiencies through the ability to cross-margin both futures and OTC positions. On a daily basis, ICE Clear Europe provides clearing services for contracts with a gross notional value of approximately \$40bn and holds \$11-12bn worth of cash and collateral as margin.

Our comments on the Discussion Paper are set out in two sections. Section 1 sets out our general comments to the Discussion Paper, and section 2 sets out our specific responses to questions posed in the Discussion Paper.

We will be happy to provide further details relating to our responses on request.

SECTION 1: General comments

1. EBA's preliminary view of capital requirements for CCPs

ICE notes that the EBA's preliminary view is that the capital of a CCP, including retained earnings and reserves, would be at all times at least equal to the higher of the following two amounts: (i) its operational expenses during an appropriate time span for winding-down or restructuring its activities, and (ii) the sum of the capital requirements for the overall operational risk and for credit, counterparty and market risks stemming from "non-clearing activities" it carries out.

ICE does not consider that the EBA's approach has been adequately justified. ICE believes that the current UK approach, whereby the holding of financial resources equal to six months' operating costs is ordinarily deemed sufficient capital for a central counterparty, is the correct approach to determining CCP capital requirements. We are not aware of any evidence of market failure in relation to the financial resources of a UK CCP since the introduction of this approach. The approach was considered, at the time of its introduction, as being conservative; we are unaware of any subsequent evidence to the contrary. This is also consistent with the approach considered in the CPSS-IOSCO draft principles for Financial Market Infrastructures (Principle 15) (the "CPSS-IOSCO principles").

ICE believes that using six months' operating costs as a proxy for operational and other risks has been proven to be effective and therefore it is appropriate for this to be retained.

2. Use of banking framework for CCP capital requirements

ICE does not agree that the banking framework is the most appropriate method for calculating a CCP's capital requirements for operational risk.

CCPs are capitalised differently from banks. Generally, CCPs have a number of protective measures in place, including variation margin, initial margin, a default fund and own capital. Frequently, CCPs will also have committed lines of credit and other measures in place which may be called upon as short-term liquidity injections.

Losses incurred by banks principally fall upon bond holders and unsecured creditors, whereas CCPs mutualise losses with clearing members through the default waterfall. In particular, it is not appropriate for operational risks of CCPs to be assessed on the basis of a proportion of annual revenue (which is the proposed approach under the standardised approach discussed in paragraph 22 of the Paper). CCP revenue arises primarily from fees to clearing members. CCP fees are automatically collected from clearing members as part of the clearing cycle, and in the event of non-performance of a clearing member, fees are deducted from the funds held by each clearing member at

the CCP. For these reasons, it is more appropriate for CCP capital requirements to be based on operational costs rather than revenues.

The approach used in the CPSS-IOSCO principles should, in ICE's view, be used as the framework for calculating a CCP's capital requirements. These principles are tailored to the specificities of market infrastructure organisations and are internationally relevant standards, which is critically important for the global business of clearing.

ICE therefore believes that while the proposed regulation of OTC derivatives, CCPs and trade repositories goes beyond the CPSS-IOSCO principles, any further amendments to the capital requirements for CCPs should be based upon the operational expenses model and ICE agrees with the approach set out in paragraph 11 of the Paper, based on a six-month calculation period.

Furthermore, as no proposals have been made in the US to use the banking framework for CCP capital requirements, this approach could place European CCPs at a competitive disadvantage.

3. Additional capital requirements for non-clearing activities

ICE does not agree with specific additional capital charges for credit/market risk in connection with non-clearing activity, particularly in relation to investment activity. It is not clear that there is any such risk in excess of the current UK requirement to hold financial resources equal to 6 months' operational costs. CCPs generally manage the risks of their investment activities through a highly conservative investment policy, which will be the subject of rigorous guidelines set out in CPSS-IOSCO principles and in EMIR level II. Such policies and controls obviate the need to hold additional capital. Such an approach is consistent with the wording of Article 12(2) of EMIR, which does not stipulate that additional capital should be held, but rather that capital "*shall at all times be sufficient to ensure...that the CCP is adequately protected against credit, counterparty, market, operational, legal and business risks which are not already covered by specific financial resources*".

SECTION 2: Specific responses to questions

In this section, we include only those questions to which we have a significant response.

Q1. Do you support this approach to capital requirements?

No, for the reasons set out in section 1 of this response.

Q2. Do you consider there to be any alternative approach which is more appropriate that would be consistent with Article 12 of the Regulation?

ICE believes that using six months' operating costs as a proxy for operational and other risks has been proven to be effective and therefore it is appropriate for this to be retained. Such an approach is consistent with the wording of Article 12(2) of EMIR, which does not stipulate that additional capital should be held, but rather that capital "shall at all times be sufficient to ensure...that the CCP is adequately protected against credit, counterparty, market, operational, legal and business risks which are not already covered by specific financial resources".

Q3. Which criteria do you take into account for estimating the appropriate time span for orderly winding down or restructuring of the CCP's activities?

Q4. What is your estimation for the number of months necessary to ensure an orderly winding-down or restructuring of the CCP's activities?

We believe that a 6 month period is sufficient for the winding down of a CCP's activities. We would add that a combination of liquid markets and a competitive environment could result in key elements of a market wind-down, including position closures/transfers, concluding well in advance of a six month period.

Q6. How do you currently measure and capitalise for operational risk?

The holding of financial resources equal to six months' operating costs.

Q7. Do you think that the banking framework is the most appropriate method for calculating a CCP's capital requirements for operational risk? If not, which approach would be more suitable for a CCP?

For reasons set out in section 1, paragraph 2, ICE does not agree that the banking framework is the most appropriate method for calculating a CCP's capital requirements for operational risk. ICE believes that the current UK approach, whereby the holding of financial resources equal to six months' operating costs is ordinarily deemed sufficient capital for a central counterparty, is the correct approach to determining CCP capital requirements.

Q9. Do you think that the Basic Indicator Approach set out for banks is appropriate for CCPs?

Q10. In your view, which alternative indicator should the EBA consider for the Basic Indicator Approach? (Please elaborate why such indicator would be more appropriate for CCPs)

Q13. Which other approaches should the EBA consider for operational risk measurement?

It is not appropriate for operational risks of CCPs to be assessed on the basis of a proportion of annual revenue. CCP revenue arises primarily from fees to clearing members. CCP fees are automatically collected from clearing members as part of the clearing cycle, and in the event of non-performance of a clearing member, fees are deducted from the funds held by each clearing member at the CCP. For these reasons, it is more appropriate for CCP capital requirements to be based on operational costs rather than revenues.

The approach used in the CPSS-IOSCO principles should, in ICE's view, be used as the framework for calculating a CCP's capital requirements. These principles are tailored to the specificities of market infrastructure organisations and are internationally relevant standards, which is critically important for the global business of clearing.

Q14. How do you currently measure and capitalise for credit, counterparty credit and market risk stemming from "non-clearing activities"?

Q15. Do you think that the banking framework is the most appropriate method of calculating a CCP's capital requirements for credit, counterparty credit and market risk stemming from "non-clearing activities"? If not, which method would be more suitable for a CCP?

ICE does not agree with specific additional capital charges for credit/market risk in connection with non-clearing activity, particularly in relation to investment activity. It is not clear that there is any such risk in excess of the current UK requirement to hold financial resources equal to 6 months' operational costs. CCPs generally manage the risks of their investment activities through a highly conservative investment policy, which will be the subject of rigorous guidelines set out in CPSS-IOSCO principles and in EMIR level II.