

Standardized Approach for Counterparty Credit Risk (SA-CCR)

Recalibrating SA-CCR to mitigate increased hedging costs for end-users

Executive Summary

As part of the Regulation (EU) 2019/876 (“CRR2”)¹, the Current Exposure Method (CEM) and the Standardized Method (SM) for the calculation of Counterparty Credit Risk (CRR) as applied to derivatives transactions, have been replaced with a new Standardized Approach (SA-CCR). While supposed to be more risk-sensitive, the SA-CCR, in its current design and calibration, will lead to disproportionate increases in capital requirements for banks and significantly increased costs for end-users (e.g. corporates – including SMEs, pension funds, etc.) who typically use non-cleared derivatives to hedge risk, and benefit less from the improvements, made through the introduction of SA-CCR, in capturing portfolio netting benefits.

Specifically, under the SA-CCR methodology, unmargined directional positions², which are typical of derivative hedges entered into with end-users, would entail the highest capital requirements on behalf of banks³. The table below highlights that, outlining that for unmargined portfolios, the exposure calculated under SA-CCR are significantly higher than under both IMM and CEM:

	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

It should be noted that the data from this study⁴ is limited to the impact on counterparty credit risk exposures and does not consider the impacts of SA-CCR in other areas of the prudential framework.

The increases highlighted are likely to result in an increase in the cost of end-users entering into derivative transactions to manage commercial risks, as pricing would need to offset the increased regulatory capital costs of such derivative contracts for banks, thus making them more expensive. This is likely to inhibit the ability of end-users to use derivative instruments, which are important tools to hedge their risks. It is crucial that end-users can continue to hedge their commercial risks, and to help protect the robustness of their balance sheets. Balance sheet strength is crucial to maintain economic stability, even more so due to the current macroeconomic conditions caused

¹ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32019R0876>

² 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.

³ It should be noted that end-users, in particular those referred to as non-financial counterparties in the EU, are not subject to clearing (margining) obligations due to their lack of access to the required margin collateral and should not be penalised accordingly.

⁴ <https://www.isda.org/a/hTiDE/isda-sa-ccr-briefing-paper-final1.pdf>

by COVID-19, and will be critical in the post-COVID-19 environment to enable the economic recovery, by making investments in the real economy attractive.

It would be important, therefore, that a cliff-effect on banks' CRR-linked capital requirements be avoided when implementing SA-CCR, to enable continued support of the real economy at an acceptable cost.

The SA-CCR will be applicable as of June 2021, and the above impacts can only be avoided by an expedited approach to recalibrate SA-CCR in the European Union. **To avoid the aforementioned difficulties for end-users, AFME and ISDA (“the Industry”) would recommend a temporary removal of the alpha factor from the calculation of Exposure at Default (EAD) for transactions with end-users, until the EBA’s planned review of the standard in June 2023. In the short-term, this removal could be accomplished through the “Securitization Quick Fix”, part of the Capital Markets Recovery Package, which proposes amendments to CRR2**⁵. A similar route, albeit for a permanent removal of the alpha factor, was taken by the Federal Reserve on November 19th, 2019, recognizing that this mitigates the concerns that the initial SA-CCR proposals would have on ‘the ability of these parties to enter into derivative contracts to manage commercial risk’. This development also brings to the fore the necessity for maintaining an international level-playing field that will encourage a competitive and efficient European banking system. The recently-released report of the High-Level Forum on the Capital Markets Union has called for the European Commission to consider the effect of the Federal Reserve’s decision in this regard.⁶

As a longer-term, and preferable, policy route, the Industry would recommend that this recalibration take place at Basel level.

I. SA-CCR: A Brief Primer

The introduction of SA-CCR, following its formulation by the BCBS⁷, was meant to address a number of deficiencies in the CEM and SM methods in the calculation of CCR – which measures the risk of a counterparty to a derivative contract defaulting. In particular, the risk-sensitive logic of the new framework addresses the following deficiencies in the previous framework:

- Lack of differentiation between margined and non-margined derivatives transactions;
- The inability of the supervisory add-on factor (under CEM) to have captured the volatilities observed over stress periods;
- Limited recognition of netting benefits.

