BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

# Capital Adequacy Framework (Basel III – Risk-Weighted Assets)

## Exposures to Central Counterparties

## Exposure Draft

Applicable to:

1. Licensed banks
2. Licensed investment banks
3. Licensed Islamic banks
4. Financial holding companies

Issued on: 16 December 2022

BNM/RH/ED 029-28

This exposure draft (ED) sets out the proposed capital requirements on financial institutions' exposures to central counterparties (CCP), which is part of the Bank's implementation of Basel III regulatory reforms.

The proposed framework requires financial institutions to capitalise their trade and default fund exposures to CCPs, where the capital requirements are differentiated based on qualifying CCP (QCCP) and non-qualifying CCP. Taking into the account the implementation roadmap of the overall Basel III regulatory reforms, the Bank is proposing the following transitional arrangements:

(a) The exposure value will be calculated based on the existing method to calculate counterparty credit risk capital, namely the Current Exposure Method (CEM) as set out in the risk weighted assets treatment of the *Capital Adequacy Framework.* The CEM will be replaced by the Standardised Approach to Counterparty Credit Risk (SA-CCR) framework when the latter is finalised by the Bank[1]. Financial institutions will be given sufficient time to prepare for the implementation of SA-CCR; and

(b) A standardised 2% risk weight will be applied for the computation of capital requirements for the default fund exposures to Bursa Malaysia Derivatives Clearing Berhad (BMDC). This will be replaced by the full-fledged approach stipulated in paragraph 10 after the SA-CCR comes into effect. For default fund exposures to other QCCPs, financial institutions shall apply the full-fledged approach specified in paragraph 10 on the effective date of this policy document.

In respect of the submission of feedback for the ED–

(a) the Bank invites written feedback on the proposals in this ED, including suggestions for specific issues or areas to be clarified or elaborated further and alternative proposals that the Bank should consider. The responses should specify the applicable paragraph, be constructive and supported with clear rationale and appropriate evidence to facilitate the Bank's assessment;

(b) the feedback received may be made public unless confidentiality is specifically requested for the whole or part of the submission;

(c) in addition to providing general feedback, financial institutions are expected to respond to the specific questions set out in the ED;

(d) the feedback must be submitted electronically by 17 February 2023 to pfpconsult@bnm.gov.my; and

(e) in the course of providing your feedback, you may direct queries to Muhammad Rasyad Mohd Razin (rasyad@bnm.gov.my) or Nik Atikah Nik Mustaffa Shapri (nikatikah@bnm.gov.my).

[1] The Bank targets to consult the industry on SA-CCR through an Exposure Draft in 2024.

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# PART A OVERVIEW

## 1. Introduction

1.1 As part of the global financial reforms since 2009, central clearing has become an important mechanism to manage counterparty credit risk through its robust margining requirements and loss sharing framework. Financial institutions are also increasingly involved in derivatives transactions that are centrally cleared.

1.2 This policy document is part of the *Capital Adequacy Framework* and it sets out the requirements to manage the risks arising from financial institutions' exposures to central counterparties in their capacity as a clearing member or as a client of a clearing member.

1.3 The provisions on the applicability of this policy document and the legal provisions pursuant to which this policy document is issued shall be the same as those set out in the following policy documents and paragraphs:

| Policy Document | Paragraph |
|---|---|
| Capital Adequacy Framework (Capital Components) issued on 9 December 2020 | • Paragraph 2 on 'Applicability'<br>• Paragraph 3 of 'Legal Provisions' |
| Capital Adequacy Framework for Islamic Banks (Capital Components) issued on 9 December 2020 | • Paragraph 2 on 'Applicability'<br>• Paragraph 3 of 'Legal Provisions' |

## 2. Effective date

2.1 This policy document will come into effect no earlier than [1 July 2023]. Sufficient notice will be provided to financial institutions before the policy document comes into effect.

2.2 Notwithstanding paragraph 2.1, the following paragraphs shall not come into effect at the effective date of this policy document and are subject to the following transitional arrangements, where applicable:

| Paragraphs | Transitional arrangements |
|---|---|
| Paragraphs 6.3, 9.4, 9.6, 9.7, 9.13 and 9.20, which reference the credit valuation adjustment (CVA) capital requirements, Standardised Approach to Counterparty Credit Risk (SA-CCR) or the Basel III Standardised Approach to Credit Risk (SA-CR) | Financial institutions shall apply the prevailing requirements under the applicable policy documents listed in paragraph 4.1 [2], [3] until the respective framework (i.e. CVA, SA-CCR or Basel III SA-CR[4]) has come into force, upon which the corresponding requirements shall be applied where applicable[5] |
| Paragraphs 10.2 to 10.18 | Financial institutions shall only apply the requirements after the SA-CCR policy document has come into force. |

**Question 1**
With regards to paragraph 2.2, please indicate any additional aspects that the Bank should consider when setting the transitional arrangements for this policy document.

## 3. Interpretation

3.1 The terms and expressions used in this policy document shall have the same meanings assigned to them in the FSA or IFSA, as the case may be, unless otherwise defined in this policy document.

