euroclear

EUROCLEAR S.A./N.V.
1 BOULEVARD DU ROI ALBERT II
B-1210 BRUSSELS, BELGIUM

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Commission Services Staff Working Document

Possible further changes to the Capital Requirements Directive

Euroclear response

The Euroclear group is the world's leading provider of domestic and cross-border settlement and related services for bond, equity, fund and derivative transactions. User owned and user governed, the Euroclear group includes the International Central Securities Depositary (ICSD) Euroclear Bank, based in Brussels, as well as the national Central Securities Depositaries (CSDs) Euroclear Belgium, Euroclear Finland, Euroclear France, Euroclear Nederland, Euroclear Sweden and Euroclear UK & Ireland.

We are pleased to be given the opportunity to provide our view on the consultation issued by the European Commission on *Possible further changes to the Capital Requirements Directive* (referred to as CRD IV). The views expressed in the responses to this consultation are similar to those communicated to the Basel Committee on Banking Supervision (BCBS).

General comments

We support the Commission's work aimed at enhancing capital requirements, and in particular efforts undertaken to improve the quality of institutions' capital, taking into account lessons learned during the financial crisis. In that respect, we understand that there is a need to take bold and swift remedial measures, as there is intense pressure on regulatory bodies, and as acceptance of necessary but radical initiatives may weaken when the dust fully settles. However, there is a general concern among industry participants that the cumulative effects of the proposed measures still need to be appropriately assessed; this concerns both the impact on institutions' capital adequacy and business models as well as the indirect consequences for lending practices and economic growth.

In that respect, the timelines proposed for the finalisation (including calibration) and for the implementation of the proposals seem excessively tight. Concerning implementation, as the proposals will require extensive IT developments, we would favour some flexibility regarding implementation deadlines. Implementation by end-2012 would oblige institutions to set aside a substantial budget for that purpose during one single budget-setting period.

We wish to draw you attention to the fact that a number of the proposals outlined in the Commission document may have unintended consequences for market infrastructures providing clearing and/or settlement services for clients, and therefore for the smooth processing of transactions in the post-trade environment. This concerns in particular proposals to take uncommitted credit lines into account in the leverage ratio, though a number of other elements may have a bearing on post-trade infrastructures that need to comply with the CRD. Arguments in favour of revising the Commission's preliminary intentions can be found in our comments below.

Note that we have only included replies to the Commission consultation questions for which we believe our views can be helpful to the Commission.

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Section I: Liquidity standards for credit institutions and investment firms

Question 1: Views are sought on the concept of the Liquidity Coverage Requirements and its likely impact on institutions' resilience to liquidity risk.

We would like to draw your attention to the fact that defining one single set of run-off factors for many different types of institutions may be challenging. Client behaviour may vary depending on the type of shock, but also on the type of institution concerned. For some institutions, the consequences of idiosyncratic and market-wide shocks may be diametrically opposed. During the recent market turmoil, highly-rated or single-purpose institutions saw negative run-off factors, as other market participants chose to leave their cash balances with such institutions. This was the case of Euroclear Bank, which, in the autumn of 2008, did not experience any liquidity shortages, but rather needed to manage exceptionally high inflows of liquidity.

We would also like to add a specific comment concerning unsecured wholesale funding provided to non-financial corporate customers, sovereigns, central banks and public sector entities with operational relationships. We believe that the accounts concerned should be comparable to the transactional accounts mentioned for retail activities. The list of services provided on such accounts could include clearing, settlement and custody services, such that they would cover "accounts used by clients for clearing, settlement and custody services". We would also like to draw your attention to the fact that such transactional accounts are also offered to credit institutions or to other financial institutions; we believe that they would deserve a lower run-off factor than that proposed for credit institutions (100%).

Question 2: Views would be welcome on whether [...] central bank eligibility should be mandatory for the buffer of assets

It is not clear to us whether central bank eligibility should be seen as an additional restriction in the possible list of acceptable assets for Liquidity Coverage Ratio purposes, or whether it would be the other way round, with the other liquidity criteria outlined in the paper limiting acceptance of assets for the LCR to a sub-set of central bank eligible assets.

