ISDA

SA-CCR: Impact on the US

The Basel Committee on Banking Supervision (BCBS) designed the new standardized approach to counterparty credit risk (SA-CCR) to replace the current exposure method (CEM) in the Basel capital framework. In December 2018, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) published their proposed version of SA-CCR for the US market[1].

On March 18, ISDA, the Securities Industry and Financial Markets Association, the American Bankers Association, the Bank Policy Institute and FIA submitted a joint comment letter to the US regulatory agencies[2]. In general, the associations support the move from CEM to SA-CCR given its greater sensitivity to risk. However, the rule as currently proposed by US agencies goes beyond the global standard set by the BCBS and would result in higher capital charges for institutions subject to US rules. This would create an unlevel playing field and would adversely affect the ability of commercial end users to hedge risk.

This paper outlines why SA-CCR is important, and summarizes the results of an in-depth quantitative impact study (QIS) conducted by the industry associations with input from nine financial institutions that account for 96% of total derivatives notional outstanding at the top 25 bank holding companies. As explained in the paper, the QIS highlights the need for changes in the calibrations within the proposed US rule to avoid negative impacts on the liquidity and functioning of the US derivatives market.

[1] https://www.govinfo.gov/content/pkg/FR-2018-12-17/pdf/2018-24924.pdf

[2] https://www.isda.org/2019/03/18/industry-response-to-standardized-approach-for-counterparty-credit-risk-sa-ccr/

WHAT IS SA-CCR?

SA-CCR is a method for calculating capital that banks must hold to cover the risk that a derivatives trading partner will fail to pay its obligations. Developed by the BCBS to replace the CEM and address its shortcomings, SA-CCR was intended to be more risk-sensitive without introducing undue complexity. In particular, regulators wanted a methodology that would differentiate between margined and non-margined trades, and would recognize the benefits of netting.

As currently proposed in the US, SA-CCR will be mandatory for banks that are regulated by the US banking agencies and have assets totaling more than $250 billion or foreign exposure totaling more than $10 billion. It will be optional for other banks.

As well as being used to calculate risk-weighted assets (RWAs) for counterparty credit risk under the Basel III standardized approach, SA-CCR will be used in other areas of the Basel III capital framework, meaning its impact will be widely felt. It is therefore critical that the calibration is appropriate. Areas in which SA-CCR will play a part include:

- The supplementary leverage ratio;
- The credit valuation adjustment capital charge;
- The exposure amount for derivatives in the BCBS output floor[3];
- The global systemically important banks buffer;
- Use in single counterparty credit limits;
- Use in the FDIC assessment charge;
- The comprehensive capital analysis and review.

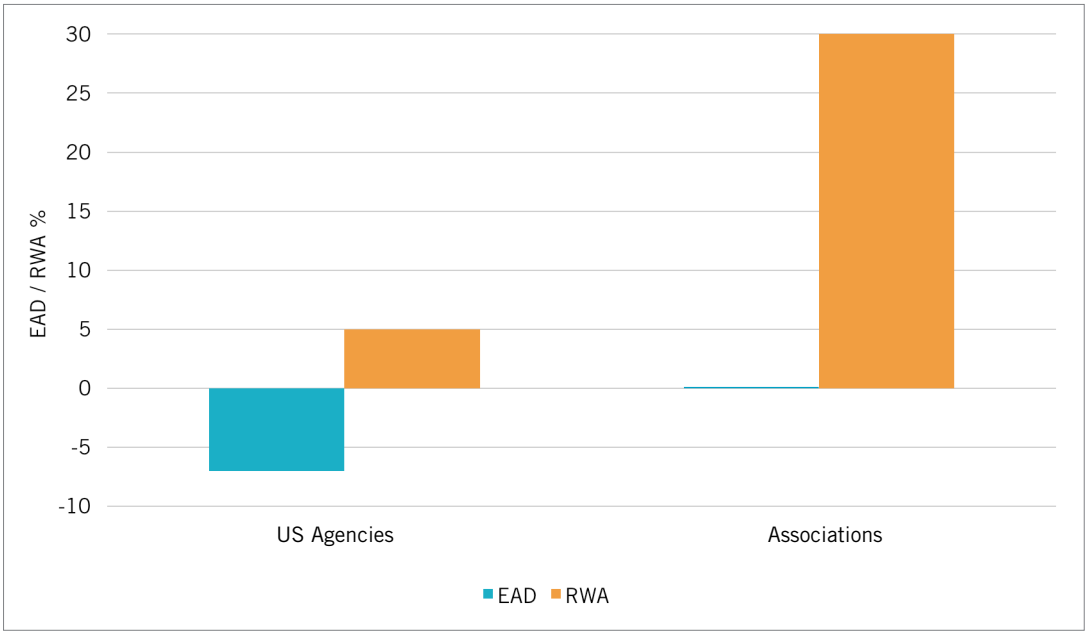
[3] Basel Committee on Banking Supervision, Basel III: Finalizing post-crisis reforms, 137 (December, 2017), available at https://www.bis.org/bcbs/publ/d424.pdf