3.2 For the purposes of this policy document–

**"S"** denotes a standard, an obligation, a requirement, specification, direction, condition and any interpretative, supplemental and transitional provisions that must be complied with. Non-compliance may result in enforcement action;

**"G"** denotes guidance which may consist of statements or information intended to promote common understanding and advice or recommendations that are encouraged to be adopted;

"**banking institution**" refers to–
(a) a licensed bank;
(b) a licensed investment bank; and
(c) a licensed Islamic bank, except for a licensed International Islamic bank;

**"central counterparty"** or **"CCP"** refers to a clearing house that interposes itself between counterparties for contracts traded in one or more financial

[2] Financial institutions shall continue to calculate the exposure value for derivatives transactions using the Current Exposure Method until the SA-CCR policy document has come into force.
[3] Financial institutions shall apply the risk weight of the CCP under the credit risk capital requirements in cases where the trade exposures to the CCP would not be eligible for the 2% and 4% risk weights.
[4] Under the Basel III SA-CR, CCP would be considered as a financial institution.
[5] For the avoidance of doubt, there are currently no prevailing Pillar 1 capital requirements for CVA. The capital requirements will be issued in due course.

markets, becomes the buyer to every seller and the seller to every buyer and thereby ensuring the future performance of open contracts. A CCP becomes a counterparty to trade with market participants through a novation, an open offer system, or other legally binding arrangements;

**"clearing member"** refers to a member of, or a direct participant in, a CCP that is entitled to enter into a transaction with the CCP, regardless of whether it enters into trades with a CCP for its own hedging, investment or speculative purposes or whether it also enters into trades as a financial intermediary between the CCP and other market participants;

"**client**" refers to a party to a transaction with a CCP through either a clearing member acting as a financial intermediary, or a clearing member guaranteeing the performance of the client to the CCP;

**"collateral"** includes an asset posted by a financial institution in the form of, but is not limited to, cash, securities and other pledged assets;

**"counterparty credit risk"** refers to the risk that a counterparty to a transaction could default before the final settlement of the transaction's cash flows. An economic loss would occur if the transactions or portfolio of transactions with the counterparty has a positive economic value at the time of default;

"**credit valuation adjustment**" or "**CVA**" refers to an adjustment to the mid-market valuation of the portfolio of trades with a counterparty which reflects the market value of the credit risk. This adjustment may include either the market value of the credit risk of the counterparty, or the market value of the credit risk of both the financial institution and the counterparty;

**"current exposure"** means the larger of zero or the current market value of a transaction or portfolio of transactions within a netting set with a counterparty that would be lost upon the immediate default of the counterparty, assuming no recovery on the value of those transactions in bankruptcy. Current exposure is often also called Replacement Cost;

**"default fund"** refers to a fund established by a CCP comprising the clearing members' funded or unfunded contributions towards, or underwriting of, a CCP's mutualised loss sharing arrangements. The determination as to whether the fund is a default fund shall be based on the substance of the arrangements, rather than the description given by a CCP. The fund may be also known as clearing deposits or guaranty fund;

**"exposure value"** refers to the exposure amount under SA-CR or the exposure at default (EAD) under the internal-ratings based (IRB) approach to credit risk, as the case may be;

**"financial institution"** refers to a banking institution or a financial holding company, as the case may be;

**"financial holding company"** or **"FHC"** refers to a financial holding company approved pursuant to section 112(3) of the FSA or section 124(3) of the IFSA and holds investment directly or indirectly in corporations that are engaged predominantly in banking business;

"**initial margin**" refers to the funded collateral of a clearing member, or a client of a clearing member, posted to a CCP to mitigate the potential future exposure of the CCP to the clearing member arising from the possible future change in the value of their transactions. It includes the collateral deposited in excess of the minimum amount required, provided that there are appropriate arrangements by the CCP or the clearing member to prevent the withdrawal of these excess collateral by the clearing member or the client of a clearing member. In a case where the CCP uses the initial margin to mutualise losses among the clearing members, the collateral shall not be included in the calculation of counterparty credit risk capital requirements and it shall be treated as a default fund exposure to the CCP;

**"long settlement transaction"** refers to a transaction where a counterparty undertakes to deliver a security, a commodity, or a foreign exchange amount against cash, other financial instruments, or commodities, or vice versa, at a settlement or delivery date that is contractually specified as more than the lower of the market standard for this particular instrument and five business days after the date on which the financial institution enters into the transaction;

**"margin lending"** refers to transactions where a financial institution extends credit in connection with the purchase, sale, carrying or trading of securities. Margin lending transactions do not include other loans that happen to be secured by securities that are posted as collateral to the financial institution;

**"margin period of risk"** or **"MPOR"** refers to an estimated time period from the last exchange of collateral covering a netting set of transactions with a defaulting counterparty until the counterparty is closed out and the resulting market risk is re-hedged;

**"offsetting transaction"** refers to the transaction leg between a clearing member and the CCP when the clearing member acts on behalf of a client, for example when a clearing member clears or novates a client's trade;

"**qualifying central counterparty"** or **"QCCP"** refers to an entity that is defined under paragraph 7.1;

