

# CRR 3 - Counterparty Credit Risk

## February 2022

### Introduction

This paper sets out the industry’s positions related to Counterparty Credit Risk (CCR). CCR[1](#_bookmark22) is 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, CCR 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.

Under the CRR framework, there are two main areas which continue to have a significant impact on banks’ capacity to maintain and develop hedging and market-capabilities services.

* + The Standardised Approach for Counterparty Credit Risk (SA-CCR) was introduced as part of CRR 2 in June 2021, which has led to disproportionate increases in capital requirements for banks under the Standardized Approach and significantly increased hedging costs for end-users, mainly due to the alpha factor applied in the SA-CCR formula. Its impact is however not limited to standardised approach calculation for CCR risk weighted assets (RWAs) as it as affects many other parts of the prudential framework. In particular, it will affect all derivatives users, not just firms that only apply standardised methodologies. Other impacts are to the leverage ratio and large exposure framework.
	+ Under CRR3, the Standardised Approach for Credit Risk (SA-CR) is of increasing relevance. SA-CR risk weights applies to both unfloored RWAs for non-IRB banks, and to the RWA output floor. For Securities Financing Transactions (SFTs), SA-CR risk weights are overly conservative and not commensurate to the low underlying risks as it does not reflect the short-term maturity and quality of collateral backing these transactions. SFTs allow investors and firms to use assets, mainly high- quality government bonds to secure funding for their activities. Unless the calibration is revised, the increased cost of SFTs that underpin the functioning of financial markets and the efficiency of EU sovereign debt markets will be negatively affected. Similarly for derivative contracts, SA-CR risk weights do not reflect that counterparty downgrade risk is already captured by the CVA risk framework and thus these risk weights should be adjusted accordingly.

This paper will cover respectively two sections, the first will cover SA-CCR and the second will focus on the SA-CR application to SFTs and derivative contracts

* The SA-CCR section with the key industry priorities can be found through pages 2 to 5.
* The SA-CR section can be found through pages 6 to 7.
* We have also included additional recommendations related to SA-CCR as an annex which can be found on pages 8-13.

1 <https://www.bis.org/basel_framework/chapter/CRE/50.htm>

 

**1. The Standardised Approach for Counterparty Credit Risk (SA-CCR)**

The new Standardized Approach for Counterparty Credit Risk (SA-CCR), which replaced the Current Exposure Method (CEM) and the Standardized Method (SM), for the calculation of Counterparty Credit Risk (CCR)[2](#_bookmark23) exposures arising from derivatives transactions, as part of the Regulation (EU) 2019/876 (“CRR2”)[3](#_bookmark24). While more risk-sensitive, SA-CCR, in its current design and calibration, leads to disproportionate increases in capital requirements for banks[4](#_bookmark25) and significantly increased costs for end-users (e.g. corporates – including SMEs, pension funds, etc.) who typically use long dated non-cleared derivatives to hedge risk, and benefit less from the improvements, made through the introduction of SA-CCR, in capturing portfolio netting benefits.

The importance of SA-CCR is not only in calculating capital requirements for CCR risk-weighted assets (RWAs). As of June 2021, SA-CCR is used in many areas across the prudential framework, such as for calculating capital requirements for CVA RWA (BA-CVA), for Large Exposures framework[5](#_bookmark26) and for the Leverage Ratio. It affects all banks and users of derivatives, and the impact is not restricted to those that apply standardized methodologies only. This impact will become even more pronounced in CRR3, as SA-CCR will also contribute towards the calculation of the newly introduced RWA Output Floor (OF)[6](#_bookmark27).

The Final Report of the High-Level Forum on the Capital Markets Union[7](#_bookmark28), noted that “SA-CCR will be used as the foundation of multiple calculations within the capital framework of banks. An overly conservative SA- CCR would have a detrimental impact on the availability and cost of financial hedges to end-users[8](#_bookmark29).” This is particularly penalising as it is crucial for banks to continue to support the real economy, whilst it is struggling to recover from the effects arising from the Covid-19 pandemic.

### Alpha Factor

Among the major reasons for the disproportionate impact of SA-CCR are its design and outdated calibration objectives, since the alpha factor of the formula, which increases exposures by 40%, was set at 1.4 in 2005 by the Basel Committee and was meant to be used to account for general wrong way risk and perceived flaws in internal models, not for standardised approaches.

