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2 April 2012

Re: Discussion Paper on Draft Technical Standards on the Capital Requirements for CCPS under the Regulation on OTC Derivatives, CCPs and Trade Repositories

Dear Sir/Madam,

UBS would like to thank EBA for the opportunity to comment on the Discussion Paper on Draft Technical Standards on the Capital Requirements for CCPS under EMIR. 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
European Banking Authority Discussion Paper on Draft Regulatory Technical Standards on the capital requirements for CCPs under the draft Regulation on OTC derivatives, CCPs and Trade Repositories

INTRODUCTION

UBS would like to thank the ESAs for the opportunity to comment on the discussion paper on Draft Regulatory Technical Standards on the capital requirements for CCPs under the draft Regulation on OTC derivatives, CCPs and Trade Repositories ("The Paper"). Please find below our response to the overall content, as well as the specific questions set out in the Paper. Please note that we did not comment on questions in section 2 (operational expense for winding-down) and section 7 (cost-benefit analysis) specifically addressed to CCPs.

As a general note we would note that EBA focuses on the question whether CCPs have sufficient capital to cover non-clearing losses. It is, in our view, equally important for EBA to assess the amount of capital at risk in the default waterfall. We would emphasize the fact that many clearing houses put at least a portion of their capital fairly high in the default waterfall. Specifically we believe that EBA should assess the probability of this amount being called upon based upon margining policies, size of the default fund and ranking of contributions.

In regards to operational expenses for winding-down or restructuring, we would as a general comment, like to emphasize our view that it is not appropriate to proxy winding down costs with day-to-day ongoing expenses. There are in our view other factors to take into account such as decommissioning of systems, termination of contracts, professional fees required as well as potential litigation fees to execute a wind down or restructuring. In relation to the criteria to take into account for estimating the appropriate time span for orderly winding down, EBA may want to consider the time period over which any potential litigation may stretch. While it is difficult to estimate the time span required for wind down or restructuring, we believe it is reasonable to assume that a restructuring will take at least 12 months.

1. CPSS-IOSCO PRINCIPLES FOR FINANCIAL MARKETS INFRASTRUCTURE (PFMIs)

Article 12 of EMIR states that capital including retained earnings and reserves of a CCP must at all times be sufficient to ensure (i) an orderly winding down or restructuring of the activities over an appropriate time span and (ii) that the CCP is adequately protected against credit, counterparty, market, operational, legal and business risks, not already covered by specific financial resources as referred to in Articles 39 to 41a of the Regulation. Under this Article, EBA is mandated to draft regulatory technical standards (RTS) on the capital requirements that a CCP should meet.

EBA suggests that a CCP should hold capital, including retained earnings and reserves, that is 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.

In developing its proposal, EBA has considered the draft CPSS-IOSCO Principles for Financial Markets Infrastructure ("PFMIs"). The draft PFMIs requires CCPs to hold sufficiently liquid assets funded by equity to cover general business losses. As a minimum, CCPs are required hold equity capital at normal times equal to [6, 9 or 12] months of expenses. A CCP's equity capital is expected to reflect a strong cash, cash equivalent or securities position. EMIR goes beyond CPSS-IOSCO principles as it states that CCPs' exposure to risks, not covered by specific financial resources, should also be considered in the setting of minimum capital requirements. The approach proposed by EBA will hence result in capital requirements that are at least equal to those resulting from CPSS-IOSCO principles.

Q1. Do you support this approach to capital requirements?

While we believe the general approach to be reasonable, we are concerned with the statement contained in paragraph 9 "A CCP's equity capital should also reflect a strong cash, cash equivalent or securities position to allow it to meet its current and projected operating expenses under a range of scenarios." In our view, liquidity and capital requirements should not be co-mingled. Equity is intended to fund fixed assets and absorb P&L losses , not finance short-term assets. More emphasis should be put on minimum liquidity requirements. We would welcome if EBA could clarify that paragraph 9 is to be understood in the context of CCP's equity capital being a multiple of cash, cash-equivalent or securities positions to be able to meet operational expenses during an appropriate time span for winding-down or restructuring its activities. Capital cannot meet cash expenditure, only liquid assets can. We will argue later in this paper that clearing houses are more akin to corporates than bank entities and financial requirements should reflect this fact. It is not appropriate to try to apply bank capital requirements to an entity whose main competence is providing an infrastructure service to the financial community.

