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Financial Services Risk and Regulation

FSRR Hot Topic

CRR2 proposes the EU implementation of Standardised Approach for Counterparty Credit Risk (SA-CCR)

Highlights

On 23 November 2016, the European Commission issued proposed amendments to Regulation (EU) No 575/2013 (the Capital Requirements Regulation or 'CRR').

The amendments form part of a broad legislative package that also includes amendments to the Capital Requirements Directive ('CRD'), the Bank Recovery and Resolution Directive ('BRRD') and the Single Resolution Mechanism Regulation ('SMR').

The proposal for amendments to the Capital Requirements Directive and Regulation, published on 23 November 2016 by the European Commission ('EC'), applies to all banks, building societies and systemically important investment firms. Leading up to the publication by the EC, market participants dubbed the latest European legislative proposal package as 'CRD V', with the changes proposed to the detailed regulations branded 'CRR II'.

In publishing the package, the EC noted: *"The present proposals aim to complete the regulatory reform agenda by tackling remaining weaknesses and implementing some outstanding elements of the reform that are essential to ensure institutions' resilience but have only recently been finalised by global standard setters"*.

This briefing forms part of a series of publications that sets out a summary of the CRR II proposals. Specifically, this note covers the proposals relating to the Standardised Approach for Counterparty Credit Risk ('SA-CCR'), together with comparisons to the SA-CCR standard issued by the Basel Committee on Banking Supervision ('BCBS') and some perspectives on their implications for banks.

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Background and timeline of developments

The case for change – The counterparty credit risk ('CCR') framework[1] within the Basel prudential regime – In respect of derivative transactions – Allowed for capital requirements to be determined using an Internal Model Method ('IMM') or one of two non-internal model methods. The non-internal model methods – Current Exposure Method ('CEM') and Standardised Method ('SM') – Were widely used by firms either in their entirety or for selected derivatives portfolios.

However, both approaches have long been the subject of fierce criticism. The Committee has summarised these as: in the case of the CEM, the most fundamental criticisms are that it fails to differentiate adequately between margined and unmargined transactions, its supervisory add-on factors do not sufficiently capture the level of market volatilities observed over recent stress periods, and it is too simplistic regarding the recognition of hedging and netting benefits because it fails to reflect economically meaningful relationships between derivative positions.

Although more risk-sensitive than the CEM, the SM has also attracted criticism for significant weaknesses. Like the CEM, the SM fails to differentiate adequately between margined and unmargined transactions and its supervisory add-on factors do not sufficiently capture the level of market volatilities observed over recent stress periods.

In addition, the SM's definition of 'hedging set' (a group of identical or similar derivative transactions between an institution and a single counterparty that is subject to a legally enforceable bilateral netting arrangement) was seen to lead to undue operational complexity, and the relationship between key parameters in the calculation (current exposure and potential future exposure) was seen to be misrepresented due to only one of these parameters being capitalised. Finally, the SM did not provide banks with a true non-internal model alternative for calculating EAD because the SM used internal models (typically VaR) or CEM for non-linear transactions.

Global developments – The criticisms of the CEM and SM approaches for calculating CCR exposures led the Committee, in June 2013 to consult on the development of a single non-internal model method[2] to replace both the CEM and SM in the Basel capital framework. The consultation was followed by a joint quantitative impact study designed to assess the capital impact of the proposed methodology, the burden associated with its implementation, and various technical features that merited further quantitative analysis. This consultation was largely welcomed by market participants, albeit with general consensus that there was still room for refinement.

In March 2014, the Committee published its final standard on the new standardised approach for measuring counterparty credit risk exposures[3], widely known as 'SA-CCR'. The Committee noted that its 'objective in undertaking this work was to develop a risk sensitive methodology that appropriately differentiates between margined and unmargined trades, and provides more meaningful recognition of netting benefits than either of the existing non-modelled approaches.' Not surprisingly, the SA-CCR generated a number of interpretation questions as firms began to digest – Practically and operationally – What the new requirements would mean for their derivative positions across their banking and trading books. In August 2015, the Committee published a set of frequently asked questions[4] which covered a range of interpretative and specific technical areas.