IMPACT ASSESSMENT

The associations conducted a QIS earlier this year to gain insight on the proposed US implementation of SA-CCR. Specifically, the analysis considers the impact on exposure at default (EAD) and RWAs under SA-CCR versus CEM.

Importantly, the industry analysis diverges significantly from the data cited by US regulators in the proposed rule. For example, the US proposal indicates an expected 7% decrease in EAD and a 5% increase in counterparty credit risk RWAs under SA-CCR when compared to CEM. In comparison, industry data shows that EAD would remain flat and counterparty credit risk RWAs would increase by 30% when compared with CEM. This divergence warrants further analysis to avoid inappropriately high capital charges and higher costs, which could have a negative impact on the liquidity and functioning of capital markets (see Figure 1).

Figure 1: EAD and RWA impact calculated by the US agencies versus the EAD/RWA impact calculated by the associations

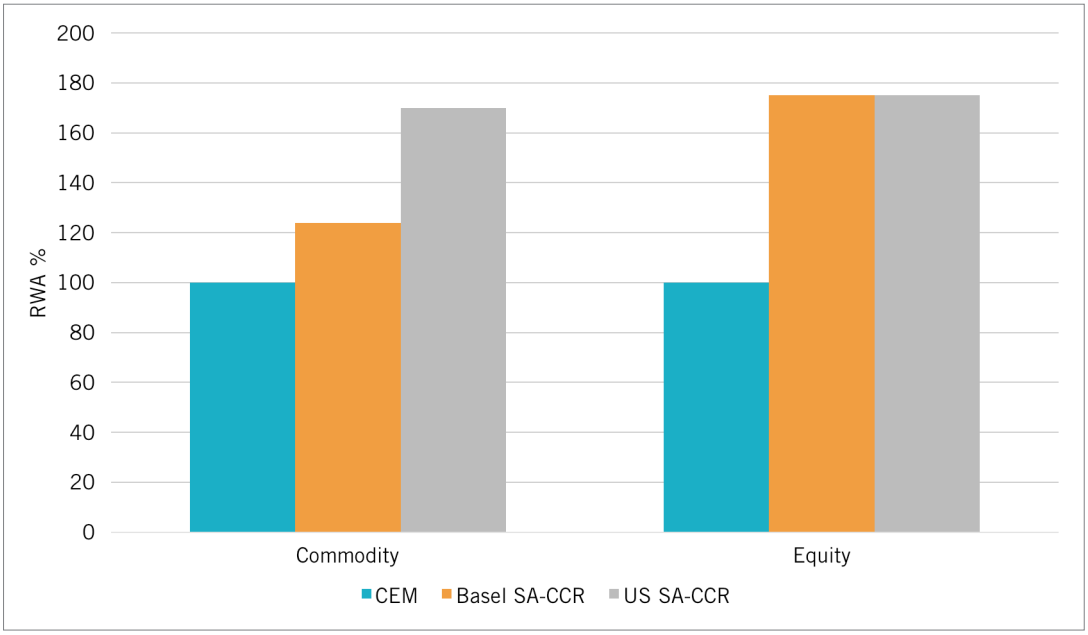


The industry analysis suggests commodity and equity derivatives will be hit particularly hard, which will have implications for commercial end users that rely on these types of derivatives to hedge their risk.

According to the QIS, the US proposed rule-making would result in a 70% increase in counterparty credit risk RWAs for commodity derivatives and a 75% increase in counterparty credit risk RWAs for equity derivatives when compared to CEM.