We are supportive, therefore, of the Commission’s proposals[[1]](#_bookmark30) to reduce the impact on the output floor RWA, per CRR Article 465(4), by resetting the alpha factor to 1 for a transitional period until 31 December 2029,

2 Counterparty credit risk (CCR) is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows.

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

4 According to ISDA-GFMA estimates, the exposure calculated under SA-CCR will be significantly higher than under both IMM (1.9 – 2.5 times higher) and CEM (2-4 times higher). This is before considering the impact of the Output floor. (See: [Link](https://www.isda.org/a/hTiDE/isda-sa-ccr-briefing-paper-final1.pdf))

5 <https://www.bis.org/fsi/fsisummaries/largeexpos.pdf>

6 Please refer to AFME’s dedicated position paper on the Output Floor.

7 [200610-cmu-high-level-forum-final-report\_en.pdf (europa.eu)](https://ec.europa.eu/info/sites/default/files/business_economy_euro/growth_and_investment/documents/200610-cmu-high-level-forum-final-report_en.pdf)

8 SA-CCR would limit the ability of end-users to hedge risks, because the increased capital requirement of SA-CCR will constrain banks’ capacity to support their demand for derivative products at an acceptable cost. This is problematic because EU corporates typically use non-cleared derivatives to hedge their commercial risks, which entail the highest capital charge in SA-CCR. Yet, corporates do not have the complex collateral management systems to support margining, and they are not required to do so by the European Market Infrastructure Regulation (EMIR). Hence, end-users would be left with no affordable alternatives to hedge their structural commercial risks, which will affect their financial strengths and competitiveness.

[1] [https://ec.europa.eu/info/publications/211027-banking-package\_en](https://eur02.safelinks.protection.outlook.com/?url=https%3A%2F%2Furldefense.proofpoint.com%2Fv2%2Furl%3Fu%3Dhttps-3A__ec.europa.eu_info_publications_211027-2Dbanking-2Dpackage-5Fen%26d%3DDwQGaQ%26c%3DeuGZstcaTDllvimEN8b7jXrwqOf-v5A_CdpgnVfiiMM%26r%3DN3qb883yVypBXk_rGqOVxA%26m%3Dw1znmJXj46vNLQVM9yLLkXJoRI3YLdLZD4Q3Y4NtTZw%26s%3DvGqpSoUfsR1EMZzsura3KLa2IiMFxbRPulDYluhpGaw%26e%3D&data=04%7C01%7C%7C615de8960d0b49f69b9608d9e5a30a2f%7Cd1039c55923b41d4ac3363147f66ea3d%7C0%7C0%7C637793311183857328%7CUnknown%7CTWFpbGZsb3d8eyJWIjoiMC4wLjAwMDAiLCJQIjoiV2luMzIiLCJBTiI6Ik1haWwiLCJXVCI6Mn0%3D%7C3000&sdata=hFeFyAy91Uz8EbOp7xI%2BjAKLD5W0llQuJllCPiaryb8%3D&reserved=0)

 

with the potential for this to be permanent, having also the benefit of the EBA report mandated by CRR2 and due by June 2023.[[2]](#_bookmark31)

However, the transitional measure only applies to the calculation of SA-CCR for the purposes of the output floor RWA, whilst no measures have been taken to address calibration issues when SA-CCR is applied under the Standardised Approach (or unfloored capital risk framework), the Leverage ratio or the Large Exposures framework respectively even though there is a distinct impact in each of these areas:

* Standardised Approach (unfloored capital) RWAs: 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.) which typically use non-cleared derivatives to hedge business risks;
* Leverage Ratio: is becoming a more biting constraint given the addition of the G-SIB surcharge, Pillar

2 requirements, Pillar 2 guidance, and notwithstanding the impact from its input into TLAC calibration. Therefore, the benefits of recalibrating alpha for the output floor may not be achieved if the exposure measure value used in the Leverage ratio is not consistent.

* Large Exposures framework: the intent of the Large Exposures framework is to measure the propensity for concentration. The increased exposure values will reduce capacity to provide hedging products to end-users, and hinder recovery from the ongoing covid crisis.

