



LSEG RESPONSE TO THE EBA CONSULTATION PAPER ON DRAFT REGULATORY TECHNICAL STANDARDS ON THE CAPITAL REQUIREMENTS FOR CCPs (15 June 2012 | EBA/CP/2012/08)

31 July 2012

Executive Summary

1. Calculation of Capital Requirement

Should be based on following:

- Use of the higher of CRD capital or winding down costs, not both;
- A minimum 6 month floor for the calculation of wind down costs, to be set by the CCP in conjunction with its competent authority;
- Recognition that operational and non-cash costs that would not be incurred in the wind down of a CCP should not be considered in the Calculation of Capital Requirement;

2. Notification Threshold

Should apply as follows:

- If a CCP holds less than threshold, it is required to notify its competent authority, explaining why and how it will maintain required capital – there should be no requirement to hold capital to threshold level.
- A CCP holding more than notification threshold level of additional capital by way of the “Skin in the Game” under ESMA RTS is deemed to hold sufficient capital and should not trigger notification threshold.
- In any event, the level of 125% is not appropriate; the notification threshold should be 105 – 110%.



INTRODUCTION

The London Stock Exchange Group (LSEG) welcomes the opportunity to respond to the consultation paper on EBA's draft technical standards on capital requirements for CCPs.

LSEG supports the objectives of seeking to strengthen the safety of CCPs and financial markets and assessing how risks can be reduced, with a view to ensuring financial stability. We believe that well-regulated, efficient competition between post-trade providers with effective harmonised standards is the best way to ensure that post-trade can, and will, respond to a dynamic and rapidly changing market place, and enable the EU financial market to remain competitive, attractive and accessible to international investors.

LSEG has significant experience of operating neutral, well regulated, fair and efficient post trade services, including Cassa di Compensazione e Garanzia (CC&G), a regulated CCP in Italy and Monte Titoli, the Italian Central Securities Depository. The Group operates equity, fixed income and derivatives markets, the latter including IDEM (specialising in Italian equity derivatives), IDEX (offering Italian energy contracts) and Turquoise Derivatives (UK and Russian derivatives).

This submission represents the views and experience of London Stock Exchange plc, Borsa Italiana, CC&G and other market operators and investment firms within the LSEG.

For this Consultation Paper, we have also contributed to the response submitted by the European Association of CCP Clearing Houses (EACH), of which CC&G is a member. We support the views expressed and the responses to the questions contained in that submission insofar as they are compatible with the views expressed in this document.

We provide our response in two parts:

- **Part A** of this document contains some comments on key aspects of CCP capital requirements, which informs our approach to our response to the consultation paper.
- **Part B** of this document contains our detailed responses to some of the individual questions posed in the consultation paper. (Responses to questions 4, 5, 12, 17, 24, 25, 26 are Confidential and submitted in a separately response to the EBA.)

We acknowledge that the responses contained in this document (excluding responses to questions 4, 5, 12, 17, 24, 25, 26) may be published by the EBA.

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PART A – OBSERVATIONS ON KEY ASPECTS OF CCP CAPITAL REQUIREMENTS

1 General

LSEG is a strong supporter of the goals of the EBA and ESMA to set high quality and effective prudential standards in Europe for CCPs, whilst also supporting the continuing development of robust and innovative financial markets. In this regard, LSEG supports the development of regulations that would increase appropriately the amount of capital held by CCPs and which will set a framework in which CCPs and their competent authorities can manage risk effectively, allowing CCPs to differentiate themselves on services and pricing, but not on risk management or margins.

However, there are a number of areas where we have some concerns that the draft technical standards proposed by the EBA (and ESMA in its parallel consultation on RTS) are not consistent with this approach and would merit some reconsideration.