We believe that both central bank eligible and other liquid assets should be included in the LCR. All assets deemed to be sufficiently liquid to provide comfort that institutions will be able to obtain liquidity in the market, even under stressed conditions, should qualify. This would maintain a level playing field internationally, which would not be achieved by limiting inclusion in the LCR to central bank eligible assets only, as criteria for central bank eligibility are not harmonised. In addition, all central bank eligible assets would also need to qualify. Excluding any central bank eligible asset would not be realistic, as they are used in day-to-day operations by market participants to obtain central bank funds when needed, and by the central bank to conduct monetary policy operations. It is unlikely that central bank eligibility criteria would be rendered stricter in times of crisis.

We would advocate also including foreign assets that are eligible at central banks other than the local central bank, as well as other foreign liquid assets (including mainly sovereign debt in countries receiving a risk-weight higher than 0% under Basel II).

Please note that the terms used in annex II "central bank eligibility for intraday liquidity needs or overnight liquidity shortages in relevant jurisdictions" seems to exclude assets eligible for (longer-term) monetary operations. This may appear unduly restrictive, the more so as such a restriction does not seem justified.

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From a more theoretical perspective, it would be advisable not to be too restrictive concerning the range of eligible assets, with a view to ensuring the continued availability of the relevant asset classes in the future. An example is government debt. A decade ago, officials started to worry about how monetary policy could be conducted in a world in which levels of government debt outstanding were declining structurally. Although this scenario has now left the realm of possible medium-term outcomes, this point still needs to be kept in mind. A too restrictive list bears the additional risk of artificially inflating demand for certain asset types; potentially affecting private investment if government debt were to be excessively favoured.

Finlly, we believe that the requirement stating that "institutions should be able to meet their liquidity needs in each currency and maintain high quality liquid assets consistent with the distribution of their liquidity needs by currency" (p.9) is too restrictive. Indeed, maintaining liquid assets in all currencies in which institutions are active, including minor currencies, would impose an unnecessarily high burden on banks, as liquidity or collateral would be trapped in numerous markets. If applied too literally, the requirement would create an undesirable incentive for banks to restrict their operations to local (and a few complementary or major) markets. In addition, this would unduly create foreign exchange risk, especially if it is sized to cover exceptional liquidity demands. It may particularly affect institutions offering settlement services in many currencies and markets, like Euroclear Bank. The positions that such institutions have at their cash correspondents in local markets is driven by client behaviour; it is therefore highly unpredictable and rather volatile. While end-of-day positions tend to be positive, debit positions can and do occur, and are generally resolved by the next business day. Agreements with cash correspondents ensure the continued provision of short-term liquidity to cover such needs.

Question 6: Views are sought on possible implications of inclusion and tentative "availability factors" (Annex II) pertaining to various sources of stable funding for respective markets and funding suppliers.

It seems to us that the treatment of repos and reverse repos may need to be clearified under the NSFR. As repos shoud not be considered as stable funding, we would have expected in application of the symmetry principle that reverse repos with a maturity shorter than one year would not need to be considered either. However, to be granted a 0% RSF factor is subject to conditions (annex 2).

Question 9: Comments are sought on the scope of application set out above and in particular on the criteria referred to in point 17 for both domestic entities and entities located in another Member State.

We believe that the liquidity standards should apply at an individual institution basis for those groups in which one single credit institution coexists with other entities that do not run material liquidity risks. This would be the case of Euroclear. While it is meaningful to apply the liquidity requirements set out in the Commission's proposal to Euroclear Bank, requesting additional measurement and monitoring of liquidity risk at consolidated level (Euroclear SA/NV or Euroclear Plc) would be overly burdensome and would not bring any benefits in terms of liquidity risk management. In addition to Euroclear Bank, the Euroclear group mainly consists of Central Securities Depositories (CSDs) that are not credit institutions. These CSDs do not incur any material credit or liquidity exposures, as they only carry out the securities leg of securities transactions and do not grant any credit to their clients. They are also subject to specific local regulatory liquidity requirements in the countries in which they operate, so as to ensure that they can continue operating under all circumstances.

