

BBVA comments on the FSB, the BCBS, the CPMI and the IOSCO report on the incentives to centrally clear OTC derivatives

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BBVA welcomes the analysis of the FSB and the other standard-setting bodies on the incentives for centrally clear OTC derivatives. BBVA considers that the regulatory standards should be periodically reviewed in order to ensure that they maintain their effectiveness and do not impose an unnecessary burden to financial market participants. This is especially true after the G20 led financial markets regulatory reform enlarged the number and increased the complexity of regulatory rules financial entities have to comply with.

Central clearing is one of the pillars of the recent reform in the OTC derivative markets. BBVA congratulates the FSB and the other standard-setting bodies for the report and the open consultation on the adequacy on the incentives for central clearing and considers timing is excellent, given that scheduled changes in the regulatory requirements will affect incentives to central clearing (specially for small market participants) and incentives for clearing members to provide client central clearing services:

- The phase-in calendar on initial margin (IM) requirements
- The finalization of the Basel III framework that include changes on the approaches to calculate risk-weighted assets (RWAs) to cover counterparty credit risk (CCR) (it also impacts on the leverage ratio) and the CVA risk

BBVA appreciates the opportunity to comment on this report. BBVA responses to the questions of the consultative document are focused on the necessity to review the regulatory framework in order to:

- Correct concentration risk in client clearing services and give the right incentive for clearing members to provide central clearing services.
- Balance the incentives for central clearing vs. access to and cost of central clearing for small financial counterparties and non-systemic non-financial counterparties, considering:
 - IM requirements on uncleared derivatives for small financial counterparties at the end of the phase-in calendar
 - Bank entities cost of capital on uncleared OTC derivative transactions entered into with non-systemic non-financial counterparties given that most of these counterparties have not the capacity enter into collateral agreements.

Incentives

1. Do you agree or disagree with the finding that, in general, there are strong incentives for dealers and larger (in terms of level of derivatives activity) clients to centrally clear OTC derivatives? Do you agree or disagree with the finding that some categories of clients have less strong incentives to use central clearing?

BBVA considers that after the G20 regulatory reform large players in the OTC derivative market have a clear incentive to use central clearing.

Apart from the mandatory central clearing, an essential push to central clearing has been the new regulatory requirements on initial margin; volumes of non-deliverable forward (NDF), not caught on mandatory clearing rules, central clearing grew significantly when IM rules began to apply to the largest dealers.

Higher capital requirements for bilaterally cleared transactions (to cover jump-to-default risk and CVA risk) also set an economic advantage for central clearing.

The new regulatory framework come on top of the natural advantage of central clearing for participants in the derivative markets; multilateral netting, greater capacity for portfolio compression and better management of counterparty credit risk.

Currently on dealer-to-dealer transactions for many types of OTC derivatives the use of CCPs for clearing has become the standard in the market.

The incentive is less clear cut for smaller players as a consequence of cost and complexity of set up. In fact, in many situations, it is the complexity that is the concern as can be evidenced by the small number of smaller counterparties that seek out a second broker in order to be able to reduce capital charges through portability.

2. Do you agree or disagree with the finding that relevant post-crisis reforms have, overall, contributed to the incentives to centrally clear? Is the consultative report's characterisation of distinctions in how the reforms have affected incentives for different types of clients consistent or inconsistent with your experience?

As expressed in the answer to Q1, the regulatory reform has set clear incentive to use central clearing for financial counterparties and large non-financial counterparties.

The incentive to centrally clear will be lower for small financial counterparties until the initial margin phase-in calendar ends.

For non-systemic non-financial counterparties, the exemption on exchanging initial margin lowers the pressure to use central clearing. In the EU, also the current exemption in CRR in the CVA capital charge when banking entities transact with smaller non-financial entities also mitigates the pressure to clear for these counterparties. These exemptions are essential for these entities as most of them have the operational capacity restrictions and do not have an amount of liquid assets large enough to consider central clearing as a viable option. However, even benefiting from these exemptions, non-systemic non-financial counterparties pay a price for entering in uncleared derivatives; the counterparty charges an spread that covers credit (CVA) risk (it may be quite high as these counterparties usually do not exchange collateral), counterparty credit risk capital charge and possibly also funding (FVA) risk.