In outline, our views on the approach to assessing capital requirements for CCPs are:

- 1.1 We believe that the focus of capital requirements should be to ensure that adequate capital is maintained in the CCP to absorb operational shocks, whilst ensuring sufficient liquid resources to support an orderly wind down in the event of a failure of the CCP, although a CCP will be either in a going concern state or in a winding down, so should not be required to provide capital to support both simultaneously.
- 1.2 We also support the requirements in EMIR that a CCP should have its own dedicated resources in the default waterfall, which are used before the general default funds in order to act as an incentive to provide effective risk management (but not to such an extent that it puts the CCP itself at risk of losing one third of its capital at a stressful time such as a clearing member default).
- 1.3 We question Recital 4 of the draft RTS which states that CCPs are exposed to the same kind of risks as credit institutions and investment firms. In our view, the principal responsibility and strategy of CCPs (including those holding a banking licence) is the management of risk; they do not have the structure, aim, scope and, most significantly, risks of credit institutions and do not perform typical banking activities. They have established very conservative risk management tools, such as
 - (a) membership requirements, ensuring that CCPs have exposures only against the most reliable entities
 - (b) margins covering all but the most extreme market fluctuations over long time periods;
 - (c) default funds, designed to withstand the most severe market circumstances; and
 - (d) risk averse investment policies, which limit proprietary risk and focus on security of investments and ability to liquidate in a default situation.

2 Calculation of Operational Expenses

- 2.1 It is appropriate that CCPs should hold sufficient financial resources to cover operational expenses over an appropriate time for winding down or restructuring their activities (Article 6, RTS). However, the current rules as drafted seem to result



in adding both Pillar 1 and Pillar 2 CRD capital to winding down expenses, which we feel incorrectly inflates a CCP's total capital requirement.

- 2.2 As we see it, a CCP operates in two, mutually exclusive, states:
 - a. Going concern – CRD capital requirements are appropriate;
 - b. Winding-down – sufficient capital to fund the winding down of the business is required.
- 2.3 As these states are mutually exclusive, the necessary capital should be the higher of the CRD capital and the winding down costs as original proposed by the EBA in the discussion paper in March 2012; like the EBA, we also interpreted the Level 1 text as requiring a CCP to have enough capital for either eventuality but that the same capital resources would only be necessary for one or the other.
- 2.4 We note the reference that the EBA now considers this to be “in conflict with the Level 1 text”- we believe that it would be of benefit to share the reasoning for this change of the EBA's view with stakeholders, as there appears to us to be no rationale for departing from the EBA's intended approach.
- 2.5 The EBA consultation paper proposes a minimum period of 12 months operating costs for calculating winding down costs. This is a very conservative approach and given the systemic importance of CCPs and the need for any wind-down and transfer of positions to another CCP to be completed in a much shorter period, we believe that the 6 month floor originally proposed in the discussion paper in March would be much more proportionate. A CCP could, working with its competent authority, increase this floor as appropriate, depending on the risks and instruments cleared. This would also be consistent with CPSS-IOSCO recommendations and rules proposed in the US under Dodd-Frank Act, thus avoiding creation of regulatory arbitrage that could tend to favour Non-EU entities.
- 2.6 The EBA also proposes that a CCP's wind-down expenses are equivalent to a CCP's on-going operating costs. However, we believe that this overstates the costs of a wind down, since a number of activities would not, in reality, be carried out (e.g. marketing expenses) and other discretionary costs would not be incurred, or would be significantly reduced. In addition, we also believe it would be appropriate to exclude non-cash costs (e.g. depreciation) from the calculation.
- 2.7 We would also observe that revenues are not included to offset expenses incurred in the winding down of a CCP. This implies (using the BIA approach to operational risk) a 100% provision against gross revenues and therefore that operational risk is incorporated into the winding down provisions. This also supports the “higher of” approach to CRD capital and winding down costs.
- 2.8 We would also be concerned that, by increasing the capital requirements, the proposal could make bilateral transactions cheaper than those subject to central clearing, making them more attractive to market participants. This could frustrate the G20 objectives to incentivise the use of central clearing.