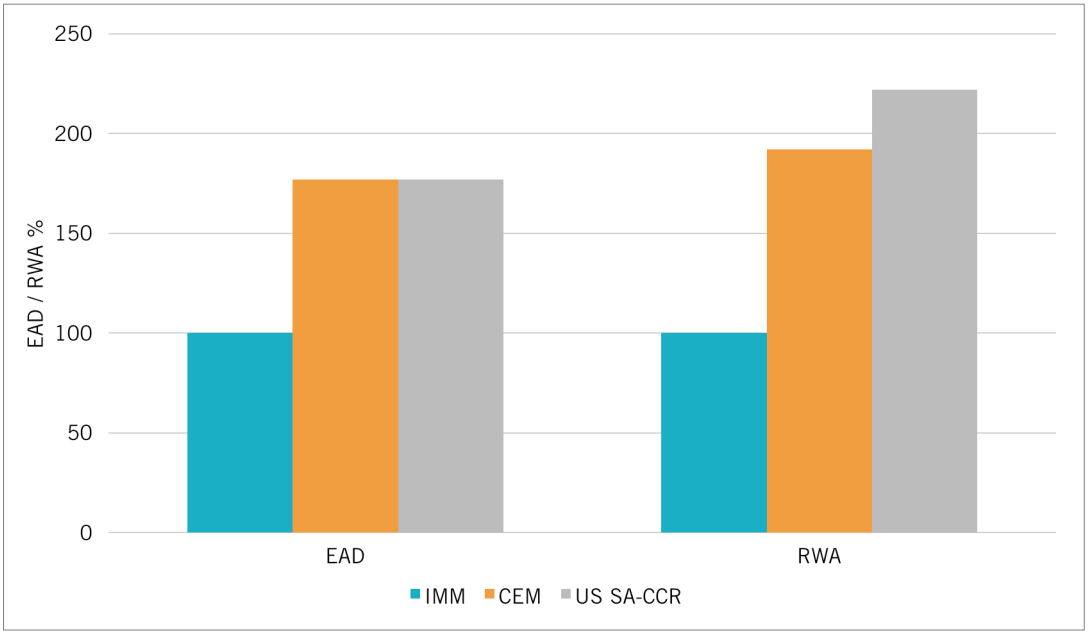
The jump is largely due to the calibration of supervisory factors (SFs), which are meant to reflect the volatilities of the transaction type. The SFs for oil/gas commodities under the US proposal deviate from those set out by the BCBS, which results in a 37% increase in RWAs for oil/gas when compared with the BCBS standard (see Figure 2).

Figure 2: RWA impact for BCBS SA-CCR and US proposed SA-CCR rule as compared to CEM



The US agencies note in the preamble of the proposed rule-making that an 'alpha factor'[4] has been introduced so SA-CCR does not produce a lower exposure amount than the internal model method (IMM). However, the industry data shows that SA-CCR results in a 77% increase in EAD and a 122% increase in RWAs compared to IMM (see Figure 3)

Figure 3: EAD and RWA compared across the three calculations: IMM, CEM and US SA-CCR



[4] The alpha factor is a multiplier that increases the exposure calculated under the SA-CCR methodology by 40%

As currently proposed, the US rule is likely to have a significant impact on the cost of hedging for commercial end users[5]. The analysis indicates the proposal would result in a 35% increase in EAD and a 50% increase in RWAs for transactions with commercial end users when compared to CEM (see Figure 4). The main drivers of this increase are:

- The differentiation between margined and non-margined exposures disadvantages commercial end users, which are generally exempt from regulatory margin requirements;
- Commercial end users hedging risk tend to have directional portfolios, and the proposed rule-making penalizes directionality in derivatives portfolios;
- The commodity SFs in the current proposal would significantly impact firms that use commodity derivatives to hedge their risk.

Figure 4: EAD and RWA for commercial end users for US SA-CCR compared to CEM

[5] Commercial end users include those entities exempt from the Federal Reserve Bank's non-cleared margin requirements under 12 C.F.R. § 237.1(d) (exemptions are also found in the OCC's and FDIC's non-cleared margin requirements). Commercial end users are also referred to in some contexts as non-financial entities or non-financial end users. See 80 Fed. Reg. 74,916, 74,919 (Nov. 30, 2015)

SA-CCR: KEY POINTS FOR CONSIDERATION

Given the impact that SA-CCR will have on the derivatives markets, the industry has made the following recommendations to the US agencies:

- Recalibrate the proposed SFs for commodities and equities. If recalibration is not feasible, then, at a minimum, the associations recommend the SFs for commodity derivatives contained within the BCBS standard are used to ensure global consistency;
- Provide a more risk-sensitive treatment of initial margin (IM) to ensure the risk-mitigating benefits of IM are better recognized;
- Reconsider the application and calibration of the alpha factor to avoid overstating the risk of derivatives;
- Recalibrate SA-CCR as it applies to transactions with commercial end users to ensure consistency across regulatory frameworks for clearing, margin and capital. At a minimum, do not apply the alpha factor to the exposure calculation for trades with these entities;
- Remove restrictions to net all transactions covered by an agreement that satisfies the requirements for qualifying master netting agreements under the existing US capital rules; and
- Ensure SA-CCR does not negatively impact client clearing.