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Question 15: What could be considered a meaningful approach for monitoring intraday liquidity risk?

Intraday liquidity deserves separate attention. It is our view that the purpose of intraday liquidity is different from that of longer-term funding. Such liquidity is often offered to facilitate the processing of payments or settlement transactions. It allows institutions to bridge the time gap between outgoing and incoming funds and therefore acts as a lubricant for financial transactions. For example, Euroclear Bank provides intraday liquidity to facilitate the settlement of securities transactions. This is described elsewhere in our replies to the consultation paper.

Section II: Definition of capital

Question 17: Are the criteria proposed for Core Tier 1, non-Core Tier 1 and Tier 2 sufficiently robust and how might they be improved?

We believe that the proposal to fully deduct certain Deferred Tax Assets (DTAs) from Core Tier 1 (Annex V) is excessively prudent. The resulting level of Core Tier 1 would not adequately reflect the capital available to the institution on a going concern basis. DTAs should be allowed to be included if there is a high degree of certainty that the institution will be able to recover them in a reasonable timeframe (e.g. 5 years). We further believe that the treatment of DTAs is adequately covered by the accounting standards, which allow their recognition only under specific conditions. We would also like to note that deducting DTAs from Tier 1 in years in which institutions incur losses may detrimentally affect their capital and thereby have a procyclical effect on institutions' balance sheets.

Furthermore, the example of deferred tax assets which do not rely on the profitability of the bank does not seem appropriate to us, in particular the prepayments to tax authorities, which in our view relate to current taxes and not to deferred taxes. Finally, the distinction between deferred tax assets which rely or do not rely on future profitability appears a bit artificial to us, as in last instance the recognition/reversal of deferred tax assets will always depend on the profitability of the institution. Indeed, an institution that never makes profit will never be able to recover its deferred tax assets (in fact, it should not recognise them in the first place), whatever their source.

We believe that the treatment of minority interest (not eligible as regulatory capital) is not appropriate: the general rule should be that minority interests are included in regulatory capital. If certain exclusions have to be foreseen for prudential purposes, such exclusions should target limited and well-defined cases only.

Question 22: We would welcome comments on the appropriateness of reviewing the use of going concern Tier-1 capital for large exposures purposes. In this context, would it be necessary to review the basis of identification of large exposures (10% own funds) and the large exposures limit (25% own funds)?

We would be in favour of restricting the basis for determining and calculating large exposures to Tier 1, and of increasing the limits accordingly. In our view, the denominator should be limited to Tier 1 capital, as limits should be set based on a going concern assumption.

Under the current calculation method, a bank whose capital base would predominantly consist of Tier 1 capital would, to a certain extent, be penalised, compared to a bank also relying on Tier 2 capital. It would only be able to incur exposures limited at 25% of its Tier 1 capital, which is much more restrictive than

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the same percentage of total capital for a bank with a 50/50 share of Tier 1 and Tier 2 capital.

Question 24: How should the grandfathering requirements under CRD II interact with those for the new requirements? To what extent should the grandfathering provision of CRD II be amended to bring them into line with those of the new capital requirements under CRD IV?

The grandfathering period should be sufficiently long to include outstanding instruments issued in the past, before supervisory intentions to revise the eligibility rules were known. Euroclear has issued a hybrid Tier 1 instrument with a step-up of 100 bps, with an in-built call option, which can be redeemed as from 2015. If it were disqualified as Tier 1 under CRD IV, the disqualifiaction event would automatically trigger the call option. We believe that this is not desirable and would go against the long term profile of this type of capital.

Leverage ratio

Question 25: What should be the objective of a leverage ratio?

We agree with the Commission's view that the leverage ratio should be a very simple and consistent metric, which should preferably rest on accounting treatment only. In that respect, the complete exclusion of netting, as proposed, would not be in line with such a treatment. The leverage ratio should be designed in such a way that it does not act as a hard constraint, in comparison with the risk-based capital ratios; it should be part of Pillar 2. Indeed, if it were to act as a brake on the non-risk weighted exposures that an institution is taking, it may create an incentive for institutions to take additional risk at the margin, so as to align the constraint imposed by the risk-weighted measure on that imposed by the leverage ratio.