3 Notification Threshold

- 3.1 Article 4 is unclear, but we interpret it to mean that a CCP may hold capital between its capital requirements under Article 3 and 125% of that requirement, and that if it holds less than 125%, it is required to notify its competent authority, explaining why this is so and how it will maintain its Article 3 capital. We do not interpret this to mean that the CCP must hold 125% of its Article 3 capital. The drafting should make this clear.
- 3.2 However, whether our interpretation is correct or the intention is in fact that the CCP should hold additional capital of 125% of its Article 3 capital, we do not see the rationale for such a threshold of 125%. This would result in an excessively high buffer. The current proposal of adding winding down costs to CRD capital (with which we disagree - see above) provides highly material and un-commercial capital buffers as the risks being managed are mutually exclusive (i.e. the going concern CRD risks are redundant in a wind down scenario and vice versa). These inherent buffers would then be significantly amplified by a 25% notification threshold. In the March discussion paper, the EBA proposed a notification threshold of 105 – 110%, which we believe is more proportionate.
- 3.3 We would also argue that a CCP that holds more than 25% additional capital by way of the skin in the game (or such level as is finally approved as the notification threshold) is deemed automatically to hold sufficient capital not to trigger the notification threshold, assuming the notification threshold is lower than the skin in the game.
- 3.4 However, on the basis we set out above of a capital requirements framework that is based on the higher of operational risk and wind down costs, with such costs based on a 6 month floor and excluding operational costs that would not be incurred, we would argue that a higher notification threshold could be justified to reflect the less duplicative nature of the calculation. We would propose, on this basis, a notification threshold of 115%.

4 Use of BIA/AMA

We question how the application of the use of basic indicator or advanced measurement approaches (Article 7), as provided by CRR, could be applied to CCPs in the timescales anticipated as the necessary regulatory technical standards under CRR are not due to be drafted until 2016. It should be clear if the application of these methodologies is to be applied on the basis of existing legislation/technical standards or whether new standards are envisaged.

5 Contributions to other default funds

We support the view expressed in Article 2 3 (a) that contributions to any default fund of another CCP should be deducted from the capital of a CCP. We believe that this is a fair point, as contributions of a CCP to default funds of other CCPs should be discouraged, as such a structure could create a spill-over, with potentially systemic effects. In addition to this, clarity is required on the treatment of margins deposited by a CCP with another CCP.



6 ESMA Consultation on RTS

The EBA consultation paper covers the proposals for the calculation of the capital requirements as required by Article 16 of EMIR. For a CCP, however, understanding the impact of capital requirements also includes consideration of how a CCP's own resources in the default waterfall are calculated (Article 45 EMIR). Although the draft regulatory technical standards for this component are covered by the ESMA consultation paper on OTC derivatives, CCPs and Trade Repositories, it is essential to consider the impact of these proposals on the approach to, and calculation of, capital requirements, as we believe the regulators must adopt a joined up approach, taking account of the impact and cost/benefit of their proposals on those of other regulatory measures proposed. We include a summary of our views on this important topic.

CCP Own Resources in Default Waterfall - "Skin In the Game"

- 6.1 The role of requiring a CCP to have some of its own resources in the default waterfall should be to incentivise CCP operators to undertake effective risk management. However, it should not be of such a scale that it becomes part of the risk mitigation arrangements in its own right; in our view, this could increase systemic risk by putting the CCP operator at risk of default at a critical time.
- 6.2 Our interpretation of the current drafting of the rules implies a substantial increase in the "skin in the game", and hence in capital to be held by a CCP but this increase will not provide any material increase/improvement in the mitigation of risks associated with a default. It will heavily penalise CCPs (particularly those that operate a conservative approach to calculating regulatory capital) but provides no real improvement in the risk profile for a default.
- 6.3 We agree with the proposal that a CCP should be incentivised to provide effective risk management by having some of its own resources in the default waterfall before default fund contributions of non-defaulting members, but we consider the proposed 50% requirement (Article 1 DW) to be unnecessarily high, given its purpose set out above. We suggest such a level would have two unintended consequences:
 - a. It will place a CCP at far greater significant risk during the most critical time of a clearing member default, as it increases the chances of a CCP itself encountering financial difficulties through potentially losing one third of its capital;
 - b. It increases the risk of a lack of liquidity to close out positions in a default. This is because clearing members will see that the default will be absorbed (to a greater extent) by the CCP's own resources, thus reducing the chance of the default reaching the mutualised default fund layer (where they will incur some of the losses). This in turn removes the incentive for members to provide market liquidity to close the positions out before the mutual fund layer is reached.
- 6.4 We propose that a 10% CCP own resources requirement would represent a more proportionate approach. It would represent a significant amount of capital for the CCP to hold and would therefore achieve the objective of incentivising good risk management procedures by a CCP, including the incentive not to compete on margins, without increasing financial instability by putting the CCP at risk of losing a significant portion of its capital.