As such, we believe the adjustment proposed for the RWA output floor, should be applied consistently across the prudential framework. A simple approach would be to re-calibrate the alpha factor to 1 in the standardised approach, as this would then feed into SA-CCR for all Standardised Approach calculations - i.e. Counterparty Credit Risk including the Leverage Ratio and Large Exposures framework - consistently with permanent application further considered as part of the EBA’s report.

Given these impacts, the EBA review mandated under Article 514 should explicitly look at the issue of calibration of the alpha factor and its impact on firms’ and end-users’ hedging capacity, as well as the international developments, with the view of ensuring adequate competitiveness of EU Capital Markets.

The question of recalibration of SA-CCR also calls for a broader review at the Basel Committee to ensure global consistency. In the US, the alpha factor has been recalibrated to 1 on a permanent basis in relation to exposures to commercial end-users and it was not limited to the RWA output floor application only. A review was also mandated in the Securitisation Quick fix package[9](#_bookmark32) for the Commission to review SA-CCR in order to ensure that EU corporates were able to hedge their financial risks in the context of the recovery from the Covid-19 pandemic and taking into account, among others, the international level playing field.

**Recommendation(s)**

Re-calibrate alpha to 1 for all applications of SA-CCR: Counterparty credit risk under the Standardized Approach, Leverage Ratio and Large Exposure.

[2] CRR2 - Article 514 Method for the calculation of the exposure value of derivative transactions 1.EBA shall, by 28 June 2023, report to the Commission on the impact and the relative calibration of the approaches set out in Sections 3, 4 and 5 of Chapter 6 of Title II of Part Three to calculate the exposure values of derivative transactions.

9 https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=OJ:L:2021:116:FULL&from=EN

 

### Beyond Alpha

**Credit Risk interlinkage: Transitional Arrangements for Unrated Corporates**

The Industry welcomes the proposed Article 465 which provides a transitional treatment lasting until 2032 for how to calculate exposures to unrated corporates under a “hybrid approach”[10](#_bookmark33), which will also feed into SA-CCR calculations of exposure values within the output floor. However, the issue of lack of ratings is not limited to banks which use models but also extends to banks that apply the standardised approach, especially with regard to investment grade corporates, which all banks are able to identify.

Consequently, we propose commensurate treatment of unrated corporates should be extended to the calculation of standardised RWAs where it can be demonstrated that the corporate is investment grade. For instance, this could be achieved by allowing institutions to make use of the internally estimated Probability of Default (PDs) for those exposures for the purposes of both either the economic capital calculation or the accounting expected credit loss calculation[11](#_bookmark34). These metrics (PDs) follow existing EU regulations, are decoupled from the capital metrics, and are used by all institutions regardless of the approach they use and allow them to identify investment grade unrated corporates with the same level of guarantee as regulatory PDs[12](#_bookmark35). Such PDs should have followed the necessary internal validation, supervisory review and governance processes to ensure maximum rigor and compliance with the principles set out in the above-mentioned guidelines, including any necessary adjustments if needed in their operations. These PDs are calculated by counterparty and are widely used by banks. The proposed treatment would identify those counterparties with a PD<0.5% and apply a RW of 65% to them.

In the same vein it should be noted that some advanced banks have entities within their group which use the standardised approach, in this instance such entities should be allowed to use the PDs within the group’s IRB entity to be able to apply the hybrid approach.

**Recommendation(s)**

We propose commensurate treatment of unrated corporates should be extended to the standardised approach where it can be demonstrated that the corporate is investment grade

### Design and calibration issues

SA-CCR retains a number of design and calibration issues beyond alpha factor recalibration that warrant attention. A more comprehensive review of SA-CCR should be conducted as part of the remaining CRR3

10 Under the ‘hybrid’ approach in article 465 (3) banks can apply a RW of 65% to corporates where the bank estimates the PD of those exposures,is no higher than 0,5 % under the IRB approach for the purpose of calculating the output floor.