**"securities financing transactions"** or **"SFTs"** refers to transactions where its value depends on market valuations and the transactions are often subject to margin agreements. This includes–

(a) a repurchase agreement transaction;
(b) a reverse repurchase agreement transaction;
(c) a securities/commodities lending or borrowing transaction;
(d) a margin lending transaction;
(e) a collateralised *murabahah* arrangement; and

(f) a sell and buyback agreement transaction;

**"Skim Perbankan Islam"** or **"SPI"** refers to a licensed bank or licensed investment bank that has been approved under section 15(1)(a) of the FSA to carry on Islamic banking business;

"**trade exposures**" refers to the current exposure, the potential future exposure and the initial margin of a clearing member, or a client of a clearing member, to a CCP arising from OTC derivatives transactions, exchange-traded derivative transactions, SFTs and long settlement transactions. The current exposure also includes any variation margin due to the clearing member that has not yet been received;

"**variation margin**" refers to the funded collateral of a clearing member, or a client of a clearing member, posted on a daily or intraday basis to a CCP based upon price movements of the transactions.

## 4. Related legal instruments and policy documents

4.1 This policy document must be read together with other relevant legal instruments, policy documents and guidelines that have been issued by the Bank, in particular–

(a) *Capital Adequacy Framework (Basel II – Risk-Weighted Assets)* issued on 3 May 2019;
(b) *Capital Adequacy Framework (Capital Components)* issued on 9 December 2020*;*
(c) *Capital Adequacy Framework for Islamic Banks (Capital Components)* issued on 9 December 2020*;*
(d) *Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets)* issued on 3 May 2019; and
(e) *Risk-Weighted Capital Adequacy Framework (Basel II) – Internal Capital Adequacy Assessment Process (Pillar 2)* issued on 2 December 2011.

## 5. Policy documents superseded

5.1 This policy document supersedes the following–

(a) Paragraphs 4 and 5 of Appendix VIII (Counterparty Credit Risk and Current Exposure Method) in the policy document on *Capital Adequacy Framework (Basel II – Risk-Weighted Assets)* issued on 3 May 2019; and
(b) Paragraphs 4 and 5 of Appendix VI (Counterparty Credit Risk and Current Exposure Method) in the policy document on *Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets)* issued on 3 May 2019.

# PART B POLICY REQUIREMENTS

## 6. Scope of application

**S** 6.1 The requirements in this policy document shall apply to financial institutions' exposures to CCP arising from over-the-counter (OTC) derivatives transactions, exchange-traded derivatives transactions, securities financing transactions (SFTs) and long settlement transactions.

**S** 6.2 Exposures arising from the settlement of cash transactions in equities, fixed income, spot foreign exchange and spot commodities are not subject to the requirements[6] in this policy document. For the avoidance of doubt, the settlement of cash transactions remains subject to the capital treatment for failed trades and non-delivery-versus-payment (non-DVP) transactions under the *Capital Adequacy Framework* as set out in the policy documents listed in paragraph 4.1.

**S** 6.3 Where the clearing member-to-client leg of an exchange-traded derivatives transaction is conducted under a bilateral agreement, a financial institution either in its capacity as a clearing member or as a client of a clearing member shall treat the transaction as an OTC derivative transaction and calculate the CVA capital requirements for such exposures.

**Question 2**
A financial institution may involve in centrally cleared transactions via a multi-level client structure. Under this structure, the clearing services are provided by an entity that is not a direct clearing member of a CCP, for example a client of a clearing member.

The Bank is presently assessing whether a financial institution that is involved in centrally cleared transactions via a multi-level client structure would need to treat them as bilateral trades. Consequently, the financial institution shall apply the risk weights under the credit risk capital requirements (and not the 2% or 4% risk weights for centrally cleared transactions as outlined in this policy document).

The Bank invites the industry to provide views on this proposed treatment. Where there are alternative views for lower risk weights, these views should be supported by strong justifications.

**Question 3**
With regards to paragraph 6.3, please state whether your institution has any bilateral arrangements for exchange-traded transactions, either as a clearing member or as a client.

[6] For contributions to prefunded default funds covering settlement risk-only products, the applicable risk weight is 0%.

## 7. Qualifying CCP

**S** 7.1 A financial institution shall be responsible in determining whether a CCP is a QCCP based on the following criteria:

(a) the CCP is an entity that is authorised by an appropriate authority in its jurisdiction to operate as a CCP (including an authorisation granted by way of confirming an exemption);

(b) the CCP is based in a jurisdiction where it is subject to prudential supervision of a CCP regulator that applies to the CCP domestic rules and regulations that are consistent with the Principles for Financial Market Infrastructures (PFMI) issued by the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions on an ongoing basis; and

(c) the CCP meets the requirements under paragraph 10 in order to permit the financial institution to calculate the capital requirements for their default fund exposures.

**S** 7.2 Where a CCP is in a jurisdiction where it is not subject to PFMI, a financial institution shall apply the capital requirements under paragraph 11 for its trade exposures and default fund contributions to the CCP unless the Bank determines otherwise.