European developments – In April 2016, the European Commission issued a call for advice[5] from the European Banking Authority ('EBA') to consider the impact that the SA-CCR methodology would have on EU institutions and to conduct a review of the existing Original Exposure Method under the CRR. The EBA's response[6] was published in November 2016 and also assessed the current derogation for 'small trading activities' contemplated within the CRR, including its use in the context of the CCR framework. Based on its assessment, the EBA outlined a range of recommendations which included, among others:

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[1] The counterparty credit risk is defined as the risk that the 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. Unlike a firm's exposure to credit risk through a loan, where the exposure to credit risk is unilateral and only the lending bank faces the risk of loss, the counterparty credit risk creates a bilateral risk of loss: the market value of the transaction can be positive or negative to either counterparty to the transaction. The market value is uncertain and can vary over time with the movement of underlying market factors.

[2] http://www.bis.org/publ/bcbs254.htm

[3] http://www.bis.org/publ/bcbs279.htm

[4] http://www.bis.org/bcbs/publ/d333.pdf

[5] https://www.eba.europa.eu/documents/10180/1466081/(EBA-2016-E-668)%20CfA+Com+implementation+counterparty+credit+risk,%20Ares(2016)1900009.pdf/2c59c7ee-06bc-41fe-ad02-4dccca04cfef

[6] https://www.eba.europa.eu/documents/10180/1648752/Report+on+SA+CCR+and+FRTB+implementation+%28EBA-Op-2016-19%29.pdf

i. Introducing a threshold for small derivative businesses below which institutions are allowed to use simple approaches currently used for the calculation of CCR capital requirements;

ii. Considering additional solutions to introduce proportionality for banks outside the traditional scope of the Basel standards that could include the use of approaches that are simpler and more conservative than the BCBS proposals; and

iii. Including more granularity in COREP reporting to provide a better overview of firms' CCR exposures and the information needed to monitor the calculation of the different proportionality thresholds included in legislation.

Additionally, while the BCBS proposed an implementation date of 1 January 2017 for the implementation of SA-CCR, its inclusion within the CRD V/CRR II package will effectively result in a 1 January 2019 implementation for European institutions.

Overview of the SA-CCR – SA-CCR effectively replaces both the non-modelled approaches (the CEM and SM) within the Basel framework for the capitalisation of CCR. While retaining some conceptual design features of the CEM, a key component of SA-CCR is to introduce greater levels of risk sensitivity into the calculation approach. Key changes include:

i. Compared to a 60% limit under the CEM, SA-CCR allows for similar trades to attract perfect off-set in a netting set's potential future exposure;

ii. No offset is allowed between the potential future exposures of trades with different underlying asset classes;

iii. Recognition of the mitigating effect of margin agreements and excess collateral is embedded in the calculation, subject to certain prescribed criteria.

In addition, under the BCBS standard, SA-CCR replaces CEM in other aspects of the prudential framework – Including exposures to central counterparties ('CCPs'), leverage ratio and large exposures.

The impact of SA-CCR on capital requirements depends on a firm's netting sets and the derivative portfolios contained therein. SA-CCR may lead to reduced capital requirements, compared to CEM, given the more risk-sensitive nature of the methodology, where derivatives portfolios in netting sets reference the same asset classes. However, firms with derivatives portfolios in netting sets referencing different asset classes may find that SA-CCR increases capital requirements as it removes the ability to net across asset classes and applies an alpha factor of 1.4 – Consistent with the Internal Model Method ('IMM') for market risk.

Summary of the key CRR II proposals

Overview of key changes – In order to introduce SA-CCR into European legislation while ensuring that the new rules remain proportionate, CRR II modifies some definitions and adds certain new definitions to reflect the new method introduced. The Mark-to-Market Method and Standardised Method have been removed and replaced by SA-CCR. Additionally, recognising that the SA-CCR is more complex for institutions to implement, the EC proposed new rules on a 'simplified SA-CCR' in order to assist smaller firms apply the rules in a proportionate manner. The current rules on the Original Exposure Method were modified – In particular, the eligibility criteria for using the OEM. This is largely because the EC recognises that for institutions which have very limited derivatives exposures and which currently use the OEM, both the SA-CCR and the simplified SA-CCR could be too burdensome to implement. Other changes to the prudential framework were also made to incorporate SA-CCR. In particular, the Large Exposure rules were modified to impose the use of the SA-CCR for determining exposures to OTC derivative transactions, even for banks that have been authorised to use internal models.

Differences at EU level compared to the BCBS standard – The table below sets out a number of differences in SA-CCR methodology between the BCBS standard and the EU proposals: The list is not intended to be an exhaustive comparison.