11 Consistent with the ‘EU Guidelines for the estimation of risk parameters for the IRB approach’ or the ‘EU Guidelines for the credit institutions' credit risk management practices and accounting for expected credit losses’, respectively

12

* **PDs used for Provisions (under IFRS9):** They are calculated by all entities using common principles and rules which homogenize this measure across entities: the “EBA Guidelines on Credit institutions’ credit risk management practices and accounting for expected credit losses (2017)” ([Link](https://www.eba.europa.eu/eba-publishes-final-guidelines-on-credit-institutions-credit-risk-management-practices-and-accounting-for-expected-credit-losses)). The reliability of these PDs is illustrated by the EBA Guidelines themselves, by giving then priority over ratings provided by credit rating agencies
* **PDs used for Economic Capital:** PDs used as risk parameters for Economic Capital are an alternative mechanism to identify investment grade unrated corporates provided that they meet minimum governance and robustness requirements. Such is the case of PDs used for Economic Capital that follow the “EBA Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures (2017)” [(Link](https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2033363/6b062012-45d6-4655-af04-801d26493ed0/Guidelines%20on%20PD%20and%20LGD%20estimation%20%28EBA-GL-2017-16%29.pdf?retry=1)).

 

process, either directly through level 1 legislative change or via a delegated act following the EBA’s report mandated in CRR Article 514. Ideally a comprehensive review should also be pursued at the Basel level to ensure international consistency potentially through the BCBS Evaluation Task Force.

The following are the priority topics contributing to the overly conservative calibration of SA-CCR beyond alpha:

1. The use of internally calculated deltas
2. The recognition of diversification benefit between FX hedging sets
3. The recognition of initial margin

Further details on these priority topics are provided below.

*Allow firms to use internally-calculated deltas*

The SA-CCR addresses one of the main shortcomings of CEM by allowing firms to delta adjust the notional for non-linear derivatives. While the Industry welcomes the application of deltas, we are concerned by the requirement to use the Black-Scholes formula to calculate the deltas for certain types of options. Firms should be allowed to follow existing internal practices applicable to path-dependent options and other complex non-linear derivatives for which the Black-Scholes formula does not work. Use of such internal practices would be subject to a firm’s internal model governance framework and supervisory oversight.

**Recommendation(s)**

Allow firms to use internally-calculated deltas.

*Recognise diversification benefit across hedging sets within an asset class*

SA-CCR does not reflect any diversification benefit across hedging sets within an asset class i.e. the positive exposure value of one hedging set cannot be offset with a negative exposure value of another hedging set. This is overly conservative and risk insensitive, and significantly overstates the exposure value compared to internal modelled approaches, where some degree of diversification is assumed.

**Recommendation(s)**

Better recognition of diversification benefit across hedging sets within an asset class.

*Improve recognition of initial margin in calculation of total exposure*

The benefit that initial margin provides to reduce derivatives exposure is not sufficiently recognised in the SA-CCR calculation of exposures. The methodology is very conservative and it leads to a disproportionate amount of initial margin needed to be posted to reduce the exposure. The lack of adequate recognition of IM results in overstated exposures and therefore unduly conservative capital requirements. Given the significant increase of IM in the financial system over the last years it is economically important that it appropriately recognises the reduction in counterparty credit risk.

**Recommendation(s)**

Better recognition of initial margin (IM), to reflect its risk-reducing properties.

 

**2. Standardised Approach for Credit Risk (SA-CR) and its application to Securities Financing Transactions and Derivative Contracts**

**Securities Financing Transactions**

One area where the revised framework results in a significant increase in capital requirements relates to SFTs. Under the revised framework, there is no significant change to how the Internal Model Method (“IMM”) exposures and the IRB risk weights are calculated. However, the new standardized approach (“SA”) adds a significant level of conservatism by not recognizing the very short-term nature of SFTs. The unintended impact of the floor could lead to an eight-fold increase in RWAs, thereby potentially rendering the SFT business uneconomical for the banks that are active in the wholesale market, of which SFTs form a very important component. Such an outcome could threaten liquidity benefits for all stakeholders, from issuers (higher cost) to end-investors (lesser liquidity).

While the impact is SA specific and banks can still use models to better capture the underlying low risk profile of SFT transactions, the SA calibration will have a direct impact for all banks through the application of the output floor. SFTs are short term positions. Based on ICMA European Repo Market Survey in November 2021, 93% of outstanding SFTs have maturities below six months and 85% below three months (see chart below). The short maturity is reflected in IRBA but not in SA except for counterparties that are banks, resulting in capitalising short-term secured transactions similarly to unsecured long-term transactions. Maturity is an objective risk parameter, not depending from internal models. Short maturities are taken into account in other aspects of the SA, and therefore, we strongly believe that SFTs should be allowed to benefit from these short term adjustments.