As stated in the rest of the answers, BBVA considers that incentives for central clearing should be lower for small financial counterparties and even lower for non-systemic non-financial counterparties; incentives should be adequate to the capacity of these type of counterparties to deal with the complexities of complying with the requirements of the regulatory framework on the derivative markets.

3. Do the margin requirements for uncleared derivatives give a sufficient incentive to clear? How do these requirements interact with mandatory clearing obligations to incentivise clearing? Are there particular instruments, and specific types of entities where the incentive to clear is not adequate? In

such cases, are there specific aspects of the requirements that diminish incentives to clear?

Initial margin sets a sufficient incentive to clear for large counterparties (see example of NDFs mentioned in answer to Q1) but possibly an excessive incentive to small and not sophisticated financial counterparties.

Large financial entities have the capacity to use quantitative models (the SIMM model as it has become a market standard) for the daily calculation of the IM amount to collect and post to each to their counterparties. The requirements for the calculation of the IM amount under quantitative models are sufficiently severe (one-tailed 99% confidence level, 10 days MPOR, the use of stressed data, no diversification requirements between risk classes) to post a clear incentive to the use of central clearing.

However, BBVA is worried that at the end of the phase-in calendar the initial margin requirement will be excessive for smaller and/or less sophisticated financial counterparties, as many of them will:

- Not have the capacity to calculate the IM amount using the SIMM model; the alternative standard tables are far too conservative and its use turns derivative transactions completely uneconomical.
- Face difficulties in getting access to third party custodians or this access may be too costly
- In the event of default of a counterparty, not have capacity to manage the assets received as collateral.

The requirement to exchange IM is already severely affecting small independent financial counterparties included on the consolidation perimeter of a larger financial group. The impact of IM requirements on these entities may prevent them from entering into derivatives transactions if they cannot rely on the support of an affiliate due to the lack of intra-group exemptions.

One way to correct the excessive IM requirement for small financial counterparties is increasing the €8 billion threshold, which is far too low and captures financial entities with no capacity to comply with IM requirements. On top of this, an additional single-entity threshold should be established in order to avoid capturing small independent financial counterparties that are included in the perimeter of larger financial groups.

The use of quantitative models (the SIMM model) to calculate the initial margin amount to post to and collect from each counterparty is too complex and many small financial counterparties will do not have the capacity to use them or their use will be too costly. And there is no viable alternative; standardised tables provide numbers about 10 times larger than models. For this reason, even if the recommendations of the previous paragraph are considered, BBVA believe that IM standard tables should be recalibrated in order to make them a viable alternative to quantitative models, and be used by less-sophisticated financial counterparties.

4. The consultative report seeks to identify the most important regulatory and non-regulatory factors which affect incentives to centrally clear OTC derivatives for dealers, other financial intermediaries, large clients and small clients. Please identify any significant missing factors and comment on the relative strength of regulatory and non-regulatory factors discussed in the consultative report.

The overriding driver for the increase in clearing has been mandatory clearing. We are now beginning to see clearing penetrate other underlyings as the costs of holding transactions on a bilateral basis grows (IM phase in calendar has an impact on it). Other non-regulatory factors, such as, counterparty credit risk management and multilateral netting also stimulate for central clearing.

One of the barriers for parts of the industry with a relatively small number of trades is the increased complexity brought by mandatory clearing and execution of various products. Where before the counterpart had to make a call to their relationship bank and execute an IRS they now have to ensure they have access to an execution platform and a clearing provider before executing. The difficulty is typically in the set up and in the medium term the simplicity of managing collateral, settlements etc via just one provider is often a benefit. However this is as a consequence of a large upfront investment of time and cost. Indeed making this more efficient for the end user requires knowledge at a local level of capital charges, legal jurisdictional issues, local documentation, language etc which is normally not provided by larger centralised providers.

Markets

5. Is the consultative report's characterisation of the shift of activity and trading liquidity towards centrally cleared products, and the consequent impact on uncleared products, consistent or inconsistent with your experience?

We do not consider that liquidity is moving towards centrally cleared products and drying out in non-cleared derivative, not even for the products that are cleared in CCPs in dealer-to-dealer transactions but on a bilateral basis on client transactions.