SA-CCR, which applies to over-the-counter (OTC) derivatives, exchange-traded derivatives, and long settlement transactions, is designed to respond to these challenges by introducing a more risk-sensitive approach in the calculation of two components: replacement cost (RC) and potential future exposure (PFE). This is handled through the recognition of excess collateral in the calculation of PFE, as well as through the introduction of a wide set of add-ons developed for

⁵ https://ec.europa.eu/finance/docs/law/200724-securitisation-review-proposal_en.pdf

⁶ https://ec.europa.eu/info/sites/info/files/business_economy_euro/growth_and_investment/documents/200610-cmu-high-level-forum-final-report_en.pdf

⁷ https://www.bis.org/basel_framework/chapter/CRE/52.htm?inforce=20191215

the five asset classes used in the calculation of CEM (interest rate derivatives, foreign exchange derivatives, credit derivatives, equity derivatives, commodity derivatives).⁸

Significantly, the sum of the RC and PFE are then multiplied by the alpha factor, currently calibrated at 1.4 by the BCBS.

In terms of its mathematic representation, the EAD⁹ (exposure at default) is thus calculated as follows, according to Article 274 of CRR2:

$$\text{EAD} = \alpha \times (\text{RC} + \text{PFE})$$

The purpose of the alpha factor, the value of which is carried over from the Internal Model Method (IMM), was to account for perceived limitations in the use of internal models. at the time IMM was introduced in 2005 (and calibrated based off a 2003 study¹⁰). Prudential and market infrastructure changes have since resolved some of the limitations and invalidated some of the original assumptions made for that calibration¹¹.

The Industry would encourage the removal of the alpha factor multiplier from the equation for transactions with end-users, which would then read:

$$\text{EAD} = \text{RC} + \text{PFE}$$

II. Limitations of the SA-CCR Framework: Consequences for Banks and End-Users

A well-calibrated SA-CCR can be a key component in ensuring a proportional implementation of Basel III in Europe, while maintaining the internationally-agreed commitment to no significant increases in capital requirements in the context of this implementation.

The Industry considers that the aforementioned change is key in order for SA-CCR to achieve its intended purpose – stemming specifically, as previously explained, from the expected increase in capital requirements for banks, and the resulting increases in hedging costs for end-users.

In terms of impacts on banks, Global industry Quantitative Impact Study (QIS) results have highlighted, in several instances, a SA-CCR capital charge equivalent to more than two times existing requirements for large wholesale banks¹².

In the case of unmargined portfolios in particular, the impact assessment based on BCBS RCAP Hypothetical Portfolios¹³ highlights a SA-CCR EAD equivalent to 1.9-2.5 times higher than that of IMM EAD , and 2-4 times higher than that of CEM EAD, which SA-CCR replaced.

⁸ A different methodology is followed for the calculation of the add-ons for each asset class, based on the number of “hedging sets” per asset class. For more information, please refer to the BCBS’s analysis of SA-CCR, available here: <https://www.bis.org/publ/bcbs279.pdf>

⁹ The EAD refers to the total value a bank is exposed to when a loan defaults.

¹⁰ The 2003 study was a joint study conducted by ISDA, TBMA and LIBA (the predecessor of AFME), known as the 2003 ISDA-TBMA-LIBA study (<https://www.sec.gov/rules/proposed/s72103/isda020404a.pdf>)

¹¹ <https://www.afme.eu/portals/0/globalassets/downloads/consultation-responses/afme-prd-sa-ccr-final-paper.pdf>

¹² <https://www.isda.org/a/hTiDE/isda-sa-ccr-briefing-paper-final1.pdf>

¹³ <http://www.bis.org/bcbs/publ/d337.pdf>

This analysis considers the impact on counterparty credit risk capital requirements alone and does not consider the impact of SA-CCR's interactions with other areas of the prudential framework. For instance, if the alpha factor is not adjusted, it would also drastically influence the calculation of the Leverage Ratio (LR) exposure measure ¹⁴, as well as the calculation of CVA (Credit valuation Adjustment) risk ¹⁵.