	Basel standard	EU implementation differences
Standardised approach (SA-CCR)	• SA-CCR introduced	• SA-CCR introduced • Eligibility criteria for simplified SA-CCR – Size of the on-and off-balance sheet derivative business is equal to or less than 10% of the institution's total assets and €150m.
Original exposure method (OEM)	• OEM not proposed	• OEM available, but modified. The exposure value is based on simplified Replacement Cost (RC) and Potential Future Exposure (PFE). • Eligibility criteria are modified – Size of the on-and off-balance sheet derivative business is equal to or less than 5% of the institution's total assets and €20m.
Hedging set categories	• Five categories – interest rate risk – foreign exchange risk – credit risk – equity risk – commodity risk.	• Six categories – interest rate risk – foreign exchange risk – credit risk – equity risk – commodity risk – other risk.
Interest rate risk and commodity risk hedging set	• Interest rate risk – There is no mention of transactions with an inflation variable as the primary risk driver being captured within the interest rate risk category. • Commodity risk – Has four sub-categories – Energy, metals, agriculture and other commodities.	• Interest rate risk – Transactions with an inflation variable as the primary risk driver shall be included in separate hedging sets, by currency. • Commodity risk – Has five sub-categories – Energy, metals, agriculture, climatic conditions and other commodities.
Collateral calculation	• The net collateral considered in the replacement cost (RC) calculation is not limited to collateral that is within the netting set.	• The amount of collateral recognised relates to variation margin (VM) and Net Independent Collateral Amount (NICA). This means that only collateral that is part of the relevant netting set can be recognised. Collateral outside netting sets cannot be recognised. • Formula for calculating the volatility-adjusted collateral value is modified for posted collateral. Hfx (volatility adjustment appropriate to currency mismatch) should be added to Hc (Volatility adjustment appropriate to collateral). Previously, Hfx was included in the formula for received collateral only.
Adjusted notional amount calculation (for PFE)	• The supervisory duration for interest rate and credit derivatives is floored at 10 business days.	• There is no mention of the floor of 10 business days for the supervisory duration.

What does this mean for firms?

- SA-CCR is more risk sensitive than either the Standardised Method or the Current Exposure Method (or 'Mark to Market Method' in CRR) that it replaces, but requires significantly more work. SA-CCR is also set to change the capital requirements for many types of derivative.
- Many firms have not had the chance to approach their preparation for the implementation of SA-CCR with the urgency some would have liked, as it fights for attention and resources against other seemingly more pressing changes. Yet, aligning SA-CCR with other developments including the Fundamental Review of the Trading Book ('FRTB'), Initial Margin for Non-Centrally Cleared Derivatives and BCBS 239 (Risk Data Aggregation and Reporting) would capitalise on the considerable synergies in data and evaluation, while giving business teams a much better indication of the overall impact on pricing and returns.
- While there are considerable overlaps in the source data, calculation and reporting between SA-CCR and these other incoming demands, in our view, leading firms would also find it valuable to build SA-CCR into an updated target operating model that embraces the broader regulatory agenda – Including the leverage ratio, stress testing and other overlapping regulatory evaluation and reporting demands.
- The complexities and business impact of SA-CCR raise a number of dilemmas for banks. For example, one of the key points of discussion among many firms was whether the risk or finance function should take the lead in managing SA-CCR. While some views suggest that the risk function is ideally equipped to analyse, understand and explain the risk sensitivities, others feel finance is best placed to manage the reporting process. However, all stakeholders would agree on the importance of close collaboration between risk and finance teams, with some firms considering setting up dedicated joint ventures responsible for exposure data or integrated operating models akin to the ones being developed for stress testing. The significance of the capital impacts of SA-CCR mean that business units should be closely involved from the outset.
- We believe there are four key considerations that will need to be addressed to ensure firms are ready to move over to SA-CCR and make the most of the synergies with other developments:
  1. Identify parallel demands and take advantage of the opportunities to develop a common, integrated implementation programme.
  2. Design the target operating model and front-to-back process with clear roles, responsibilities and accountabilities.
  3. Identify who needs to supply, analyse, verify and aggregate the data across risk, finance and business teams and how they can collaborate most effectively.
  4. Assess the impacts of SA-CCR on capital requirements, and identify options for mitigating its impacts through considering new trade structures, portfolio effects and commercial strategy.

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Financial Services Risk and Regulation

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