The agencies have indicated the proposed rule will be finalized by the end of 2019. The associations are committed to working with US regulators as they finalize this rule. The associations also encourage the agencies to take the changes from their final analysis back to the BCBS and obtain the necessary revisions to SA-CCR. Changes at the Basel level are necessary to facilitate consistent implementation on a global basis.

Finally, the formal compliance deadline in the US should be aligned with the mandatory compliance date for the various other components of Basel III in the US. This would ensure consistent implementation of SA-CCR and the other elements of Basel III that have a direct impact on SA-CCR, which include the Fundamental Review of the Trading Book and revised credit risk weights. Piecemeal implementation of SA-CCR followed by further changes to the US capital framework would be disruptive, burdensome and inefficient. The Basel III package projects a January 2022 compliance date for relevant reforms.

See the joint association comment letter to US regulatory agencies for further details on the industry recommendations[6].

[6] https://www.isda.org/2019/03/18/industry-response-to-standardized-approach-for-counterparty-credit-risk-sa-ccr/

INDUSTRY FEEDBACK ON SA-CCR

"The adoption of SA-CCR without offset will maintain or increase the clearing members' supplementary leverage ratios by more than 30 basis points on average, will continue to disincentivize clearing members from providing clearing services, and thereby limit access to clearing in contravention of G-20 mandates and Dodd Frank."
Commodity Futures Trading Commission[6]

"The proposal would lead to a 550-plus percentage point increase in the capital costs associated with providing risk management products for commercial end users."
Financial Services Forum[7]

"For the top three clearing members representing roughly 45% of SwapClear's client cleared notional volume, failure to recognize IM unnecessarily adds 55% more capital. Of this, roughly 75% of the increase is represented by real money client activity because their portfolios are generally more directional."
LCH Group[8]

"While we recognize that the proposed rule is a direct requirement on banks, the proposed rule would have indirect, adverse, and material impacts on end users, which rely on derivatives executed with bank counterparties in order to hedge risks associated with their commercial operations."
Coalition for Derivatives End-Users[9]

"US prudential regulators, acting in accordance with their Dodd-Frank mandates, have continued to issue rules that have resulted in increased costs for end-users' risk mitigation activities. The cumulative effects of these burdens and costs have threatened the ability of American businesses to affordably protect against risks associated with their day-to-day commercial operations."
National Association of Corporate Treasurers, quoting testimony delivered to the US House Committee on Financial Services[10]

[6] CFTC comment letter, Capital Adequacy: Standardized Approach for Calculating the Exposure Amount of Derivative Contracts, https://www.federalreserve.gov/SECRS/2019/March/20190319/R-1629/R-1629_021519_133502_463110080916_1.pdf

[7] Financial Services Forum comment letter, Standardized Approach for Calculating the Exposure Amount of Derivative Contracts, https://www.federalreserve.gov/SECRS/2019/March/20190320/R-1629/R-1629_031819_133559_401384201417_1.pdf

[8] LCH comment letter, Standardized Approach for Calculation the Exposure Amount of Derivative Contracts, https://www.federalreserve.gov/SECRS/2019/March/20190319/R-1629/R-1629_022619_133514_499431436295_1.pdf

[9] Coalition for Derivatives End-Users, Comment to Notice of Proposed Rulemaking – Standardized Approach for Calculating the Exposure Amount of Derivative Contracts, https://www.federalreserve.gov/SECRS/2019/March/20190320/R-1629/R-1629_031819_133558_425805351312_1.pdf

[10] National Association of Corporate Treasurers, Comment Letter re Standardized Approach for Calculating the Exposure Amount of Derivative Contracts, Notice of Proposed Rulemaking, https://www.federalreserve.gov/SECRS/2019/March/20190319/R-1629/R-1629_021519_133501_464408715310_1.pdf

ABOUT ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 71 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. Follow us on Twitter @ISDA.