The removal of the alpha multiplier for end-users will reduce the exposure amount by approximately 29% compared to similar derivative contracts with a counterparty that is not an end-user.

In terms of the effects on end-users, the impact of an unadjusted SA-CCR will be to constrain banks' ability to support their demand for derivative products at an acceptable cost. A potential implication for end-users is an increase in the cost of entering into derivative transactions to manage commercial risks, as pricing would be adjusted to help offset the increased regulatory capital costs of such derivative contracts for banks. This is likely to inhibit the ability of end-users to use derivative instruments, which are important tools to hedge their risks. Users typically use non-cleared derivatives to hedge risks and do not have the systems or collateral to support margining. Therefore, end-users would 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).

As a result of the current requirements therefore, end-users are left with two choices. Firstly, because of the higher capital cost to banks of providing end users with derivatives for hedging purposes, for example to cover foreign exchange risk on the sale of products outside the EU, end-users may choose not to hedge at all, therefore increasing their risk and introducing volatility into their earnings. Alternatively, if they do choose to hedge then the higher cost of doing so will weaken profitability. In either eventuality this might discourage investment in these end users.

It should be noted that that significant impact on end-users will be even greater when considering prospective requirements arising from the upcoming CRR3 package, most notably the introduction of the output floor, in accordance with the December 2017 agreement at Basel level.

SA-CCR and the Output Floor

The output floor refers to one of the non-risk based requirements introduced by the BCBS as part of the Basel III agreement, which is meant to address any non-risk based variabilities in the calculation of capital requirements between modelled and standardized approaches. The floor, currently envisaged as a reporting requirement, sets the capital requirements derived from using internal models to not lower than 72.5% of those required under standardized approaches. SA-CCR would be necessary to calculate this threshold, leading to an increase in minimum capital requirements.

¹⁴LR Exposure Measure: The LR refers to one of the non-risk based components of the Basel III agreement, meant to ensure that banks have adequate capital in relation to their amount of leverage, or indebtedness. The LR is a quotient of the capital measure (CET 1) and the exposure measure. The exposure measure, as per Article 429 of CRR, is meant to follow the accounting value and, in terms of derivatives, it is calculated based on the EAD.

¹⁵ CVA Risk: CVA refers to a provision for an expected loss resulting from CCR in a derivative transaction, by accounting for loss resulting from changes in the fair value of the relevant derivatives – a significant occurrence during the Financial Crisis. Put simply, CVA is meant to calculate the market risk of CCR.

Notably, a recent analysis¹⁶ conducted by the Deutsches Aktieninstitut (DAI) with the support of KPMG estimates that, under the current SA-CCR calibration, when considering the impacts of the output floor, the additional hedging costs for the sample of 16 non-financial end-users could rise by between €112 and €167 million per year, depending on the average corporate rating assumption. This equates to a 200% increase in costs related to own- funds requirements.

III. Routes to a timely temporary recalibration

The EBA has an existing mandate to review the overall calibration of CCR methodologies by June 28th, 2023, which would be approximately two years after the application of the current SA-CCR framework, as agreed in the CRR2. The Industry's view is that this should be conducted as soon as practicably possible and that a review of the Basel standard should also be encouraged in conjunction with the EU to enable international consistency.

We believe that changes are required in advance of CRR2 implementation in June 2021 to avoid a cliff effect on capital requirements, particularly as they relate to end-users. As such, we believe the forthcoming CRR3 proposals would not allow for easing the disproportionate impacts on banks and end-users in a timely way: the CRR3 proposal will be presented at the earliest in December 2020 and its final adoption can be expected at the end of 2022.

As previously mentioned therefore, prior to a full review of SA-CCR, we recommend that the co-legislators consider a time-sensitive recalibration under the recently-released "Securitization Quick Fix", **which will partly amend the CRR2.**

¹⁶https://www.dai.de/files/dai_usercontent/dokumente/positionspapiere/191213%20Position%20Paper%20Basel%20IV%20Implementation%20Deutsches%20Aktieninstitut.pdf

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About AFME

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Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 66 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org.