**S** 7.3 A financial institution shall provide to the Bank a list of CCPs to which it has exposures to, as and when requested by the Bank. The financial institution shall, if required by the Bank, revise the status of a CCP based on its evaluation of the QCCP criteria as specified in paragraph 7.1.

**S** 7.4 When a financial institution is clearing transactions listed under paragraph 6.1 through a QCCP, the financial institution shall apply the capital requirements under paragraphs 9 and 10 for its trade exposures and default fund contributions to the CCP[7].

**S** 7.5 In the case where the sum of a financial institution's capital requirements for its trade exposures and default fund contributions to the QCCP is higher than the total capital requirement that would be applied to the same exposures under paragraph 11 if the CCP were a non-qualifying CCP, the financial institution shall cap the capital required at the latter amount.

**S** 7.6 In the event where a CCP ceases to be a QCCP because it no longer meets any of the conditions as set out in paragraph 7.1, a financial institution shall continue to account for the exposures to the CCP as though it is still a QCCP for the next three months unless the Bank requires otherwise. Thereafter, the financial institution is required to capitalise the exposures to the CCP based on paragraph 11.

[7] For the avoidance of doubt, a financial institution shall apply the capital requirements under paragraphs 9 and 10 to the transactions listed under paragraph 6.1 that are cleared through Bursa Malaysia Derivatives Clearing Berhad (BMDC) as well as on the default fund contributions to BMDC.

**Question 4**

(a) Please share the list of CCPs which your institution has transactions with, either directly (i.e. as a clearing member of CCP) or indirectly (e.g. via a clearing member of a CCP), and please indicate whether they meet the QCCP criteria as specified in paragraph 7.1.

(b) Please share your institution's processes, if any, that are undertaken to establish whether a CCP is a QCCP at the initial recognition stage as well as on an ongoing basis.

(c) With regards to paragraph 7.6, please provide your views on whether a three-month window is sufficient to make the necessary adjustments in the event a CCP ceases to qualify as a QCCP (for example, switching to another QCCP). If not, please suggest an alternative proposal that is supported by well-grounded justifications.

## 8. Risk management requirements for centrally cleared exposures

**S** 8.1 A financial institution shall maintain adequate capital for its exposures to all CCPs. In particular, a financial institution shall consider whether it needs to hold capital in excess of the minimum capital requirements as part of its Internal Capital Adequacy Assessment Process (ICAAP) based on the following events which include but are not limited to:

(a) its dealings with a CCP which may give rise to riskier exposures;

(b) where the financial institution is not able to establish that the CCP meets the definition of a QCCP; or

(c) an external assessment[8] has found material shortcomings in the CCP or the regulation of the CCP, and the CCP or the CCP regulator has not addressed the issues identified.

**S** 8.2 A financial institution that acts as a clearing member shall undertake appropriate scenario analysis and stress testing to determine whether the level of capital held against exposures to a CCP adequately addresses the inherent risks of those transactions. This assessment shall include potential future or contingent exposures resulting from future drawings on default fund commitments, and from secondary commitments to take over or replace offsetting transactions from clients of another clearing member in the event of a default or an insolvency of the clearing member, where applicable.

**S** 8.3 A financial institution shall monitor and report to its senior management and Board on a regular basis, at minimum, its overall exposures to CCPs, including exposures arising from trading through a CCP and exposures arising from CCP membership obligations such as default fund contributions.

**Question 5**

(a) Please indicate whether your institution is currently a clearing member of a CCP, and whether your institution has any plans in the foreseeable future to expand the clearing services to clients or migrate bilateral transactions that are not mandated to be centrally cleared towards central clearing.

[8] For example, a Financial Sector Assessment Program by the International Monetary Fund.

| | |
|---|---|
| (b) | Please share your institution's specific practices on scenario analysis and stress testing, if any, to manage the additional risks associated with providing clearing services and becoming a clearing member of a CCP. These include arrangements where the stress testing and scenario analysis exercises are conducted together with the CCP. |
| (c) | Please state whether your institution currently holds capital in excess of the minimum capital requirements to account for the risks associated with providing clearing services and becoming a clearing member of a CCP. If so, please indicate the quantum as a % of the Total Capital Ratio. |

## 9. Trade exposures to qualifying CCPs

***Exposures to a QCCP where a financial institution is a clearing member***

**S** 9.1 A financial institution shall apply a 2% risk weight to its trade exposures to the QCCP arising from transactions entered for the financial institution's own purpose.

**S** 9.2 A financial institution shall also apply a 2% risk weight to its trade exposures to the QCCP that arise when the financial institution is obligated to reimburse the clients for any losses from changes in the value of its transactions in the event that the QCCP defaults.

**S** 9.3 A financial institution shall calculate the exposure value for its trade exposures in accordance with the relevant policy documents as listed in paragraph 4.1.