Pricing on non-centrally cleared products has increased but not as a cause of liquidity issues; it reflects the cost (XVA) dealers have to pass to their clients to cover their credit risk (CVA), funding risk (FVA), initial margin costs (MVA) and capital charges costs (KVA). These costs are set to still increase as more counterparties will be caught by the IM phase-in calendar and jurisdictions implement the latest reviews on the Basel Committee CCR framework (SA-CCR) and CVA framework (see answers Q7).

6. There are various industry efforts underway to reduce the cost of clearing, including portfolio compression and direct clearing membership models. Based on your experience are these proposals, or other forthcoming changes to clearing infrastructure and models, likely to affect incentives to provide or use clearing services?

The new models are promising however the take up remains to be seen. It is hard to judge at this stage the level of penetration that they will achieve.

We do not consider portfolio compression a tool for the reduction of the cost of clearing, but a tool for reducing the counterparty credit risk. In addition portfolio compression mostly benefits players with a large number of offsetting derivative transactions, while the reduction of the cost of clearing is most needed for small clients and counterparties with directional positions.

Reforms

7. Do you agree or disagree with the report's characterisation of the effects of the following reforms on incentives to centrally clear?

a. central clearing mandates (both in terms of product scope and entity scope);

BBVA is on the view that Clearing Obligation (CO) is one of the necessary obligations to reduce systemic risk, and under this objective is how we understand the Central Clearing.

In terms of product scope we support that only high liquid and high degree standard derivatives have to be subject to CO, taken into account that this obligation has to be harmonized at a global level trying to avoid regulatory arbitrage between geographies. In that sense, in Europe the Trading Obligation (TO) imposed by MiFIR rests on the CO by EMIR, and we urge regulators to carefully review both obligations when analyse new derivatives that could be subject to Central Clearing.

In terms of entity scope, and in line with our concern related in that paper, we understand that small Financial Counterparties that doesn't generate systemic risk trading derivatives, have to be excluded from this obligation.

b. minimum standards for margin requirements for uncleared derivatives;

BBVA considers that initial margin requirement is the element of the G20 reform that most incentivise central clearing. The severity of the calibration (99% one-tailed confidence level, MPOR at 10 business day, the use of stressed data and no diversification benefits between risk classes) makes this requirement an essential factor to consider when entering into an OTC derivative transaction not subject to mandatory clearing.

At the end of the phase-in calendar, initial margin requirements will be excessive for many small financial counterparties as they

- will not have the capacity to calculate the IM amount using quantitative models
- will have less capacity to optimise the use of assets as collateral
- will face higher costs for getting access to custodians.

These larger initial margin costs for small financial counterparties uncleared transactions may be considered even more excessive if we take into account the lower benefits of forcing these companies to use central clearing. Small financial counterparties:

- Pose lower individual counterparty credit risk
- Benefits less from multilateral netting and portfolio compression
- Have to use indirect central clearing; higher costs, clearing service providers default risk (especially when the effectivity of porting is in doubt), higher CCR capital charge (see answer Q7d).

c. capital requirements for credit valuation adjustment (CVA) risk;

It is important that non-financial counterparties have access to risk management tools at a reasonable cost.

The introduction of capital requirements for CVA risk in Basel III has raised significantly the cost of uncleared OTC derivatives transactions entered into with

clients. The implementation of Basel III in the EU through the Capital Requirements Regulation (CRR) introduces an exemption for non-systemic non-financial counterparties.

Most non-financial counterparties cannot enter into collateral agreements as they do not have the cash flexibility and do not hold liquid assets to satisfy short-term collateral calls. CVA risk capital charge are particular severe on transactions not covered by collateral agreements. The application of Basel III framework without an exemption for exposures to this type of entities significantly reduces the access of non-financial counterparties to risk management tools.

The finalisation of the Basel III framework includes changes on the calculation of the CVA capital charge. The new framework will substantially increase the CVA risk capital charge for banks currently using the standardised approach if they do not get the approval to use the new standardised approach and for banks currently using de IMM approach.

