Deutsche Börse Group
Response

to European Commission - DG FISMA

‘Exploratory Consultation on the Finalisation of Basel III’

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A. Introduction

Deutsche Börse Group (DBG) welcomes the opportunity to comment on DG FISMA ‘Exploratory consultation on the finalisation of Basel III’ published on 16 March 2018.

DBG operates in the area of financial markets along the complete chain of trading, clearing, settlement and custody for securities, derivatives and other financial instruments and acts as such as a provider of highly regulated financial market infrastructures (FMIs).

Among others, Clearstream Banking S.A., Luxembourg and Clearstream Banking AG, Frankfurt/Main, acting as (I)CSD\(^1\), as well as Eurex Clearing AG as a leading European Central Counterparty (CCP), are authorised as credit institutions within the scope of the European Capital Requirements Directive (CRD) and Capital Requirements Regulation (CRR) which transposed i.a. the Basel III rules into European law. Clearstream subgroup is supervised on a consolidated level as a financial holding group.

In addition, 360 Treasury Systems AG and Eurex Repo GmbH classified as investment firms (according to Article 4 Paragraph 2 CRR) operating multilateral trading facilities (MTFs) are currently in scope of the rules of CRR. (However, following the proposed revised prudential regime for investment firms they may not be in scope anymore going forward.)

Moreover, Eurex Clearing AG and European Commodities Clearing AG are both authorised as CCP under Regulation (EU) No. 648/2012 (EMIR) and Clearstream Banking AG, Clearstream Banking S.A. as well as LuxCSD S.A. are CSDs, which will be authorised according to Regulation (EU) No. 909/2014 (CSD-R) in the future. For these CCPs and CSDs the respective level 2 texts define capital rules based on the CRR rules.

Any banking services performed by our FMIs is only ancillary to their core functions and clearly limited by law to support their role to secure financial markets stability.

Across all our group entities, the respective balance sheets contain mainly exposures towards credit institutions (mostly collateralised), towards central banks and sovereign debt. Our businesses are due to the function as financial market infrastructures risk-averse. As such, financial risks of our entities resulting from credit, counterparty or market risks are in general low. Contrary, operational risks are the driving risk factor and receive appropriate attention.

Regarding the determination of the respective credit risk own funds requirements, all our group entities are using the standardised approach.

As none of our entities is performing trading on own account calculation of CVA risk as well as market risk result in marginal own funds requirements compared to the other risk capital charges.

Clearstream subgroup, containing Clearstream Banking S.A., Luxembourg and Clearstream Banking AG, is currently using the Advanced Measurement Approach (AMA) while Eurex Clearing AG, European Commodities Clearing AG as well as LuxCSD S.A. are applying the Basic Indicator Approach (BIA) determining the operational risk capital charge.

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\(^{1}\) (International) Central Securities Depository
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360 Treasury Systems AG and Eurex Repo GmbH are currently calculating their respective own funds requirements based on their fixed overheads according to Article 97 CRR.

The document at hand contains our general comments to the prudential standards developed by the Basel Committee to finalise the Basel III reforms and to the EU Commission thoughts to implement them into applicable law (Part B) as well as dedicated responses to the questions raised which do effect our businesses (Part C).

B. General comments

The transposition of the final Basel III rules into EU legislation needs to follow the principle of proportionality. In this regard different business models and their inherent risk profiles need to be taken into account. As such, a treatment of our FMIs in scope of the rules either based on the status as credit institution resulting from banking services being ancillary to their core activities or based on the usage of parts of the banking framework within the FMI legislation (i.a. the capital framework) needs to be appropriate.

The prudential framework for investment firms is currently under review\(^2\) and is supposed to be put in place explicitly segregated from the banking ruleset for small- and medium-size investment firms (class 2 and 3). It is necessary that this segregation – where intended – is fully reflected in both IFD/IFR and CRD/CRR at any point in time taking into account the two current legislative processes (CRD V/CRR II and IFD/IFR) as well as the implementation of the elements of the finalisation of Basel III (CRD VI/CRR III) and the transitional provisions of the different packages.

Additionally, over the last decade a variety of financial markets legislations have introduced numerous categories of regulated financial services undertakings. However, despite the fact that some of them may be captured under the definitions of ‘financial institution’ or ‘ancillary service undertakings’ they are not explicitly taken up related to the treatment under CRD/CRR. The two items above are in particular important when defining the rules on consolidated banking supervision. The future rules on consolidated banking supervision in the EU therefore need to clarify

a) If and how the different types of investment firms are to be taken into account for consolidated supervision;

b) If and how the various types of financial service undertakings are to be captured for consolidated banking supervision. In this regards, financial service undertakings not operating under an (additional) authorisation as credit institution comprises i.a.