We would like to add the following specific comments.

Collateral

If the Commission decides to introduce some risk-based elements in the determination of the leverage ratio, we believe that these should include risk mitigation techniques such as collateral, provided collateral agreements are valid and enforceable. Treating unsecured exposures and secured exposures in the same way may create undesirable incentives. It may also disproportionally penalise institutions that incur very short-term secured exposures that do not result from a desire to benefit from leverage, but from client activity related to the settlement of their securities transactions. This is the case, for example, of Euroclear Bank, which, as a single-purpose institution, provides only settlement-related services to clients. Euroclear Bank extends short-term credit to its clients to facilitate the settlement of their securities transactions. Such credit is generally secured with securities collateral held within the Euroclear system. While most of the credit is intraday and is repaid before the end of the day, it may occur that a client incurs a delay in funding its overdraft position and, as a result, that Euroclear Bank faces a secured exposure on that client overnight. Euroclear Bank also aims at using, as much as possible, secured transactions when placing the funds in the market that participants with a credit position overnight leave at its cash correspondents.

Off-balance sheet items

We believe that off-balance sheet items that are unconditionally cancellable should not be taken into account in a leverage ratio, and in particular low risk items as included in Annex II of the CRD (mainly unconditionally cancellable credit lines). There are several reasons for which such an inclusion would not provide a meaningful contribution to the leverage ratio:

- Such elements are unlikely to lead to a material increase in the de facto leverage ratio, as the institution is entitled to revoke them unilaterally,

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unconditionally, and immediately. For example, reputational considerations would not prevent Euroclear Bank from reducing or eliminating outstanding credit lines if they were believed to increase the risk to the ICSD beyond its risk appetite.

- Such credit lines are unlikely to be used simultaneously. Including all these lines in the leverage ratio assumes simultaneous usage of the lines.

In addition, including unconditionally revocable credit lines is likely to substantially affect institutions providing payment, clearing and settlement services for clients. Intraday credit provided by such institutions contributes to the well-functioning of financial markets. Including it in a regulatory ratio bears the risk of hampering the smooth settlement of financial market transactions, thereby increasing risks in the market.

As explained in Euroclear's Pillar 3 report (p.34, to be found on www.euroclear.com), Euroclear Bank extends short-term credit to its participants to facilitate the settlement of securities transactions. When the buyer does not have sufficient cash on its account to settle a transaction, temporary credit is extended, allowing settlement to take place efficiently. Such credit extensions occur when participants do not hold their cash reserves in Euroclear Bank and/or there are structural time lags in the flow of funds as a result of time-zone differences and differences in operating hours of the various intermediaries involved in payments.

Generally, the duration of exposures is less than 24 hours (ie intraday). The duration varies with the sources of exposure and funding. Participants for which cash flows are mainly driven by purchase and sales within the Euroclear system in a back-to-back mode, may need credit only for a few milliseconds, to allow the chain of transactions to settle. Exposure that needs to be funded by either cross-border deliveries or credits on Participant accounts from external intermediaries tends to last longer, up to several hours. Only in unforeseen circumstances (primarily as the result of settlement failures or delayed credits), part of the exposure can become an end-of-day overdraft retained in the books of Euroclear Bank until the next day.

This credit is unilaterally, unconditionally and immediately cancellable, and Euroclear Bank would not hesitate to decrease or cancel such lines when the financial health of a client would deteriorate. Therefore, we believe that such credit lines should not be considered as leading to leverage build up.

Finally, we wish to highlight that (intraday) credit provided by Euroclear Bank is collateralised in the vast majority of cases (on average, more than 98% of the value of such credit is collateralised), with some uncollateralised credit facilities offered to central banks that cannot enter into secured transactions for various legal reasons. We have argued on the previous page why not taking collateral into account may not be appropriate. As mentioned above, we believe that collateralisation should be taken into account in the calculation of the leverage ratio, if some risk-based elements are included in that ratio.

Section IV: Counterparty credit risk

Question 31: Views are sought on the suggested approach regarding the improved measurement or revised metric to better address counterparty credit risk. With respect to the suggestion to incorporate – as an interim measure – a simple capital add-on by means of calculating the loan-equivalent CVA charge, views are sought on the implications of using VaR models for these purposes instead.