Graph 5: Maturity analysis of outstanding repo transactions



*Source: ICMA, European Repo Market Survey, November 2021*

Furthermore, implementing the SA risk weighting rules without a sensible maturity adjustment for repo-like transactions will undermine the existing measures that target facilitation of market-making in other parts of EU prudential regulation, whether on Net Stable Funding ratio (NSFR) and Liquidity Coverage Ratio (LCR). Notably:

 

* LCR: no LCR cost when Level 1 HQLA are used as an SFT collateral. On the contrary, monetising High Quality Liquid Assets (HQLA) often depends on ability to repo the securities.
* NSFR:
	+ SFTs generate no regulatory *Required Stable Funding* if backed by HQLA Level 1 collateral
	+ Beyond six-month maturity, SFTs are subject to a 50% Required Stable Funding ratio.

Such measures would fail to reach their goals if liquidity in HQLA assets is undermined by such a punitive capital treatment in the credit risk framework, forcing market-makers to possibly restrict their inventories and therefore the liquidity they can provide to the market.

### Derivatives

For derivative contracts, the calibration of SA-CR risk weights do not account for the fact that the counterparty’s downgrade risk is already captured by the CVA risk framework.

The flat calibration of SA-CR risk weights embeds in its horizon the downgrade risk of the associated counterparties and therefore overlaps with the capitalisation of downgrade risk for positions in scope of the CVA risk framework. Under the CRR3 proposal, Article 162(2)(i) allows banks to cap the M factor in the IRB risk weight formula with the effect of eliminating the double counting of downgrade risk between CCR and CVA risk RWAs. A similar adjustment is not being proposed for the SA-CR method.

To avoid impacting the cost of derivative contracts and users’ ability to afford them, SA-CR risk weights should be adjusted accordingly.

**Recommendation(s)**

* Amend the SA-CR treatment of SFTs by introducing a short-term maturity adjustment. The CRR3 proposal already assigns lower risk weights for selected short-term exposures:
	+ In the Standardized Approach, specific short-term RW exist for exposures to “institutions”, externally rated (Art 120 – Table 4) or unrated (Art 121 – Table 5), below 3 months for all exposures, and below 6 months for exposures related to “the movements of goods across national borders”, i.e. trade finance
	+ In the IRB-Foundation Approach, a 6 months maturity applies for SFTs, instead of the fixed 2.5y maturity for all other exposures (Art 162)
* When applied to derivative positions, SA-CR risk weights should be adjusted accordingly for positions in the scope of the CVA risk framework.

 

### Annex : Other SA-CCR Recommendations

*Increase flexibility in certain parts of the methodology, such as allowing index decomposition*

Firms should be allowed to use a look-through approach to decompose indices within credit, equity and commodity asset classes to more accurately reflect the exposure of highly correlated long and short positions. The hedging set amount for equity and credit derivative contracts requires a firm to differentiate between index and single name underliers for the purposes of different supervisory factors, option volatilities and correlation parameters. With respect to commodity indices, a firm would have to select a single supervisory factor to the index and treat it as a single commodity sub-class as opposed to a diversified index. As a result, firms are unable to decompose an index into its underlying components as they do for other capital requirements (e.g. in the FRTB under the Basel standards)[13](#_bookmark36).

The option to use a look-through approach to decompose credit, equity or commodity derivatives referencing an index into single-name derivatives each referencing one component of the index recognises the hedging benefit provided by the component of an index and provides enhanced risk sensitivity to SA-CCR framework.

The decomposition of indices for the purpose of calculating capital requirements is a well embedded practice for firms that is already required or permitted in other parts of the prudential framework. Therefore the Industry would support EU policymakers providing for an option to decompose equity, credit and commodity indices within SA-CCR, should firms be able to carry out such decompositions. This approach will more appropriately represent the risk and will better align with the FRTB. It will also match the approach chosen by US regulators.

**Recommendation(s)**

Allow firms to use a look-through approach to decompose multi-underlying credit, equity and commodity derivatives into their single-name derivative constituents to improve recognition of hedging / offsetting benefits and hence better reflect the risk associated with transactions.