- central counterparties,
- central securities depositories,
- trade repositories,
- payment institutions,
- regulated markets,

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\(^2\) EU Commission proposal for a directive and regulation on the prudential requirements of investment firms (IFD/IFR).
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- market operators,
- index providers,
- data reporting services providers and
- rating agencies.

In course of reviewing and updating capital rules in the banking framework also adequate and tailored updates for the frameworks of CCPs (Delegated Regulation (EU) No 152/2013) and CSDs (Delegated Regulation (EU) 2017/390) need to be ensured.

More specifically regarding the revised BCBS ruleset, we assume that the adjustments related to credit risk are in general appropriate, but from our point of view, some small amendments are needed:

- The revised Basel rules clearly grant discretion to banks to use external ratings or not for determining the capital charge on exposures (i.e. banks have the right to nominate an recognised external credit assessment institution (ECAI) which is than to be used consistently for a given claim category). Thus, only eligible ratings of recognised ECAIs that are nominated by the bank in addition may be used to calculate the capital charge for exposures. Consequently, in case no eligible ECAI has been nominated for a given claim category, all exposures are treated as ‘unrated’.

In contrast, the usage of debt securities as collateral within the credit risk mitigation framework builds on ratings without specifying whether or not the respective rating agency which has issued the concerned rating is nominated by the bank for that purpose. Consequently, banks have to consider ANY rating which has been issued by ANY rating agency being recognised by the national supervisor. This creates operational uncertainty as this requires always the usage of rating information of ALL eligible ECAIs. As such, the EU should introduce the same nomination process it has introduced for determining risk weights for exposures for the usage of ratings in the credit risk mitigation framework. Therefore, independent of the claim category the usage of ratings for credit risk mitigation purposes should be limited to those ECAIs that the bank has nominated for credit risk mitigation purposes. However, it should be made mandatory in the EU to nominate at least one ECAI in case debt securities are intended to be used for credit risk mitigation purposes. Banks should be free to refrain from nominating ECAIs for some or all claim categories and consequently treat the respective exposures as ‘unrated’.

Moreover, we urge the EU Commission to precise the wording in the CRR to reflect banks’ choice to nominate ECAIs for risk weighting purposes of exposures in line with the BCBS rules. In other words, it should be clear that nominating an ECAI is the bank’s choice and not a mandatory obligation.

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3 According to Paragraph 52 in conjunction with Paragraph 94 of the Basel II framework; Paragraph 94 is transposed to Paragraph 103 of the revised Basel III rules; the choice is explicitly mentioned in the footnote 15, 21 and 22 of the revised Basel III rules.
• The application of the newly introduced Standardised Credit Risk Assessment Approach (SCRA) for claims towards banks rises several operational issues. Clarification is needed at least in form of a level 2 text. Questions to be considered in such a clarification are i.a.:
  - At what point in time and how often does a bank have to capture an update by any change in the underlying data of the counterparties?
  - As of which date a new/changed classification/grade would be considered in determining exposures' risk weights?
    - ...

In this regards, practicability has to be ensured.

• The finalised Basel III rules do not yet contain changes on the treatment of exposures on sovereigns. The rules applicable for these exposures continue to allow deriving the respective risk weight from the Country Risk Classification (CRC). In this context, it is to be noted that the OECD since 2013 does not give CRCs to High Income OECD Countries (nor to High Income Euro Area Countries). Consequently, they are currently to be regarded as unrated which means being at the lower end of the risk scale while in fact being viewed as even better than top ranked countries with a classification of ‘0’. As the OECD is not going to change their approach in the foreseeable future, it needs to be clarified that High Income OECD Countries are being treated like countries with a CRC/minimum export insurance premium (MEIP) of ‘0’.

Capturing the capital requirements for operational risk, we fully support a simplified approach to consolidate the existing approaches. Nevertheless, the proposed new formulas still look quite complex and add complexity in comparison to the current Basic Indicator Approach and to the Standardised Approach.

Determining the revised Basic Indicator (BI) for the operational risk capital charge, differences in the various accounting frameworks should not lead to material deviations. This has to be secured and is particularly true for the definition of interest income, interest expenses and interest earning assets. As such, the determination of the BI has to be accounting standards neutral. Therefore, the EU supervisory banking framework should follow definitions as well as categories of the EU directive on the annual accounts and consolidated accounts of banks and other financial institutions (Council Directive 86/635/EEC). When using any other accounting standards (e.g. IFRS) or national accounting standards of a non-EU country, the used standards need to be mapped by the bank on a best effort to the terminology of the Council Directive 86/635/EEC.
C. Response to selected questions raised in the consultative document

Questions to ‘1. Standardised approach for credit risk (SA-CR)’:

c) What are your views on the revisions? Please provide details.
In general, we see the adjustments related to credit risk as appropriate. Nevertheless, some small amendments are needed from our point of view:

- We clearly reject the introduction of a 10% credit conversion factor (CCF) for unconditionally cancellable commitments (as described in Paragraph 84 of the revised BCBS ruleset).
  This is particular true for such commitments in relation to the provision of money transmission including the execution of payment services, clearing and settlement in any currency and correspondent banking or financial instruments clearing, settlement and custody services. Such commitments are used to foster efficient interbank operations during the day and only exceptional overnight. They have a history of very limited defaults and effective execution of commitment cancellation is feasible and enforceable. Introducing a positive CCF would affect the interbank market and the efficient exchange of funds between banks especially for the purposes named above.

