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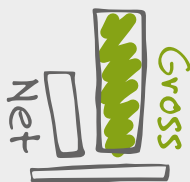
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SA-CCR shortcomings and untested impacts

SA-CCR impacts across the regulatory framework

The Standardised Approach for Counterparty Credit Risk (SA-CCR) is a methodology to calculate the capital required to address the risk that the counterparty to a derivative contract will not live up to its contractual obligations. It is a replacement for two existing 'simple' and outdated non-modelled exposure methods – the Current Exposure Method (CEM)¹ and the Standardized Method (SM).

While SA-CCR is intended to address some of the long-standing criticisms of the CEM and SM approaches, it still has several shortcomings, including its calibration and lack of recognition of margining and netting, which result in significantly overstated exposures. This could severely impact the availability and pricing of hedging products for end users. Moreover, the full impact resulting from the implementation of SA-CCR remains untested. It is therefore imperative that the shortcomings of SA-CCR be remedied, as well as a full impact study on its calibration and its aggregate impact performed, before it is implemented through the CRR.



Shortcomings

Calibration

The calibration of SA-CCR needs to be adjusted to avoid unjustified and disproportionate increases in exposures and capital requirements, particularly for equity derivative and foreign exchange derivative exposures, which are most affected. The Basel Committee intends to review the calibration of SA-CCR in the future. However, this review will be too late for the European implementation, which needs to be addressed in CRR II / CRD V. A short-term fix to address the undue conservative calibration is to remove the "alpha" multiplier used to calculate exposures. The multiplier is not relevant for the very conservatively calibrated SA-CCR measure for the reasons set out in the AFME-ISDA position paper², including the multiplier being based on a study from 2003 - a study which was for the internal models approach and is now out of date.

SA-CCR does not adequately reflect risk reducing measures

Since the publication of SA-CCR in 2014 by Basel, regulators have introduced rules requiring initial margin (collateral) to be posted for non-cleared derivatives, which significantly reduces counterparty credit risk. However, the design and calibration of SA-CCR does not adequately reflect the risk reducing effect of margin which leads to unduly conservative capital requirements. Such requirements are not representative of the risk and not representative of the legal enforceability of the collateral. Furthermore, although legal agreements recognise netting across products, accounting standards recognise netting and prudent risk management is performed on this basis, SA-CCR does not allow netting across different products.

Cost of hedging for end-users may increase

In SA-CCR, unmargined directional positions³, which are typical of derivative hedges used by end-users (particularly corporates, pension funds and sovereign funds) attract the highest capital requirements. The capital requirements for these portfolios is estimated at 2 – 4 times higher (see box on next page) than the requirements they currently attract under CEM. This is notwithstanding the potential impact from implementing SA-CCR across other elements of the framework as outlined below. This may constrain banks' ability to support end-users' demand for derivative products at an acceptable cost. If increased costs are passed on, they are likely to inhibit the ability of end-users to use derivative instruments to hedge their risks, leading to an increasing risk left in the real economy, particularly corporates, pension funds and sovereign funds. Users typically do not have the systems or collateral to support margining and therefore have no alternative to unmargined derivative products, which are crucial for structural reasons (many EU end-users strongly rely on derivatives for supporting their exportations).

² <https://www.afme.eu/globalassets/downloads/consultation-responses/afme-prd-sa-ccr-final-paper.pdf>

³ Unmargined direction positions are derivative portfolios in which variation margin is not exchanged and the net positions are either long or short positions i.e. positions that are not perfectly hedged.

¹ Current Exposure Method is known as the Mark-to-Market method in the CRR (Article 274)