**S** 9.4 With respect to paragraph 9.3, a financial institution shall apply the following computation:

(a) in a case where the netting set does not contain illiquid collateral or exotic trades[9] and there are no disputed trades within the netting set[10], the floor of 20 business days[11] for netting sets where the number of trades exceeds 5,000 does not apply;

(b) in all cases, a minimum MPOR of 10 business days must be used for OTC derivatives; and

(c) where a QCCP retains variation margin against certain trades and the clearing member collateral is not protected against the insolvency of the QCCP, the minimum time risk horizon applied to the financial institution's trade exposures on these trades must be the lesser of one year and the remaining maturity of the transactions, with a floor of 10 business days.

[9] Must be determined in the context of stressed market conditions. These are characterised by the absence of continuously active markets where a counterparty would, within two or fewer days, obtain multiple price quotations that would not move the market or represent a price reflecting a market discount (in the case of collateral) or premium (in the case of a trade).

[10] For the avoidance of doubt, this refers to no margin call disputes on a particular netting set.

[11] Specifically, the MPOR floor under SA-CCR and minimum holding period under Basel III SA-CR.

**Question 6**
Does your institution foresee operational challenges to implement paragraph 9.4? If so, please provide views on specific areas that should be clarified to ease the implementation of the requirements.

**S** 9.5 Where the settlement of transactions is legally enforceable on a net basis in an event of default, regardless of whether the counterparty is insolvent, bankrupt, or in liquidation, a financial institution shall only calculate the total replacement cost of all contracts relevant to the trade exposures as a net replacement cost if the applicable close-out netting sets meet the requirements set out in the relevant policy documents as listed in paragraph 4.1[12]. If the financial institution is not able to demonstrate that the netting agreements meet these requirements, the financial institution shall regard each single transaction as a netting set of its own for the calculation of trade exposures.

***Exposures to clients where a financial institution is a clearing member***

**S** 9.6 A financial institution shall capitalise its trade exposures to clients as bilateral trades, irrespective of whether the financial institution guarantees the trade or acts as a financial intermediary between the client and the QCCP. In this regard, the financial institution shall–

(a) assign the risk weights of the clients under the credit risk capital requirements and calculate the exposure value, in accordance with the relevant policy documents as listed in paragraph 4.1; and

(b) apply the CVA capital requirements.

**S** 9.7 In respect of paragraph 9.6(a), a financial institution shall capitalise its exposure to clients by applying an MPOR of at least 5 days under the SA-CCR[13]. The reduced exposure value shall also be used to calculate the CVA capital requirement.

**S** 9.8 A financial institution shall only recognise a collateral[14] for both the QCCP-clearing member leg and the clearing member-client leg of the client-cleared trade if the financial institution collects the collateral from a client for client-cleared trades and this collateral is passed on to the QCCP.

***Exposures to a QCCP where a financial institution is a client***

**S** 9.9 Subject to the conditions in paragraph 9.10, a financial institution shall also apply the treatment as set out in paragraphs 9.1 and 9.3 to 9.5 to the following trade exposures:

(a) exposures to a clearing member where the financial institution is the client, and the transactions arise as a result of the clearing member

[12] To the extent that the requirements include the term “master agreement” or the phrase “a netting contract with a counterparty or other agreement”, this terminology must be read as including any enforceable arrangement that provides legally enforceable rights of set-off.

[13] The lower floor for MPOR is to recognise the shorter close-out period for client cleared transactions.

[14] Including the initial margin posted by clients to the financial institution, which mitigates the exposure the financial institution has against these clients.

acting as a financial intermediary (i.e. the clearing member completes an offsetting transaction with a QCCP); or

(b) exposures to a QCCP where the financial institution is the client and the clearing member guarantees the performance of the financial institution's exposure to the QCCP.

**S** 9.10 For the purpose of paragraph 9.9, the conditions which must be met by a financial institution are as follows:

(a) the offsetting transactions are identified by the QCCP as client transactions;

(b) the collateral to support the offsetting transactions is held by the QCCP or the clearing member, or both, under arrangements that prevent any losses to the client due to:

(i) the default or insolvency of the clearing member;

(ii) the default or insolvency of the clearing member's other clients; and

(iii) the joint default or insolvency of the clearing member and any of its other clients;

(c) upon the insolvency of the clearing member, there is no legal impediment (other than the need to obtain a court order as required or entitled by the client) to transfer the collateral belonging to the clients of a defaulting clearing member to the QCCP, to one or more surviving clearing members, or to the clients or their respective nominees;

(d) the financial institution has conducted sufficient legal review and has a well-founded basis to conclude that, in the event of a legal challenge, the relevant courts and administrative authorities under their respective jurisdictions would find that the arrangements would be legal, valid, binding and enforceable under the relevant laws of the relevant jurisdictions. The financial institution shall undertake further review as necessary to ensure continuing enforceability of the arrangements; and

(e) the relevant laws, regulations, rules, contractual or administrative arrangements provide that the offsetting transactions with the defaulted or insolvent clearing member are highly likely to continue to be indirectly transacted through the QCCP, or by the QCCP. In such circumstances, the client positions and collateral held with the QCCP will be transferred at market value unless the financial institution requests to close out the position at market value.

**S** 9.11 With regards to paragraph 9.10(e), a financial institution shall consider whether the offsetting transactions are highly likely to be ported based on prevailing market practices and precedence. These include whether there is a clear precedent for transactions to be ported at a QCCP and that there is a clear industry intent for such practices to continue. The financial institution shall not determine that the trades are highly likely to be ported solely on the basis that the QCCP documentation that does not prohibit client trades from being ported.