- Beside this, technical clarity should be given on the process of using external ratings (clarification of the choice for banks to nominate ECAIs for both risk weighting of exposures and credit risk mitigation purposes), practical aspects of the SCRA for claims towards banks and the use of OECD Country Risk Classification for sovereign exposures of High Income OECD Countries as described in Part B of this response.

d) How would the revisions impact you/your business? Please specify and provide relevant evidence.

More specifically:

i. How does the revised SA-CR compare to the current approach in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

We expect an increase of the capital requirements as a consequence of the revised SA-CR. Beside sovereigns including central banks the majority of our counterparties are credit institutions. The respective exposures prior of the application of any credit risk mitigation technique in general receive a 20% risk weight due to the short-term nature of the exposures and the capturing of risk weights derived from the sovereign rating. Hence, we partially expect an increase of risk weights. Please note, that our overall capital charge depending on credit risk is limited anyway due to tight risk management measures and counterparty selection process as well as a high degree of collateralisation.
ii. Do the revisions affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.

Please see our response to i.

e) Where do you expect particular implementation challenges and why? Please specify.

The introduction of the SCRA for ‘unrated’ bank exposures will lead to substantial efforts. Monitoring and assessing the ‘published minimum regulatory requirements’ of each unrated counterparty constitute an extensive workload. By implementing the technical details of the BCBS ruleset, an adequate transitional period has to be ensured.

Questions to ‘4. Operational risk framework’:

a) What are your views on the revisions? Please provide details.

In general, we welcome the standardised approach for operational risk (SA-OR) seeking for more simplicity. Nevertheless, we have concerns that a bank’s actual risk-profile is captured in the operational risk framework in an appropriate manner especially regarding the adjusted Basic Indicator (BI).

Thus, we are sceptical about the usage of the proposed financial component (FC). Efficient trading strategies with efficient controls would lead to high charge for operational risk. Poor strategies which lead to a close to zero net P&L on the trading book or the banking book do not receive any relevant capital charge at all (though missing controls could be the reason) and very poor results are again charged.

Regarding the interest component within the interest, leases and dividend component (ILDC) we have some doubts on its appropriateness. We in general understand the approach trying to capture the operational risk stemming from bank’s interest bearing business. Nevertheless, we are sceptical that the proposed approach is adequate. As such, we want to briefly raise our concerns in the following in order to consider them designing an appropriate approach capturing operational risk despite not offering a better solution ourselves.

In general, we cannot see any relationship between interest income and any potential underlying operational risk. The magnitude of the interest income is depending on the interest rate level and the margins, though neither the interest rate level nor the margins are an adequate indicator of the operational risk of a bank. E.g. given an environment of low or negative interest rates resulting in a bank’s negative interest income, the absolute amount of the bank’s net interest income seems not to be the appropriate determinate of the ILDC.

Consequently, the usage of the BI should be subject of further analysis and discussion also on the Basel level and periodic reviews should assess if there are more adequate indicators which could be used.
b) How would the revisions impact you/your business? Please specify and provide relevant evidence.

   More specifically:

i. Which approach for the calculation of the operational risk requirement do you use at the moment?

   As mentioned in more detail in Part A of this response our regulated group entities are currently using different approaches determining their operational risk charges. Partially the Advanced Measurement Approach (AMA), the Basic Indicator Approach (BIA) as well as the approach based on the respective fixed overheads according to Article 97 CRR is used.

ii. How does the new approach compare to your current approach in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

   We regard the new approach as more adequate especially in comparison to the AMA that has a tendency of increasing capital requirements due to capturing new risks c.p. requiring additional capital charges. Consequently, we in general expect lower capital requirements for operational risks.

c) Where do you expect particular implementation challenges and why? Please specify.

   Main implementation challenges will be setting up internal loss databases according to new SA-OR criteria in order to take them into account as internal loss multiplier (ILM). Therefore, the whole loss history has to be verified what will take certain efforts.

   In addition, regarding the basic indicator, the new SA-OR criteria of relevant income components differ from the current approaches, especially from the AMA criteria. Implementation challenges are mainly operational especially regarding the calibration of parameters in the IT applications and IT systems.

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   We are at your disposal to discuss the issues raised and proposals made if deemed useful.

Faithfully,

Jürgen Hillen                     Ralph Kowitz