We believe that this proposal should be applied in accordance with the proportionality principle. Euroclear Bank, for example, is only marginally involved in market activities, and only incurs market risk as a by-product of its settlement services. It is only engaged in derivatives transactions with a clear hedging purpose.

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Counterparty credit risk at Euroclear Bank is therefore very low. Building an infrastructure to calculate a bond equivalent to capture CVA losses would not be justified by the size of the exposures that Euroclear Bank is running. A quick estimate of the impact on Euroclear Bank's exposure calculation of introducing this method yielded an insignificant add-on. If exempting small or single-purpose institutions that do not run large derivative books is not deemed desirable, the Commission may consider a simple solution, requiring such institutions to include some pre-defined supervisory add-ons to their calculations.

Question 33: Views are sought on the suggested approach regarding the multiplier for the asset value correlation for large financial institutions, and in particular on the appropriate level of the proposed multiplier and the respective asset size threshold. In addition, comments are sought on the appropriate definitions for regulated and unregulated financial intermediaries.

The paper notes that AVCs for financial firms have tended to be higher than those of other firms by 25% or more. If such higher correlations are found in the overall population of financial firms, it is unclear why the proposal focuses on the largest firms only. Are there any indications that large financial firms would exhibit relatively large correlations compared to smaller institutions? If that is not the case, the higher correlation level should be applied to all exposures to financial institutions, independently of size. This would be methodologically consistent, and maintain a level-playing field among credit institutions. We do not believe that tampering asset value correlations is the right tool to achieve internalisation of externalities related to the systemic importance of large firms. Using one single correlation measure for financial firms presents the additional advantage of simplicity and can be easily implemented without unnecessary IT developments (as current systems do not allow for a selection based on institution size).

Such a methodological change should be accompanied by sufficient safeguards (in the calibration) to ensure that this does not prove unnecessarily detrimental for credit institutions, compared to the Commission's proposal.

Question 35: Views are sought on the suggested approach regarding central counterparties and on the appropriate level of the risk weights to be applied to collateral and mark-to-market exposures on CCPs (on the assumption that the CCP is run to defined strict standards) and to exposures arising from guarantee fund contributions.

We fully support the Commission's intention to reduce counterparty risk in derivatives markets. While we recognise the benefits that can be brought by standardisation of contracts and more generalised use of CCPs, we believe that CCPs should be only one of the building blocks contributing to managing counterparty credit risk appropriately in derivatives markets. We believe that upcoming regulations should not stifle financial innovation, which may be translated temporarily in the emergence of new non-standardised contacts, per se, nor should they prevent the market from developing alternative solutions to CCP clearing for managing the counterparty risks related to derivatives transactions.

Industry experience and market reality in OTC derivatives and other financial instruments demonstrate that a significant part of the OTC derivatives is likely to remain less standardised or less suitable for CCP clearing (e.g. total return swaps). The main reason for this is their specific risk profile or because the market for some of these instruments may be too small (making it difficult to price these instruments correctly). In addition, notwithstanding progressing standardisation of existing OTC derivatives contracts, new/innovative contracts will continue to emerge. Therefore, we are convinced that, while the importance of CCP-cleared contracts will steadily increase, it remains important for supervisors to recognise that other solutions exist in the market that fulfil clear market needs, which are complementary to CCP clearing (e.g. DerivManager, triResolve, Markit PortRec). When appropriately linked

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1 BOULEVARD DU ROI ALBERT II
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to collateral management solutions, these solutions allow participants also to effectively manage their exposure and/or collateral for the non-CCP cleared part of the portfolio. They can also offer a high degree of transparency to allow relevant regulators to assess the underlying risks.

Since capital requirements should be based on an objective risk assessment of the relevant instrument and counterparty, we are not convinced, prima facie, that non-CCP cleared derivatives should necessarily face higher capital requirements where they are subject to highly effective bilateral exposure mitigation techniques.