**S** 9.12 Where the condition in paragraph 9.10(b)(iii) is not met but all other conditions in paragraph 9.10 are met, a financial institution shall apply the treatment as

set out in paragraphs 9.3 to 9.5, together with a risk weight of 4%, to the financial institution's trade exposures as listed in paragraph 9.9.

**S** 9.13 For cases where a financial institution cannot apply the treatment in paragraphs 9.9 and 9.12, the financial institution shall capitalise its trade exposures as bilateral trades. In this regard, the financial institution shall assign the risk weight of the clearing member under the credit risk shall–

(a) assign the risk weights of the clients under the credit risk capital requirements and calculate the exposure value, in accordance with the relevant policy documents as listed in paragraph 4.1; and

(b) apply the CVA capital requirements.

**Question 7 (for financial institutions that are clients)**
Would your institution be able to apply the treatment in paragraph 9.9 or 9.12? If not, please highlight the specific conditions in which your institution cannot meet now. If these conditions cannot be met by 1 July 2023, please suggest a specific timeline where your institution would be able to apply such treatment.

***Treatment of posted collateral***

**S** 9.14 A financial institution shall continue to apply the relevant risk weights on any collateral posted, including excess initial margin or variation margin, based on the prevailing banking book or trading book treatment under the *Capital Adequacy Framework* as set out in the policy documents listed in paragraph 4.1, regardless of whether such assets have been posted as a collateral to a QCCP.

**S** 9.15 In the case where a collateral posted with a QCCP or a clearing member is not held in a bankruptcy-remote manner, a financial institution shall apply the counterparty credit risk capital requirements to the collateral by recognising the credit risk based on the risk of loss of these collateral due to the creditworthiness of the entity holding such collateral[15].

**S** 9.16 Where a collateral is included in the definition of trade exposures and is held by a custodian[16] and bankruptcy-remote from the QCCP, a financial institution shall apply zero counterparty credit risk capital requirements to the collateral.

**S** 9.17 Where a collateral is included in the definition of trade exposures, held by the QCCP and not held in a bankruptcy-remote manner, a financial institution shall apply the following risk weights to the collateral:

(a) a 2% risk weight, where the financial institution is a clearing member;

(b) a 2% risk weight, where the financial institution is a client and applies the treatment in paragraph 9.9;

[15] The requirements include, but not limited to, increasing the counterparty credit risk exposure due to the application of haircuts.

[16] Custodian may include a trustee, agent, pledgee, secured creditor or any other person that holds property in a way that does not give such person a beneficial interest in such property and will not result in such property being subject to legally enforceable claims by the creditors of such persons, or to a court-ordered stay of the return of such property, should such person become insolvent or bankrupt.

(c) a 4% risk weight, where the financial institution is a client and applies the treatment in paragraph 9.12; or
(d) the risk weight of the clearing member, where the financial institution is a client and applies the treatment in paragraph 9.13[17].

**S** 9.18 Notwithstanding paragraph 9.17 (a), the financial institution shall apply zero counterparty credit risk capital requirements to the collateral collected from a client and posted to the QCCP where–
(a) the collateral is not held in a bankruptcy-remote manner; and
(b) the financial institution is not obligated to reimburse the client for any loss of the posted collateral in the event that the QCCP defaults.

**S** 9.19 For collateral that is not included in the definition of trade exposures and is not posted as a default fund contribution, a financial institution shall apply the counterparty credit risk capital requirements to the collateral by assigning such collateral with the risk weight of the QCCP under the credit risk capital requirements in accordance with the relevant policy documents as listed in paragraph 4.1.

**S** 9.20 In respect of the calculation of the exposure value, a financial institution shall account for all collaterals posted that are not held in a bankruptcy-remote manner in the net independent collateral amount term[18] under SA-CCR.

**Question 8**
Does your institution foresee that capital needs to be set aside for counterparty credit risk capital requirements on the collateral posted? If so, please highlight the specific cases (e.g. collateral not included in definition of trade exposures, collateral not held in bankruptcy-remote manner) and the materiality of the capital requirements.

[17] For the avoidance of doubt, similar treatment applies in the case where a collateral is included in the definition of trade exposures, but the collateral is held by a clearing member and not held in a bankruptcy-remote manner.
[18] Net independent collateral amount (NICA) represents any collateral (segregated or unsegregated) posted by the counterparty less the unsegregated collateral posted by the financial institution.

## 10. Default fund exposures to qualifying CCPs

**S** 10.1 As part of the transitional arrangement for this policy document, a financial institution shall–

(a) apply a 2% risk weight to its default fund exposures to Bursa Malaysia Derivatives Clearing Berhad; and

(b) capitalise its default fund exposures to any other QCCP based on the requirements in paragraphs 10.3 to 10.16.

**S** 10.2 A financial institution shall determine the capital requirement for its default fund exposures to the QCCP in accordance with paragraphs 10.3 to 10.16, upon the expiry of the transitional arrangement in paragraph 10.1.