The combination of the treatment of the final Basel III framework on CVA risk and the potential suppression of the exemption for non-systemic non-financial counterparties in the CRR will completely reprice OTC derivative transactions for non-financial clients. Many of these clients will have not the capacity to correctly manage their financial markets risk; most have neither the capacity to collateralise their uncleared transactions to reduce the CVA risk of their counterparties nor the capacity to centrally clear their transactions (e.g. tailor-made products, operational capacity, collateral flexibility)

d. capital requirements for jump-to-default risk (including where applicable the Standardised approach for counterparty credit risk (SA-CCR) and the Current exposure method (CEM));

i- Counterparty credit risk (CCR): risk-weights

For smaller credit institutions that use client clearing providers because they do not have the volume or the sophistication to have direct access to CCPs, incentives to central clearing can be improved by making them easier to comply with the requirements necessary to apply the 2% risk weight on their exposures. Difficulties in complying with these requirements forces many small credit institutions to apply the risk weight of the clearing service provider instead the 2% that correspond to exposures to CCPs.

In the EU, the CRR requires clients to obtain independent legal opinions that concludes that under the laws of the client, the clearing member and the CCP, their exposure and collateral is protected from the default of the clearing member or any of its clients, and the laws, regulations, rules and contractual arrangements facilitate the transfer of positions and collateral to a non-defaulted clearing member. Such legal opinions are difficult to obtain in current indirect clearing models.

The last review of the Basel Committee on the capital requirements for bank exposures to central counterparties reduces these requirements, however, they are still difficult to obtain. Simplicity in indirect clearing models is necessary in order to make easy for clients to demonstrate that their positions and collateral are protected and portable.

ii- Counterparty credit risk (CCR): Exposure at default

BBVA considers that the implementation of the SA-CCR will significantly increase the jump-to-default capital charge for exposures not covered by collateral

agreements (mainly exposures to non-financial counterparties) and directional exposures (to non-financial counterparties and small financial counterparties) for banks that do not use the IMM approach.

SA-CCR will enlarge the difference in the calculation of CCR RWAs between entities that have received that supervisory authorisation to use the IMM approach and entities that have not the authorisation to use such approach. This will penalise that participation of smaller banks in the uncleared and cleared derivative markets and it will push for a further concentration of the derivative markets.

Finally, it will increase the exposure level on the leverage market, increasing the costs for the provision of central clearing services to clients.

e. G-SIB requirements; and

f. The leverage ratio.

The leverage ratio is main factor that makes the provision of central clearing services uneconomic for most of the largest derivative markets players.

A review of the calculation of this ratio (that considers the collateral passed to CCPs from clients effective in the reduction of the client exposure for clearing members) or new client clearing models that reduce credit risk exposure would help to reduce the concentration on client clearing providers.

8. Do you agree or disagree with the consultative report's characterisation of the impact of these reforms on the incentives to provide client clearing services?

BBVA agrees that the leverage ratio is the main factor behind the limited interest of banking entities in providing client clearing services (see answer previous page). The implementation of SA-CCR will make this ratio even more restrictive.

The G-SIB assessment methodology may also impact the appetite of large banking entities in providing these services.

9. Are there any areas where potential policy adjustments should be considered which would enhance the incentives for or access to central clearing of OTC derivatives, or the incentives to provide client clearing services?

Greater provision of client clearing services will be most effectively delivered through the introduction of incentives for new players to enter the market. The current capital charge combines with technological and operational hurdles to make it difficult for anyone but the larger institutions to provide clearing services. Additionally, as the report notes, the knowledge of the market flows is concentrated in a small number of market making counterparties who also provide clearing services. This knowledge is a further advantage not available to small and medium sized participants.

An area that we feel has not received sufficient attention in the report is the facilitation of client clearing services by players who are not in the G-SIB category. Introducing mandatory clearing and encouraging clearing through a wide variety of incentives has gone hand in hand with increased concentration of the provision of these services. We feel that there is a strong argument that this is concentrating the risk, it makes it more difficult for clients to port positions when required and leaves the market as a whole vulnerable to business decisions taken by a small number of players. Consequently the focus should be on measures to

improve the conditions for provision of these services by new entrants, specifically:

1. Institutions providing these services should receive a capital charge exemption provided they do not surpass a certain level of volume or risk per underlying in the systemically important CCPs, i.e. become a clearing concentration risk. Above this concentration risk level the capital charges may be applied as normal. This would reduce capital charges for all players and encourage new entrants to the market thereby improving service provision, porting, etc
2. Ensure that regulatory actions do not unintentionally inhibit the creation of utilities to manage the technological and operational activities of clearing.
3. Remove the requirement that some CCPs have for the submission of prices on all of their underlyings as a prerequisite for membership, particularly where that relates to client clearing services.