Euroclear believes that existing market infrastructure (reconciliation and collateral management) solutions supporting bilateral clearing, such as Euroclear Bank's integrated DerivManager exposure / tri-party collateral management solution can achieve very similar risk mitigation effects in OTC derivatives markets as CCP clearing. They provide for a solution for aligning positions and exposures bilaterally and agreeing on margin calls, and integrate this with an efficient same-day collateral process to cover the full exposure (with a possibility to move to intraday collateral management if required). We believe that regulators should take a balanced approach to risk mitigation, ensuring that existing bilateral risk mitigation techniques are actually recognised by regulators and are used by the market.

We kindly ask the Commission to clarify in the text how CCP-cleared trades and bilaterally cleared transactions that would be fully collateralised with eligible collateral would be treated. Would the treatment be different from CCP cleared trades? Would there be any residual exposure? If yes, how would the exposure value be calculated?

Question 36: Views are sought on the risk management elements that should be addressed in the strong standards for CCPs to be used for regulatory capital purposes discussed above. Furthermore, stakeholders are invited to express their views whether the respective strong standards for CCPs to be used for regulatory capital purposes should be the same as the enhanced CPSS-IOSCO standards.

In addition to the CPSS-IOSCO standards, we understand that the Commission European Market Infrastructure Legislation may indeed contain provisions related to risk-based capital requirements for CCPs, although it is not clear if these will be similar to those imposed to banks. Capital requirements for CCPs should take into account exposures that CCPs face on their clearing members in the frame of their clearing activities, as well as on market counterparties (mainly in relation to the holding and management of cash collateral).

Section V: Countercyclical measures

Question 40: Do you agree with the proposed dual structure of the capital buffers? In particular, we would welcome your views on the effectiveness of the conservation buffer and the counter-cyclical buffer, separately and taken together, in terms of enhancing the resilience of the banking sector going into economic downturn and ensuring the flow of bank credit to the "real economy" throughout the economic cycle.

Proposals regarding forward-looking provisioning and capital conservation are sensible. But we believe that measures to prevent excessive credit growth need more detailed consideration before being enacted.

We wish to highlight the fact that any such capital conservation buffers should be designed to be applied on top of regulatory capital requirements (Pillar 1), and not on top of institutions' own assessment of capital needs (Pillar 2). Although this seems to be the Commission's intention (§ 158 refers to "a credible regulatory minimum"), we believe that it should be clearly stated in the text. When assessing how much capital it needs under its ICAAP process, Euroclear applies a number of

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1 BOULEVARD DU ROI ALBERT II
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capital buffers designed, among other things, to ensure capital stability. The resulting economic capital requirement is higher than the regulatory Pillar 1 capital requirement.

Question 43: What is the most suitable macro variable (or group of variables) that may be used in the counter-cyclical buffer to measure the dynamics of macro-level risks pertinent to the banking sector activities?

It seems to us that any measures aimed at addressing pro-cyclicality would need to be taken in conjunction with central banks. Given the fact that monetary policy also aims at limiting excessive credit growth, insofar as it could fuel inflation. This is done mainly by directly manipulating short-term interest rates. The introduction of supervisory measured intended to constrain credit growth in boom years may lead to unforeseen interactions with monetary policy measures. The potential impact of any such supervisory measures on transmission mechanisms is as yet untested. Such measures, if they share the intentions of monetary policy decisions, could reinforce the effect of such decisions beyond what may be desirable to adequately rein in inflation. In contrast, disagreements between supervisors and central bankers may lead to opposite moves, potentially preventing either measure to effectively achieve its goal. With that in mind, developing appropriate supervisory tools to address excessive credit provision and, in particular, asset price inflation, at times at which the central bank maintains interest rated low, will be challenging. This difficulty extends to the choice of criteria, as such criteria may be endogenously determined. For example, the credit growth-to-GDP ratio is unlikely to remain stable over the credit cycle, as credit drives economic growth, and economic growth increases incentives for credit growth.

Contact

For further information, please contact:

Elisabeth Ledrut +32 (0)2 326 7088 or elisabeth.ledrut@euroclear.com
Ilse Peeters +32 (0)2 326 25 24 or ilse.peeters@euroclear.com