**G** 10.3 The capital requirement for a financial institution's default fund contributions to the QCCP is determined according to a risk-sensitive formula that considers the size and quality of the QCCP's financial resources, the counterparty credit risk exposures of the QCCP and the application of the QCCP's financial resources via its loss bearing waterfall structure, in the event of default by one or more clearing members.

**S** 10.4 Where a default fund of the QCCP is shared between products or types of business with settlement risk only[19] and products or types of business which give rise to counterparty credit risk[20], a financial institution shall apply the capital requirements for all its default fund exposures to the QCCP, without apportioning to the different classes or types of business or products.

**S** 10.5 Where the contributions from clearing members to a default fund of the QCCP are segregated by products or types of business (product types) and only accessible for specific product types, a financial institution shall apply the capital requirements for the default fund exposures for each specific product type giving rise to counterparty credit risk. If the QCCP's prefunded own resources are shared among product types, the financial institution shall ensure that the funds are allocated to each of the calculations in proportion to the respective product-specific exposure value.

**S** 10.6 The calculations of the capital requirement for a financial institution's default fund contributions to the QCCP may be performed by the financial institution, the QCCP, the QCCP supervisor or any other entity with access to the required data. These include calculations of the hypothetical capital requirement of QCCP ($K_{CCP}$), the total prefunded default fund contributions from all clearing members ($DF_{CM}^{pref}$) and the QCCP's own prefunded resources which are contributed to the default waterfall, where these are junior or *pari passu* to the prefunded clearing members' default fund contributions ($DF_{CCP}$). Where the financial institution relies on another entity to undertake any of these calculations, the financial institution shall ensure that the capital

[19] For example, cash transactions in equities and bonds.

[20] OTC derivatives transactions, exchange-traded derivative transactions, SFTs and long settlement transactions.

requirements are calculated according to paragraphs 10.9 to 10.15 and that the following conditions are met:

(a) the entity performs the calculations of $K_{CCP}$, $DF_{CM}^{pref}$ and $DF_{CCP}$ in a transparent manner that allows the QCCP supervisor to oversee those calculations;
(b) the entity shares sufficient information of the calculation results to allow the financial institution to calculate the capital requirement for its default fund contributions, and to allow the Bank to review and confirm the calculations;
(c) the entity calculates $K_{CCP}$ on a quarterly basis at a minimum, or more frequently if so by required by the Bank in case of material changes[21];
(d) the entity performing the calculations makes available to the Bank on a quarterly basis at a minimum, or more frequently if required by the Bank, sufficient aggregate information about the composition of the QCCP's exposures to clearing members and the information provided to the financial institution for the purposes of calculating $K_{CCP}$, $DF_{CM}^{pref}$ and $DF_{CCP}$; and
(e) the entity calculates $K_{CCP}$ on a quarterly basis, and whenever there are material changes to the number or exposures of transactions cleared by the QCCP, or material changes to the financial resources of the QCCP.

**S** 10.7 The risk-sensitive capital requirement for a financial institution's default fund contribution ($K_{CM_{FI}}$) to a QCCP is obtained in two steps as follows:

(a) determine the $K_{CCP}$ due to the counterparty credit risk exposures of the QCCP to all its clearing members and their clients; and
(b) apply the capital requirement for the financial institution based on the formula and inputs specified in paragraph 10.16.

***First step: Hypothetical capital requirement of the QCCP***

**G** 10.8 The $K_{CCP}$ is a hypothetical capital requirement for a QCCP, calculated on a consistent basis for the sole purpose of determining the capitalisation of the clearing members' default fund contributions. It does not represent the actual capital requirements of the QCCP.

**S** 10.9 For purposes of paragraph 10.8, the following formula shall be used to calculate the $K_{CCP}$:

$$K_{CCP} = \sum_{CM_i} EAD_i \times RW \times \text{capital ratio}$$

whereby–

(a) CM is the clearing member;
(b) the sum (Σ) is over all clearing member accounts;
(c) $EAD_i$ is the exposure value of the QCCP to clearing member "*i*", relating to the valuation at the end of the regulatory reporting date before the margin called on the final margin call of that day is exchanged. The exposure includes the clearing member's own transactions and client

[21] For example, the clearing of a new product by a QCCP.

transactions guaranteed by the clearing member, as well as all values of collateral held by the QCCP (including the clearing member's prefunded default fund contribution) against these transactions;

(d) RW is a risk weight of 20%, except where the Bank has communicated a higher risk weight[22]; and

(e) the capital ratio is 8%.

**S** 10.10 Where a clearing member provides client clearing services, and the client transactions and collateral are held in a separate (individual or omnibus) sub-accounts to the clearing member's proprietary transactions, each of such client sub-account shall be included in the sum of $EAD_i$ in the formula under paragraph 10.9 separately. In this regard, the exposure value of the QCCP to clearing member "*i*" is the sum of the exposure value of the client sub-accounts and the exposure value of any house sub-account[23]. If any of these sub-accounts contain both the derivatives and SFTs, the EAD of that sub-account is the sum of the derivatives EAD and the SFT EAD.