We furthermore note that according to Article 12 of EMIR, capital must be sufficient to ensure that "(…) the CCP is adequately protected against credit, counterparty, market, operational, legal and business risks, not already covered by specific financial resources as referred to in Articles 39 to 41a of the Regulation". In addition, financial resources described in Articles 39 to 41a of the Regulation are intended to cover the <u>counterparty risk</u> stemming from clearing activities.

We have three concerns to share in relation to the above Articles.

First, we are of the opinion that the approach suggested by EBA to only consider operational expenses, operational risk and "non-clearing activities" is not complete as such a calculation of regulatory capital does not take into account the potential default of clearing members.

Second, EBA's approach indirectly encourages low capitalisation of CCPs as it assumes that financial resources (as per Articles 39 to 41a, which we refer to below as the "Guaranty Fund") is always sufficient to cover the risk of clearing activities. In our view, the current general construct of CCPs is such that CCPs only have a nominal contribution into the "waterfall" and subsequent liabilities are entirely covered by clearing members via the Guaranty Fund contributions and further obligations to "top-up" the Fund. Hence, there is a clear dependency of the CCP's survival on clearing members' ability to operate as a going concern.

We would draw to EBA's attention to the fact that Guaranty Funds are typically sized based on 1 or 2 of the largest members defaulting. Therefore, there are residual counterparty risks (remaining members defaulting) not already covered by the specific financial resources. This needs to be incorporated into the determination of CCP capital requirements. To the extent that a CCP is willing to place additional resources into the Guaranty Fund to cover these residual risks, it is, in our view, not unreasonable to exclude this component from the CCP's regulatory capital requirement.

As a third and last concern, we would raise the fact that in its approach, EBA has not taken into account the litigation risk faced by a CCP when going through a wind-down or restructuring, which is likely to be significantly more complex and severe when compared to legal risks as part of day-to-day operations. Therefore, the capitalisation framework should recognise this difference and ensure appropriate amounts of capital are in place.

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

Yes, we believe there is an alternative approach which is more appropriate. Minimum Equity requirements could be designed around minimum leverage ratios after deduction of clearing assets from both sides of the balance sheet. This would, in our view, be a much simpler approach. In addition, the clearing house should have a minimum level of cash and liquid investments to fully cover current liabilities and an agreed number of months of operating expenses.

In this context, we would note that it is not appropriate to treat a clearing house in the same way as a financial institution for regulatory purpose. 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. Generally speaking the regime applicable to CCPs should be similar to that of a corporate rather than a bank.

3. CAPITAL REQUIREMENTS FOR OPERATIONAL RISK

EBA considers that the operational risk amounting to the risk of loss from inadequate or failed internal processes, people and systems or from external events, including the legal risk, should be appropriately capitalised. A CCP is subject to operational risk from its payment and settlement of monies and investment of collateral. EBA proposes that the three different approaches for operational risk measurement envisaged for banks under CRD should be available for CCPs: (i) Basic Indicator Approach, (ii) Standardized Approach and (iii) Advanced Measurement Approach.

Q6. 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.

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?

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. Whilst the banking framework provides a useful starting point, CCPs should be encouraged to migrate towards more advanced approaches to risk management and capital adequacy calculation under that framework to optimise the protection of all market participants and the system as a whole.

Q8. What would be the 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 how they currently measure and capitalise for operational risk.

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

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 the risk and whether the approach shares the limitations recognised in the BIA more generally. Further to our response to Q7, 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.

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)

We refer to our response in Q9.

Q11. In your view, with regard to the Standardised Approach, which different lines of business or type of products can be relevant for CCPs' operational risk?