Untested: Aggregate SA-CCR impacts

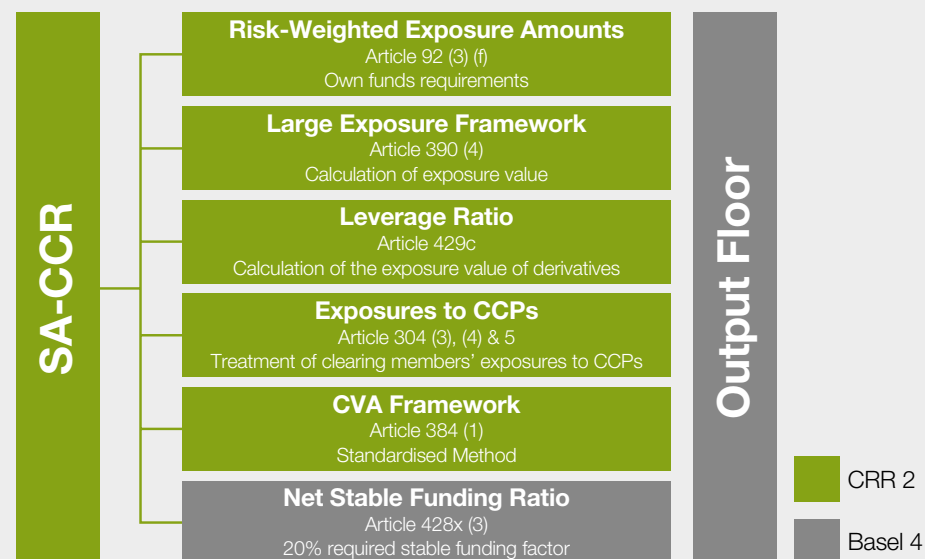
SA-CCR will be used in many areas across the prudential framework and will affect all banks and users of derivatives. The impact will not be restricted to the small institutions for which SA-CCR was designed. However, the full impact of SA-CCR has not been assessed as current estimates do not consider the impact of SA-CCR's interactions with other areas of the prudential framework. As currently set out in the CRR2 proposals, SA-CCR will:



- Replace** internal models in the Large Exposure framework. This creates an un-level playing field with the US where the equivalent US regime (Single Counterparty Credit Limits or SCCL) currently allows internal models.
- Replace** CEM in the leverage ratio and may affect the calibration of the leverage ratio as a non-risk based backstop measure.
- Be used** for the Central Counterparty ("CCP") hypothetical capital calculation and in the calculation of exposures for the CVA risk capital requirements.
- Be part of** an output floor for capital requirements and for calculating the net stable funding ratio subject to ongoing work in Basel, which may present significant additional issues.

To date, no impact assessment has been performed by standard setters on the **aggregate impact** of SA-CCR across the prudential framework. EBA's reply to a call for advice notes that *"both the impact and the scale of potential implementation issues may have been underestimated."*⁴ As such, it is imperative that the interactions in all areas of the prudential framework are reviewed and a full impact study on the calibration and aggregate impact of SA-CCR **across the prudential framework**⁵ is performed before its implementation.

It is imperative that a full impact study on the calibration and aggregate impact of SA-CCR is performed



Box: Preliminary Impact Study

A quantitative impact study of SA-CCR was performed using a set of hypothetical portfolios defined by Basel that highlights the significantly higher calibration of SA-CCR versus CEM and internal model methods (IMM), for both margined and unmargined portfolios. Note, this study is limited to the impact on counterparty credit risk exposures and does not consider impacts of SA-CCR in other areas of the prudential framework:

EAD comparisons	SA-CCR v IMM	SA-CCR v CEM
Unmargined portfolio i.e. End-user portfolio	SA-CCR 1.9 – 2.5 times higher	SA-CCR 2 – 4 times higher
Margined portfolio	SA-CCR 1.9 – 2.8 times higher	Broadly in line

For certain portfolios, including those covered by initial margin, the difference can be even larger, with SA-CCR exposures more than 10 times greater than under both CEM and IMM for portfolios tested.

The comparison versus CEM is indicative of the direct impact of implementing SA-CCR on an institution's counterparty credit risk capital requirement. The comparison with IMM is relevant for Large Exposure requirements where SA-CCR will be mandated and subsequently available limits will be reduced, and when a standardised approach output floor is introduced.

⁴ <http://www.eba.europa.eu/about-us/missions-and-tasks/calls-for-advice>

⁵ See ISDA-AFME position paper for details on the issues and recommendations for improving SA_CCR: <https://www.afme.eu/globalassets/downloads/consultation-responses/afme-prd-sa-ccr-final-paper.pdf>

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