**S** 10.11 In the case where the collateral is held against an account containing both derivatives and SFTs, the prefunded initial margin provided by the clearing member or client must be allocated to the derivatives and SFT exposures in proportion to the respective product specific EADs, calculated according to:

(a) the credit risk mitigation component under SA-CR[24] for SFTs; and

(b) the SA-CCR calculation without including the effects of collateral, for derivatives transactions.

**S** 10.12 In the case where the default fund contributions of a clearing member are not split with regards to client and house sub-accounts, such default fund contributions must be allocated per sub-account according to the respective fraction the initial margin of the sub-account has in relation to the total initial margin posted by or for the account of the clearing member.

**S** 10.13 For derivatives transactions, $EAD_i$ is calculated using the SA-CCR as the bilateral trade exposure the QCCP has against the clearing member and is also subject to the following:

(a) an MPOR of 10 business days must be used to calculate the QCCP's potential future exposures to its clearing members on derivatives transactions. For the avoidance of doubt, the floor of 20 business days on the MPOR for netting sets with more than 5000 trades does not apply; and

(b) all collateral held by a QCCP to which the QCCP would have a legal claim in the event of the default of the clearing member or its client, including the default fund contributions of that member, is used to offset

[22] For example, the Bank may consider increasing the risk weight if the clearing members in a QCCP are not highly rated.

[23] This ensures that the collateral posted by the client and held at the QCCP cannot be used to offset the QCCP's exposures to clearing members' proprietary activity in the calculation of $K_{QCCP}$.

[24] Specifically, the treatment of repo-style transactions covered under master netting agreements.

the QCCP's exposure to that clearing member or client though inclusion in the potential future exposure (PFE) multiplier[25].

**S** 10.14 For SFTs, $EAD_i$ is equal to max ($EBRM_i - IM_i - DF_i$; 0), whereby:

(a) $EBRM_i$ is the exposure value to clearing member "*i*" before risk mitigation as according to the credit risk mitigation component under SA-CR[26]. For the purposes of this calculation, the mark-to-market value of the transactions incorporate the variation margin that has been exchanged before the margin called on the final margin call of that day;

(b) $IM_i$ is the initial margin collateral posted by the clearing member with the QCCP; and

(c) $DF_i$ is the prefunded default fund contribution by the clearing member that will be applied upon such clearing member's default, either along with or immediately following such member's initial margin, to reduce the QCCP loss.

**S** 10.15 With respect to the calculations in paragraphs 10.9 to 10.14:

(a) the standard supervisory haircuts and the holding period requirements for SFTs as set out in the credit risk mitigation component under SA-CR must be applied; and

(b) the netting sets that are applicable to regulated clearing members are the same as paragraph 9.5. For all other clearing members, the netting rules as laid out by the QCCP based upon the notification of each of its clearing members shall be applicable. Notwithstanding this, the Bank has the discretion to require more granular netting sets than those laid out by the QCCP.

***Second step: Capital requirement for each financial institution***

**S** 10.16 A financial institution shall calculate the capital requirement for its default fund contribution ($K_{CM_{FI}}$) based on the following formula:

$$K_{CM_{FI}} = \max\left(K_{CCP} \times \frac{DF_{FI}^{pref}}{DF_{CCP} + DF_{CM}^{pref}}; 8\% \times 2\% \times DF_{FI}^{pref}\right)$$

whereby–

(a) $K_{CM_{FI}}$ is the capital requirement on the default fund contribution of the financial institution;

(b) $DF_{CM}^{pref}$ is the total prefunded default fund contributions from all clearing members;

(c) $DF_{CCP}$ is the QCCP's own prefunded resources[27] which are contributed to the default waterfall and these are junior or *pari passu* to the prefunded clearing members' default fund contributions;

[25] The PFE multiplier reflects the risk-reducing property of collateral, including excess collateral. This multiplier decreases as the excess collateral increases without reaching zero, and is also activated when the current value of derivatives transactions is negative.

[26] Specifically, the treatment of repo-style transactions covered under master netting agreements.

[27] For example, contributed capital and retained earnings.

(d) $DF_{FI}^{pref}$ is the prefunded default fund contribution provided by the financial institution; and
(e) 2% is the risk weight floor on the default fund exposures.

## 11. Exposures to non-qualifying CCPs

**S** 11.1 A financial institution shall compute the capital requirement for its trade exposures to a non-QCCP by–
(a) calculating the exposure value for the trade exposures in accordance with the relevant policy documents as listed in paragraph 4.1; and
(b) applying the risk weight under the SA-CR, based on the category of the exposures, to its trade exposures to the non-QCCP.

**S** 11.2 A financial institution shall apply a risk weight of 1250% to its default fund contribution to a non-QCCP. The default fund contribution shall include both the prefunded and unfunded contributions which are liable to be paid by the financial institution if the non-QCCP so requires.

**G** 11.3 With respect to paragraph 11.2, where there is a liability for unfunded contributions arising from unlimited binding commitments to the default fund of the non-QCCP, the Bank will communicate the amount of unfunded commitments to which the 1250% risk weight applies.