Definition in respect of business lines needs to be modified to ensure clear mapping to the revenue sources of CCPs. Clearing activities would appear to be a better definition of the activities performed by a CCP as compared to Payments and Settlement. In addition, the "reinvestment activities" would appear to be a better definition than asset management. In respect of product types, CCPs themselves are best positioned to define how best to split their activities in the context of operational risk capital considerations.

Q12. 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. Furthermore, it is appropriate as CCPs will be required to meet stringent oversight requirements of regulators. The use of an internal model is likely to encourage and incentivise management to focus on better management of operational risk within the CCP.

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

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

4. CAPITAL REQUIREMENTS FOR CREDIT AND MARKET RISKS STEMMING FROM "NON-CLEARING ACTIVITIES"

According to EBA, a CCP can face various types of credit risk. First it faces credit risk when performing clearing activities. It is the risk that a clearing member will be unable to meet fully its financial obligations when due. Second, a CCP faces credit risk, as well as counterparty and market risk even when it performs "non-clearing activities", in particular investment operations. According to EMIR, credit, counterparty credit and market risk stemming from "non-clearing activities" should be covered by additional capital. EBA considers that approaches applicable to banks under CRD should be used as the basis for calculating such risk exposures as investment activities expose the CCPs at least to the same kind of credit risk that is typically faced by credit institutions. CCPs should calculate their risk-weighted assets per the Standardised Approach for credit risk. Capital requirements for credit risks would be equal to [8%] of RWAs. Equally, market risk could be calculated on the Standardised Approach set out for banks under CRD. A CCP could be allowed, after competent authority approval, to use internal models for calculation of capital requirements for the credit/counterparty/market risk from non-clearing activities.

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

It is up to CCPs to advise how they currently measure and capitalise for credit, counterparty and market risk.

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?

We have no comments to offer.

Q16. What would be the cost of employing Standardised Approach methods for the calculation of your capital requirements for credit, counterparty credit and market risk stemming from "non-clearing activities"?

We have no comments to offer.

Q17. In your view, are the Standardised Approach methods appropriate for the calculation of credit, counterparty credit and market risk a CCP faces stemming from "non-clearing activities"?

We agree that a standardized approach for capital requirements to cover credit risk is appropriate.

Q18. Do you think that CCPs, which concentrate risks stemming from derivatives, should be allowed to calculate their capital requirements for credit, counterparty credit and market risk using internal models?

CCPs are not likely to have the credit resources or models sufficient to adopt more advanced approaches as they do not have a strong proprietary risk-taking history. The use of internal rating models should not be permitted unless a clearing house could demonstrate that it has adequate credit resources. We would emphasize that all credit models require qualitative input since models based on balance sheet numbers cannot capture concentrations of, for example, credit risk, quality of capital, or access to external support and liquidity. Alternative solutions could be for the CCPs to (i) buy more sophisticated tools off the shelf from credit rating agencies, (ii) build their own credit expertise, or (iii) rely on the credit expertise of clearing members.

Q19. In your view, which assets held by a CCP should be better capitalised with a market risk treatment?

All derivatives with observable prices and high levels of liquidity should be eligible for a market based approach.

Q20. In your view, which other approaches should the EBA consider for credit, counterparty credit and market risk measurement?

The approach should be in line with approaches applied to large corporates. We refer to our response in Q2.

6. NOTIFICATION THRESHOLD

EBA is considering the possibility of establishing a notification threshold equal to [105-110%] of the capital requirements. Where the capital falls below the threshold, a CCP should immediately inform the competent authority and explain actions it will take to ensure compliance. CCP is expected to develop a general capital plan, specifying measures it intends to take when the level of capital falls below the notification threshold.

Q21. What is your view on the notification threshold? At which level should it be set?

110% is in our view reasonable.

Q22. In your view, in which case should restriction measures be taken by the competent authority once the notification threshold is breached?

The CCP should be required to present and agree recapitalization plans with the competent authority with restrictive measures only on those plans which are not deemed to be sufficiently robust.