*Align with Basel standards on the treatment of liquidation period for un-margined netting sets*

Article 276(3)(a) requires firms to apply a 1-year liquidation period to all unmargined netting sets for the calculation of collateral haircuts, irrespective of the maturity of the transactions in the netting set. This diverges with Basel FAQ CRE52.10[14](#_bookmark37), which takes into consideration maturity by requiring the liquidation period to be the maturity of the longest transaction in the netting set, capped at 250 days. The proposed treatment unduly penalizes netting sets with short maturities and unreasonably undermines the risk mitigation effect received from eligible collateral. It also adversely impacts the regulatory capital benefit arising from market developments in Settle-To-Market (STM), under which the variation margin is treated as cash settlement rather than collateralization and leads to a shorter, i.e., 1 day, trade maturity.

13 MAR21.31 (Treatment of index instruments and multi-underlying options) [https://www.bis.org/basel\_framework/chapter/MAR/21.htm?inforce=20230101&published=20200327#paragraph\_MAR\_21\_20230101\_21\_31](https://www.bis.org/basel_framework/chapter/MAR/21.htm?inforce=20230101&published=20200327&paragraph_MAR_21_20230101_21_31) 14 <https://www.bis.org/basel_framework/chapter/CRE/52.htm>

 

Under the current EU standard, the value of cash and securities collateral received for these transactions is reduced by a factor of 5 times more (√250/10) than required under global standards. Therefore, the Industry recommends that the EU implementation should align with Basel standards.

It is suggested to allow firms to apply a lower liquidation period that equals:

* + Maturity (“M” as defined in Article 279c for Maturity Factor) floored at 10 business day, when the longest maturity of the trades in the netting set is less than 1 year;
	+ 1 year, when the longest maturity of the trades in the netting set is more than 1 year.

This proposal is aligned with the determination of the Maturity Factor for unmargined netting sets.

**Recommendation(s)**

Consider amending Article 276(3)(a) to read: ‘*the remaining maturity of the longest transaction in the netting set, capped at 250 business days and floored at 10 business days, for the netting sets referred to in Article 275(1)*’ and adding the following: ‘W*here a transaction is structured to settle outstanding exposure following specified payment dates and where the terms are reset so that the market value of the transaction is zero on those specified dates, the remaining maturity of the transaction shall be equal to the time until the next reset date*’.

*Supervisory Delta: Provide methodology to deal with negative underlyings across all asset classes*

The shift parameter in the Supervisory Delta formula was introduced to accommodate negative interest rates. However, this fix is limited to interest rate options. The underlying assumption is that in other risk classes (e.g. equities and commodities), prices should always be positive. That is, however, not always the case. For example, on April 20th, 2020, the WTI futures contract turned negative. While this was a very unusual circumstance, it is common to trade commodity spread options (e.g. Brent vs WTI or WTI Houston vs WTI Midland) where the underlying spread can be negative. Another common example include options on the difference in performance across two equity indices which, by design, can be negative. At the moment, firms have to use a default mechanism to handle such situations. The Industry suggests the following alternatives to address this issue:

* The preferred method is for the Industry to expand the shift parameter application to all asset classes. In this case, the shift parameter could be kept at 0.1% or a higher value given that the underlying are price-based as opposed to yield-based.
* A more simplistic and less preferred method would be to set the Supervisory Delta for all call options to 0, long put options to -1, and short put options to 1. The underlying assumption is that the strikes are positive and therefore anything close to 0 or less is out of the money for a call option or deeply in the money for a put option.

**Recommendation(s)**

Use of the lambda (λ) parameter to accommodate negative prices should be allowed for all asset classes

not just interest rates.

 

*Adjusted Notional Amount*

As a general principle, it is important to align the notional definition of a derivative contract with the firm’s actual closeout risk. While standard notional definitions may produce reasonably accurate exposure estimates for the majority of derivatives, this would not always be the case. For some derivatives, it is impossible to accurately calculate exposure using standard notional definitions.

**Recommendation(s)**

Firms should be allowed to use internal definitions in cases where the rules are not prescriptive subject to internal governance practices and consultation with, and oversight from, their onsite supervisory teams.

