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Response by Swedish authorities to the Consultation by the Commission on Counterparty Credit Risk

The Riksbank and Finansinspektionen would like to thank the European Commission for providing this opportunity to comment on these issues. Central counterparties (CCPs) can, equipped with proper financial resources and risk management, serve as an important vehicle to increase the resilience of the financial markets. However, it is imperative that CCPs are not viewed as risk free and that banks dealing with them should be properly capitalized against this exposure.

In general, we would like to underscore the importance of ensuring consistency between capitalization of bank exposures to CCPs and the forthcoming European Markets Infrastructure Regulation (EMIR) as well as other reforms including the revised CPSS/IOSCO principles. Further, it is imperative that any regulation ensures a level playing field for the derivatives industry.

1. Are the two conditions and the approach outlined above broadly appropriate? If not, please explain why and how they should be modified?

The two conditions are broadly appropriate though they need to be more clearly defined. It is important to have a clear definition in order to ensure a uniform interpretation. Opacity may lead to diverse interpretations and a lack of regulatory level-playing field conditions. Given that the derivatives markets truly are global this may encourage CCPs to locate in jurisdictions with a lax interpretation of the conditions. Such a development would not be conducive to financial stability and consequently we encourage a more clear definition.

3. Would a single-tier system, i.e. one where only qualifying CCPs would be allowed to exist, be preferable? If so, could making condition 2 a legal requirement for CCPs be considered as a way of doing that? Are there any other ways in which this could be done?

We see no need to regulate against non-qualifying CCPs given that there are appropriate rules concerning capitalization of banks' exposures to such CCPs. Further, a single-tier system may cause problems concerning how to handle exposures to a CCP that suddenly loses its qualifying status.

4. Are there any legal, confidentiality or other obstacles that would prevent CCPs to fulfil condition 2?

Links or transactions between CCPs may generate a circular reference that can result in calculation and coordination problems as one CCP cannot properly calculate its hypothetical capital charge before the other CCP has done so. It is important that this is addressed so that it does not hinder the development of links between CCPs.

6. Is the proposed treatment of exposures of banks accessing a CCP indirectly appropriate? If not, why?

We broadly agree with the proposed treatment of exposures of banks accessing a CCP indirectly. Banks that trade with a CCP through a clearing member are exposed to the same risks as in a bilateral transaction, assuming either of the two conditions stated in the consultation is not met. As a consequence they should be capitalized in the same way as a bilateral trade regardless of any potential impediments to fulfilling these conditions.

8. Do you agree with the outlined approach to the capitalisation of trade exposures? If not, why?

It is important that trade exposures should be capitalized at a small but positive charge in order to reflect the fact that these trades are not risk-free but rather low-risk. However, it is also important to ensure that the relative incentives between bilaterally and centrally cleared trades are balanced to give the proper incentives for banks to transact through a CCP where possible. Consequently, trade exposures should not be capitalized too heavily. It is our view that a 2 % risk weight provides the right balance.

10. Do you agree with the approach to the capitalisation of default fund contribution exposures outlined above? If not, why?

We broadly agree with the proposed approach to capitalization of default funds. However, we recognize the difficulties of developing a risk-sensitive yet simple and implementable approach. At this stage it is difficult to appreciate the potential consequences of an implementation of this proposal for banks, CCPs and for the rest of the financial system. As a consequence, we would like to underscore the importance of additional impact studies and to encourage further exploration of the proposed approach.

<u>Current Exposure Method (CEM)</u>

CEM is a simple method for calculating counterparty credit risk. This is an advantage as it makes the proposed methodology relatively easy to implement and comprehend. However, it is important to recognize that its simplicity may give rise to shortcomings.

Banks are encouraged to use advanced methods in the Basel framework by offering the possibility of lower capital charges when using more advanced methods. As a consequence, many large banks use advanced methods for bilateral counterparty credit risk. It is therefore imperative that the usage of CEM for capitalization of banks' exposures to CCPs does not result in higher capital charges for centrally cleared trades compared to bilaterally cleared trades which would go against the G20 Leaders' call for increased incentives to use CCPs.

Trade exposures to a CCP benefit from multilateral netting, as stated in the consultative document. Indeed, increased netting is one of the main advantages of CCPs as it effectively reduces the outstanding amount of risk in the system. However, CEM was developed for bilateral trades and treats netting only in a very crude fashion. As a consequence, we would like to stress the importance of further exploring if netting can be more accurately captured within the CEM framework.

CEM only provides a very rough parameterization of risk. Consequently, it might be desirable to explore if further granularity between maturity buckets as well as instrument types might increase the accuracy of the hypothetical capital charge. In particular, the 0 % add-on for interest rate derivatives with a remaining maturity of less than one year may need to be revised. However, any modifications need to be balanced against potentially increased computational burden for the CCPs.

CEM is a static method e.g. in terms of add-ons. By contrast, CCPs typically use dynamic methods when determining initial margin and for the valuation of collateral. This difference may result in a countercyclical capital charge as CCPs demand "too little" collateral when volatility is low and "too much" collateral when volatility is high compared to what CEM indicates. The hypothetical capital charge may thus be negatively related to volatility and as a consequence banks may be undercapitalizing for exposures to default funds if volatility is higher than what CEM implies. Given that volatility in the financial markets and credit risk among banks can be positively linked the proposed approach may result in undercapitalization of exposures to default funds during those periods when the risks inherent in them are high. This underscores the importance that banks should form an independent view of the appropriateness of any capital charge toward default funds as they are themselves responsible for holding sufficient capital against such exposures (please see question 15).

Defaulting members' own contribution to default fund

The proposed approach does not adequately reflect the fact that other banks' contributions to the default fund can be used only after the defaulting member's own contribution and posted collateral has been exhausted. However, we recognize the difficulties associated with developing such a model as well as the potentially limited impact any such modifications may have.

Consistency with European Markets Infrastructure Regulation (EMIR) regarding terminology

In order to avoid confusion and to ensure consistency, it might be desirable to, where possible, develop a common and consistent terminology between this proposal and other relevant regulations etc. In particular, the term default fund may benefit from a more uniform definition across proposals.

15. Should CCPs be the ones calculating the hypothetical capital or could/should this calculation be performed by someone else? If the latter, who?

It is important to stress that the calculation of the hypothetical capital charge is the CCPs responsibility. However, it may outsource this activity to a third party if the CCP ensures that the relevant supervisory authority has all information necessary and all other reasonable outsourcing requirements are in place. Further, the CCP cannot outsource its care but shall retain all responsibility for the calculation.

Banks cannot perform the calculation of the hypothetical capital charge and consequently cannot calculate their own individual capital charge for exposures against CCPs default funds. However, it is imperative that banks form an independent and plausible view of an interval in which their own capital charge reasonably would fall. It is ultimately the banks themselves that are responsible for holding sufficient capital against any exposures, including exposures to CCPs default funds. Consequently, it should be a minimum requirement that banks understand how the calculation of the capital charge for their exposures to a CCPs default fund is performed and that banks themselves should deem if such a capital charge is reasonable. These are the same prerequisites as when banks utilize external models.

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