PART B – RESPONSE TO INDIVIDUAL QUESTIONS

Q 1. Do you support this approach to capital requirements?

Please see our response in Part A.

Whilst we understand and support the general approach, we do not consider that adoption of some of the approaches to capital requirements that flow from banking institutions is appropriate or useful and could, indeed, have the opposite effect to that intended.

In particular, unlike banks, the business model is not based on a structural maturities mismatch between assets and liabilities. While a bank takes proprietary risk with the principal aim of maximising returns within a sensible risk management framework, a CCP primarily considers risk management, liquidity and preservation of the market, with investment returns being only a consequential (but important) consideration. The level of available financial resources for a CCP is independent of investment strategy, i.e. the optimal amount of margins and default funds (i.e. deposits and investments) is not a strategic choice but a consequence of risk management policy and of participants' trading activity, otherwise they could face distorted incentives potentially undermining market integrity, i.e. lowering the level of margins strategically to lessen the capital requirements.

In general, the margin setting policy does directly impact the level of re-investable financial resources. However, any automatic link between investments and capital could potentially create distortions, through a feedback effect, to the risk management policy. This could result in a less prudent approach being adopted in order to avoid additional regulatory capital charges and we therefore broadly support the approach proposed by the EBA to calculate capital requirements according to the risks identified in Article 16(2) of EMIR.

ESMA, in its consultation paper, recognises the potential consequences of linking margin and default fund contributions and the “skin in the game” and therefore links it to the capital. Whilst we agree with this approach, as we point out in Part A, we do not consider the proposed level of 50% to be justified and, as proposed, potentially introduces circularity to the “skin in the game” and capital calculations.

We would also comment that it should always be borne in mind that an increase in capital, whilst increasing systemic resilience, will usually result in some additional cost to users, to whom increased costs will be passed; this should always inform any policy decisions around the level of capital required and its consequent cost/benefit.

Q 2. Do you have any other option to suggest that is not covered in this draft RTS?

In our responses, we are effectively advocating an approach that uses a mix of the principles of banking capital requirements with application of risk based measures and requirements that are related to the practical operation of CCPs.

It is also important not to require European CCPs to comply with higher capital requirements than those required by global standards, which would open the way for regulatory arbitrage and direction of business flow in favour of third country CCPs.



Q 3. Do you consider there to be any alternative approach which is more appropriate that would be consistent with Article 16 of the Regulation?

Please see our observations in Part A and response to Q2 above; we suggest a more proportionate framework that reflects the risks faced, and managed, by a CCP, including:

- Use of the higher of CRD capital and winding down costs and not both;
- A minimum 6 month floor for the calculation of wind down costs, to be set by the CCP in conjunction with its competent authority;
- Recognition that operational and non-cash costs that would not be incurred in the wind down of a CCP should not be considered in the Calculation of Capital Requirement;
- A more proportionate notification threshold that also takes account of the ESMA skin in the game requirements.

Q 4. What is the incremental cost to your CCP for the implementation of this proposal?

Q 5. What is the incremental benefit to your CCP for the implementation of this proposal?

See separate Confidential response submitted to EBA- not for publication.

Q 6. What is the incremental cost for the supervisors for the implementation of this proposal?

This must be for the supervisors to identify.

Q 7. What is the incremental benefit for the supervisors for the implementation of this proposal?

This must be for the supervisors to identify.

Q 8. What is your view on the notification threshold? At which level should it be set?

Article 4 is unclear, but we interpret it to mean that a CCP may hold capital between its capital requirements under Article 3 and 125% of those requirement, and that if it holds less than 125%, it is required to notify its competent authority, explaining why this is so and how it will maintain its Article 3 capital. We do not interpret this to mean that the CCP must hold 125% of its Article 3 capital. The drafting should make this much clearer.

