
AFME Position Paper

CRD 5: The Standardised Approach for Counterparty Credit Risk

October 2016

The Standardised Approach for Counterparty Credit Risk (SA-CCR) is a non-modelled approach for measuring the counterparty credit risk exposure associated with derivatives. It was finalised by the Basel Committee in early 2014 as a more refined method to replace the Current Exposure Method (CEM).

AFME broadly supports the replacement of the EU implementation of CEM (known as the Mark-to-Market method) and the Standardised Method (SM) by SA-CCR in the CRD/R's risk-based framework as it provides a more accurate measure of exposure than the latter approaches¹. This being said, SA-CCR remains a standardised approach with inherent simplifications and, while it is an option for some firms, it should not be viewed as an outright replacement for internal models when firms have obtained permissions to use these.

While we are supportive of its adoption into the CRD/R, the BCBS SA-CCR framework has a number of issues that still need to be addressed before it can be implemented. For example, parameters calibrated in 2014 require adjustment so as to reflect changes in market conditions that have occurred since then and refinements that have already been incorporated into other areas such as the market risk framework, should also be reflected in SA-CCR. It is crucial for the BCBS to undertake an assessment of the overall coherence and calibration of its framework and we recommend that these changes be considered as part of this work. The EU should support these changes being made at Basel level to ensure global consistency. Moreover, its implementation of SA-CCR should therefore allow for sufficient flexibility to ensure that international developments in calibration can be taken into account appropriately.

We provide more details on the areas that still require adjustment below.

The risk mitigation effect of initial margin (IM) needs to be better recognised in SA-CCR...

SA-CCR allows some reduction of the Potential Future Exposure (PFE) resulting from the receiving of IM. However, because the PFE multiplier is calibrated at an overly conservative level, this reduction is not sufficiently in line with the level of risk mitigation provided by the IM. In our view, this undermines regulatory efforts to increase the level of collateralisation of exposures as a means to decrease counterparty credit risk. This issue has become even more important for the industry given the margin requirements for uncleared derivatives and the considerable associated funding costs. SA-CCR should therefore be made more sensitive to over collateralization and negative MTM.

...as does the future volatility of collateral

Additionally, under SA-CCR, the collateral haircut approach is used to reflect the volatility of collateral where market price volatility and foreign exchange haircuts are applied to incoming and outgoing collateral as appropriate. This simplistic approach is problematic as, on the one hand, it models the volatility of collateral in isolation from other collateral or the overall trade population and does not recognise any diversification benefits, while on the other hand it fails to reflect the uniqueness of certain types of collateral. We recommend therefore that the future volatility of collateral be incorporated into the PFE calculation.

¹ We would agree however with an alternative measure, such as the original exposure method, being retained from smaller institutions on the grounds of proportionality

The SA-CCR supervisory parameter 'alpha' requires recalibration

The BCBS set the alpha parameter in the exposure calculation $EAD = \alpha (RC + PFE)$ at $\alpha = 1.4$. However, this calibration is based on studies dating back to 2013 and no longer reflects the market environment and in particular the increase in collateral agreements. A more recent study on a real portfolio shows alpha remains below 1.2. Consequently, alpha should be recalibrated in the Counterparty Credit Risk capital framework to reflect the new capital markets environment.

Moreover, alpha should be set to one for use in Large Exposure framework, where the intent is to measure the propensity for concentration (not assume it, as is done when using the alpha factor). Alpha should also be set to one for the replacement cost component in the Leverage Ratio calculation.

A number of other issues should also be revisited before SA-CCR implementation to reflect improvements already integrated into the market risk framework

These include the recognition of diversification benefits for interest rate and foreign exchange derivatives in line with new standardised approach for market risk under the FRTB, allowing the netting of cash flows in each currency to a single amount and then use the net buy amount converted to the domestic currency as the effective notional for FX derivatives and considering the use of internally modelled option deltas to be allowed when these are approved as part of the market risk framework.

The use of SA-CCR under the leverage ratio

Finally, we wish to stress that the SA-CCR requires adjustments if it is to be used to determine the exposure measure for derivatives for all banks under the leverage ratio. While risk based capital is determined on a portfolio-based level and requires consideration of correlation or diversification, the replacement cost (RC) component of the LR exposure is a simple sum of balance sheet exposures. As noted above, we therefore believe that the alpha factor should be set to 1 in this case. Further, SA-CCR should be implemented so that it recognises the exposure-reducing effect of initial margin (IM) received from counterparties, particularly as that margin cannot be used to increase a bank's leverage (it cannot be reused). In the specific case of centrally cleared derivatives, treating client clearing exposures as additional exposure under the leverage ratio creates an economic disincentive for clearing members to offer clearing services, which goes against objectives to encourage these activities.

AFME contact

Sahir Akbar, sahir.akbar@afme.eu

+44 (0)203 828 2721

About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.