*Leverage Ratio – NICA calculation*

Non-segregated collateral posted and included in the definition of the NICA are already included in the other assets exposure for the leverage calculation. Institutions should not be penalized by counting this collateral a second time in the calculation of the exposure value of derivatives.

**Recommendation(s)**

Consider amending Article 429c(4) to read:

‘4. For the purposes of paragraph 1 of this Article, institutions shall not include collateral received or posted in the calculation of NICA as defined in Article 272, point (12a).’

This amendment is consistent with the Basel framework LEV30.16

*Margin in Transit*

Under the current capital rules, firms are only allowed to reduce their credit risk exposures for derivatives by the amount of any eligible variation margin (VM) received by the firm. This frequently results in increased exposures to counterparties because of timing differences between a margin call and the receipt of variation margin, which is generally on a T+1 basis. Under the capital rules, VM received on T+1 cannot be used to offset derivatives exposures calculated on day T+0 even though firms fully expect the collateral to be received on T+1. This timing issue can result in significant increases in capital charges for firms in periods of stress and high volatility when trade values can move sharply. Most recently, this has been observed last year as a result of increased market volatility in response to the COVID-19 pandemic.

This timing issue can result in procyclicality whereby capital increases cause client facilitation to become more expensive precisely when liquidity is required. Under both the IMM and the SA-CCR, the calculated exposure at default (EAD) represents an expected exposure measure. In this regard, it should be noted that over time the non-zero current exposures resulting from timing differences should be on average zero. Therefore, removing these timing differences by allowing firms to reflect collateral that has been called but not yet settled should be allowed as it is consistent with an expected exposure measure as long as there is no underlying margin dispute.

 

In order to prevent increased capital charges for the firms due to these timing differences and to align more closely with an expected exposure measure, the Industry proposes that firms should be allowed to reflect the VM that is received and posted on a T+1 basis under both SA-CCR and IMM. This change will reduce unwarranted volatility in exposures and RWA, because of collateral shortfalls as a result of ordinary settlement cycle.

**Recommendation(s)**

Margin in transit rules allowed under IMM should be extended for their use under SA-CCR to ensure consistent treatment of collateral under both approaches. That is, firms should be allowed to reflect the VM that is received and posted on a T+1 basis under both SA-CCR and IMM.

*Supervisory Factors*

The EC should revisit the supervisory factors set by the BCBS for all asset classes, as they seem to be calibrated to higher volatilities than can be justified by historical data. The Industry urges the regulators to consider observed volatilities during periods of varying market stress and recalibrate the supervisory factors accordingly.

**Recommendation(s)**

Revisit supervisory factors for all asset classes.

*Net cash flows to single amount per currency*

In terms of FX transactions, SA-CCR calculates RWAs linked to distinct currency pairs (e.g. EUR/USD), which means that multiple exposure values could be calculated across multiple pairs separately. Nonetheless, if considered together, the exposure value would have been zero. This issue would be resolved if firms were allowed to net exposures by currency instead of currency pair. SA-CCR should allow for netting by currency (excluding settlement currency) instead of currency pair but only if this is combined with a correlation parameter to aggregate currency exposures or if only the maximum of the net long and net short exposures by currency are included in the add-on calculation.

**Recommendation(s)**

Allow for netting by currency (excluding settlement currency) instead of currency pair, but only if this is combined with a correlation parameter to aggregate currency exposures or if on the maximum of the net long and net short exposures by currency are included in the add-on calculation.

*Mandatory Use of SA-CCR in the Large Exposures framework*

The introduction of SA-CCR not only affects the calculation of capital requirements for CCR, it will also be used in many other areas across the prudential framework, such as for calculating capital requirements for CVA risk, the exposure measure in the Large Exposures framework (replacing the IMM), for the Leverage Ratio, and for the forthcoming capital Output Floor requirement the Finalised Basel package.

Thus it will affect all firms, regardless of their current model approvals and users of derivatives. The impact to firms and the distortion versus risk calculated under previous methods are likely to be significant.

 

Therefore, in the Industry’s view, the significance of this change on a standalone basis warrants further review

With specific reference to the Large Exposures framework, it should also be noted that in the US implementation of SA-CCR, US Agencies have retained the use of IMM in the Single Counterparty Credit Limit (SCCL) rule because the available standardised approaches were not deemed to be adequate replacements.