However, whether our interpretation is correct or the intention is in fact that the CCP should hold additional capital of 125% of its Article 3 capital, we do not see the



rationale for such a threshold of 125%. This would result in an excessively high buffer. The current proposal of adding winding down costs to CRD capital (with which we disagree - see above) provides highly material and un-commercial capital buffers as the risks being managed are mutually exclusive (i.e. the going concern CRD risks are redundant in a wind down scenario and vice versa). These inherent buffers would then be significantly amplified by a 25% notification threshold. In the March discussion paper, the EBA proposed a notification threshold of 105 – 110%, which we believe is more proportionate.

We would also argue that a CCP that holds more than 25% additional capital by way of the skin in the game (or such level as is finally approved as the notification threshold) is deemed automatically to hold sufficient capital not to trigger the notification threshold, assuming the notification threshold is lower than the skin in the game.

However, on the basis we set out above of a capital requirements framework that is based on:

- the higher of operational risk and wind down costs,
- with such costs based on a minimum 6 month floor and
- excluding operational costs that would not be incurred,

we would argue that a higher threshold could be justified to reflect the less duplicative nature of the calculation. We would propose, on this basis, a notification threshold of 115%.

Q 9. In your view, in which case should restriction measures be taken by the competent authority once the notification threshold is breached?

Not for simple breach of the threshold as drafted - as we understand Article 4, disciplinary action would only be merited if the minimum capital requirement under Article 3 is not fulfilled (along the lines set forth in principle 15, key consideration 5, of the CPSS-IOSCO Principles) or for a failure to explain why a CCP is holding capital at a level between the Article 3 capital requirement and the threshold. As an example, in this case authorisation can be refused or removed if capital is not reintegrated for more than one year.

In general, as the measures will depend on the specific circumstances, discretionary powers to decide measures should be left to the competent authorities in case the notification threshold is breached or the capital is not sufficient.

Q 10. Which criteria do you take into account for estimating the appropriate time span for orderly winding down or restructuring of the CCP's activities?

The relevant criteria include the national insolvency law, the flexibility in the labour market and the organisational and group structure determining the time required to reduce fixed costs, in particular those related to labour, technology and premises.

As we observe in part A, it does not seem appropriate to base the calculation on wind-down costs simply on the basis of on-going operational expenses of a CCP.



The calculation should not include expenses such as variable remuneration, travel and marketing/promotions that would be unlikely to be incurred during a winding down or restructuring period.

Q 11. What is your estimation for the number of months necessary to ensure an orderly winding-down or restructuring of the CCP's activities?

Given the diverse nature of European CCPs, it is difficult to provide the EBA with a single estimation. We agree, therefore, with the explanatory text to Article 6 of the Regulatory Technical Standards that the estimation of the winding down or restructuring period should remain the responsibility of the CCP. Any estimate will depend on a number of factors, including the ability of the CCP to retain existing business, the confidence levels of users and trading venues, the appetite of shareholders, users and infrastructure to recapitalise and the time this would take and the availability of competing offerings. These factors will need to be analysed before a decision is taken to wind down or seek to recapitalise.

While we consider that, on the basis of the CPSS-IOSCO proposals, and given the systemic importance of CCPs and the need for any wind-down and transfer of positions to another CCP to be completed in a much shorter period, we believe that the 6 month floor originally proposed in the EBA discussion paper in March would be much more proportionate.

However, a CCP, should, on the basis of its own estimation and in conjunction with its competent authority, provide for a longer winding up period if that is necessary.

Q 12. 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 month?

See separate response submitted to EBA, not for publication.

Q 13. How do you currently measure and capitalise for operational risk?

Currently operational risk is covered by a group insurance policy, which would guarantee the protection of the CCP against such risks. CC&G do not currently calculate separate capital requirements for this (see response to question 14). We recognise that the operational risk faced by CCPs (in particular those not holding a banking licence) is significantly different from that characterising the banking sector, and therefore such an approach is appropriate in this context.