A greater supply of providers will increase competition and innovation in the provision of these services and make access easier and safer for smaller counterparties.

Access

10. Do you agree or disagree with the report's characterisation of the difficulties some clients, especially clients with smaller or more directional derivatives activity, face in:
 - a. accessing clearing arrangements; and
 - b. conducting trading and/or hedging activity given the restrictions imposed by their client clearing service providers?

BBVA agrees that financial and non-financial small clients may have difficulties in reaching agreements with client service providers or may face extremely high cost when receiving these services.

For this reason, BBVA considers that the regulatory framework should not disproportionately penalise these clients when they enter into bilaterally cleared OTC derivatives; the standard setting bodies should review the adequacy of initial margin requirements for small financial counterparties and the capital requirements for banking entities when they enter to bilaterally-cleared transactions with small non-financial counterparties.

In addition, for their access to CCPs to be less problematic, we believe that several issues need to be addressed including the number of providers, the ability to operate under a variable cost base by encouraging outsourcing of technology and operations and reduced capital charges for smaller providers to encourage resolution of these issues.

11. Do you agree or disagree with the finding that the provision of client clearing services is concentrated in a relatively small number of banks? Does the current level of concentration raise any concerns about incentives to centrally clear, or risks to the continuity of provision of critical economic functions, including during periods of stress?

Yes, client clearing is a very centralised activity with a small number of global providers. This concentration leads to problems of access, worries about loss of access at times of stress and little choice.

12. Do you agree or disagree with the report's characterisation of the incentive effects created by up-front and ongoing fixed costs of:
- using clearing services?
 - providing client clearing services?

BBVA broadly agrees with the thrust of the report in this respect.

13. In light of the finding in this report that economic factors generally incentivize central clearing for certain market participants but perhaps not for others, please describe your views regarding the costs and benefits of the scope of the clearing mandates, both in terms of the products and entities covered.

To a large extent we believe that the regulations have introduced transparency, collateral and standardisation to the derivatives industry and in that respect has made the industry more robust.

The likelihood is that as the phase-in calendar for IM requirements advances, an increasing portion of product flow will be centrally cleared independently of the extent of the mandatory clearing requirements. In that sense, we do not feel that the scope of clearing products needs to increase. In Europe, the IM requirement will caught small financial entities that have not yet been subject to mandatory clearing. For some of them, it may be too difficult to enter into OTC derivatives transactions; it will be too costly and complex both (i) to post and collect IM for non-centrally cleared derivatives, (ii) to connect to a clearing member and post IM.

For small financial entities, it is necessary to reduce IM costs for bilateral-clearing transactions (see answer Q3) and to reduce the cost of providing clearing to these entities (answer to Q9).

14. Should regulation seek to create incentives to centrally clear OTC derivatives for all financial firms, including the smallest and least active? If so, what would that imply for the costs of uncleared trades? If not, for which types of firm and product is it most important to have incentives for central clearing? Conversely for which types of firm and product would it be acceptable not to have incentives for central clearing? Please elaborate.

As explained in answer to Q3 and to Q13, we consider that it should be less cumbersome to post and collect IM to small financial entities.

The €8bn. IM threshold should be significantly raised; for many small and non-sophisticated financial firms it will be very difficult to calculate the IM to post and collect from their counterparties, to reach agreements with custodians and to be able to manage the assets they would receive as collateral from their counterparties.

An additional single-entity IM threshold should also be established for small independently-managed entities included in a bigger financial group. Right now these entities can only rely on intra-group exemptions and the support of larger same-group entities for entering into new uncleared OTC derivatives.

Finally, IM standardised tables should be recalibrated; they are too costly compared to quantitative models (SIMM model), and most of small financial entities do not have the capacity to handle with the regulatory (and ISDA) requirements for the use of the model.