**Recommendation(s)**

Permit IMM banks to use their internal models to calculate Large Exposures requirements.

*Multiple netting sets subject to one margin agreement*

Under the CRR capital rules, when multiple netting sets are jointly margined then Article 278(2) requires firms to calculate the Potential Future Exposure (PFE) by using the unmargined methodology.

According to CRR Art. 272 (4), individual transactions not subject to a bilateral netting under section 7 are treated “as its own netting set”. An example of such transactions can occur when entered into one with a branch of a counterparty in a non-netting jurisdiction. As a result, the rule for unmargined PFE methodology could be interpreted such that it also captures cases where an individual non-nettable transaction (not qualifying under section 7) is jointly margined with a large regulatory netting set (qualifying under section 7).

The Industry’s proposal to amendment Article 278(2) ensures that the unmargined PFE methodology is applied only in case multiple netting sets (each of which qualify as per section 7) are jointly margined. The margined PFE methodology can however still be applied if there is only one netting set qualifying as per section 7 and some trades facing e.g. a branch in specific non-netting jurisdictions which do not qualify as per section 7.

**Recommendation(s)**

Consider amending Article 278(2) to read: ‘The potential future exposure of multiple netting sets as per section 7 that are subject to one margin agreement, as referred in Article 275(3), shall be calculated as the sum of the potential future exposures of all the individual netting sets as if they were not subject to any form of a margin agreement’.

*Treatment of volatility transactions*

Article 277a (2) seems to indicate that there should be a distinct hedging set for each volatility risk driver (i.e. one distinct for each distinct equity). The Basel text as per CRE52.47 states that “Derivatives that reference the volatility of a risk factor (volatility transactions) must be treated within separate hedging sets within the corresponding asset class. Volatility hedging sets must follow the same hedging set construction outlined in CRE52.45 (for example, all equity volatility transactions form a single hedging set). Examples of volatility transactions include variance and volatility swaps, options on realised or implied volatility. For hedging sets consisting of volatility transactions, the supervisory factor applicable to a given asset class must be multiplied by a factor of five”.

 

The industry proposes an alignment of the European (CRR) with the Basel text for assigning hedging sets.

**Recommendation(s)**

Consider amending Article 277a (2) to read: ‘For the purposes of point (a) of the first subparagraph of this paragraph, institutions shall assign transactions to a separate hedging set of the relevant risk category following the same hedging set construction outlined in paragraph 1’.

*Recognition and treatment of collateral*

Under the current capital rules, the following assets are eligible as potential credit risk mitigants for derivatives exposures:

* Assets listed in CRR Article 197 (Eligibility of collateral under all approaches and methods);
* Assets eligible under CRR Article 299, if the derivative is in the prudential Trading Book (Article 276 (1) (a)).

The Industry proposes to enlarge the eligible collateral assets to CRR Article 198 (additional eligibility of collateral under the Financial Collateral Comprehensive Method (FCCM)).

* The standardised approach SA-CCR applies a haircut method when valuing financial collateral. Those haircuts are the same as the ones that apply under the supervisory haircut method (Article 220) and the FCCM (Article 223) i.e. those of Article 224 for collateral of Article 196, i.e. those listed in Articles 197 and 198 (Basel at CRE52.11 states that the applicable haircuts are identical to that applicable to repo-style transactions which, in CRR, would be those applicable under either Article 220 or 223, i.e. all collateral listed at Articles 197 and 198).
* Logically, the perimeter of eligible financial collateral under SA-CCR should be the same than the perimeter under the supervisory haircut method (Article 220) or the FCCM (Article 223) listed in CRR Article 196 (“Without prejudice to Article 299, the collateral taken, and securities or commodities borrowed within such agreements or transactions shall comply with the eligibility requirements for collateral set out in Articles 197 and 198”)

**Recommendation(s)**

Consider amending Article 276 (1) (a) (b) to read: ‘1. For the purposes of this Section, institutions shall calculate the collateral amounts of VM, VMMA, NICA and NICAMA, by applying all the following requirements:

1. where all the transactions included in a netting set belong to the trading book, only collateral that is eligible under Articles 197, 198 and 299 shall be recognized;
2. where a netting set contains at least one transaction that belongs to the non-trading book, only collateral that is eligible under Article 197 and 198 shall be recognized;.

 

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