Q 14. 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?

See question 2. The banking framework is, in principle, an appropriate method for calculating the capital requirement for operational risk. However, the operational



risks faced by CCPs are significantly different from those faced by banks and we believe that the suggested approach for assessing additional charges for operational risk is inappropriate for the reasons we outline in Part A, in the context of the proposed additive nature of the operational risk and winding down cost calculations.

Q 15. Do you think that the Basic Indicator Approach set out for banks is appropriate for CCPs?

We believe that the Basic Indicator Approach as it is now overestimates investments risks incurred by CCPs and this may introduce distorted incentives in Risk Management in favour of lower requirements; CCP investments risks should be managed *ex ante* by careful supervision of CCP's investment policies, given that the *ex post* protection provided by capital set aside (which is limited by definition) cannot ensure coverage against margins and default funds contributions collected (which are indefinite, particularly in time of volatile markets with large volumes and when interoperability agreement are in place).

In addition, we believe that, given the nature and the specificities of the investment risk to which CCPs are exposed, the Basic Indicator Approach should not be applied to net treasury income, as further detailed in answers to questions below, as they are not exposed to relevant operational risks.

We question how the application of the use of basic indicator (or advanced measurement approaches), as provided by CRR, could be applied to CCPs in the timescales anticipated by EMIR, as the necessary regulatory technical standards under CRR are not due to be drafted until 2016. It should be clear whether these methodologies are to be applied on the basis of existing legislation/technical standards or new standards.

Q 16. In your view, which alternative indicator should the EBA consider for the Basic Indicator Approach?

No response.

Q 17. 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?

See separate confidential response submitted to EBA.

Q 18. 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?

No response

Q 19. Which other approaches should the EBA consider for operational risk measurement?



Please see response to question 3.

Q 20. What are the incremental costs and benefits to your CCP for the implementation of the advanced measurement approach for operational risk?

No response.

Q 21. Do you think CCPs should be allowed to calculate the capital requirements for market, credit and counterparty credit risks with internal models?

There is a major difference between the investment approaches of banks and CCPs. A bank invests principally to gain a return, whilst a CCP invests with a view to risk management and critically being able to access liquidity in the event of a default. We would expect this to lead to CCPs principally investing in AAA secured investments with a high volume of very short term positions (e.g. Overnight). The current credit scoring approach within the CRD rules applies the bank rules with the same credit score for tenors below 3 months. This gives no greater credit for the far lower risk overnight investment compared to a three month investment.

We would therefore recommend a specific CCP credit scoring mechanism that gives lower credit risk ratings for shorter dated investment positions within the three month period.

Q 22. How do CCPs currently measure and capitalise for credit, counterparty credit and market risk stemming from non-covered activities?

Credit, counterparty and market risk are monitored by CC&G on a daily basis following the guidelines outlined in the "Financial management policy" of CC&G. Such guidelines provide for an investment framework allowing CC&G to choose within a wide panel of national and international commercial banks, adequately rated by the three recognised CRAs.

Q 23. 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-covered activities?

We argue in Part A, and in response to question 1, that in general CCPs are not exposed to the same kind of risks as credit institutions and investment firms and therefore that issues arise in the application of the banking framework to some aspects of the calculation of CCP capital requirements. We recognise, however, that where CCPs are exposed to similar risks, for example in respect in the investment of margins and default funds received from clearing members, such a framework is appropriate.

We would also repeat the point from Part A, in respect of the investment policy (covered by the ESMA consultation), that CCPs need to manage the investment of these funds with a view to maintaining a balance between security and the prompt



availability of resources in the event of a clearing member default. The proposed 98% coverage through secured investments is excessively restrictive in this regard and we would propose a lower limit to allow CCPs to manage this trade-off and to reflect this via higher capital requirements.

- Q 24. 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?**
- Q 25. 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?**
- Q 26. 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?**

Separate responses submitted to EBA.

- Q 27. 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.

- Q 28. In your view, which other approaches should the EBA consider for credit, counterparty credit and market risk measurement?**

No response

- Q 29. What other risks should be considered in Article 9?**

No response.