

# Comments

## **On the Basel Committee for Banking Supervision's Consultation Paper "The non-internal model method for capitalising counterparty credit risk exposures" (BCBS 254)**

Contact:

Silvio Andrae

Telephone: +49 30 20225-5437

Telefax: +49 30 20225-5404

E-Mail: [silvio.andrae@dsgv.de](mailto:silvio.andrae@dsgv.de)

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Coordinator:

German Savings Banks Association  
Charlottenstrasse 47 | 10117 Berlin |  
Germany

Telephone: +49 30 20225-0

Telefax: +49 30 20225-250

[www.die-deutsche-kreditwirtschaft.de](http://www.die-deutsche-kreditwirtschaft.de)

## **Comments “The non-internal model method for capitalising counterparty credit risk exposures”**

On 28 June 2013, the Basel Committee for Banking Supervision published its Consultation Paper entitled “The non-internal model method for capitalising counterparty credit risk exposures”. We appreciate the present opportunity to share our comments.

### **I. General Comments**

On principle, we welcome the introduction of the NIMM as the successor method for the current exposure method and the standard method (CEM and SM). This is due to the fact that the NIMM seeks to overcome shortcomings of the currently applicable methods outside of the internal model or, moreover, at least attempts to mitigate these shortcomings. We particularly subscribe to the following principles:

- Greater consideration of the specific features of collateralised transactions
- The basic option of including hedge relations in the add-on

Given the low derivatives volume of small or, moreover, medium-sized banks, however, the calculation logic appears too complex for a so-called “standard approach”. In our view, the resulting degree of precision unwarranted; for instance, whilst not limited to, our caveat particularly applies to the calculation of the portfolio future exposure add-ons (PFE), the breakdown into maturity classes or the calculation of the “multiplier”. This is especially true considering that the supervisory factor still introduces a standard component into the equation which is imposed by prudential legislation.

More specifically, in the context of NIMM we would like to comment on scenarios which in our view would be counterproductive with regard to the NIMM’s underlying economic and risk mitigation rationale. Our main concerns are owed to an insufficient recognition of over-collateralisations (and the ensuing over-statement of risks).

### **II. Specific Comments**

*Q1. Should the Basel Committee replace the CEM and SM with the NIMM in all areas of the capital framework? What are the benefits and drawbacks of using the NIMM in each of these areas?*

In our view, a unified method features clearly more benefits than drawbacks. Preserving the “old methods” CEM and SM in individual areas such as large exposures, central counterparty (CCP) or leverage ratio would lead to a situation where banks would see the coexistence of several valuation models for derivatives which would require constant maintenance and administration. In the absence of any adequate benefit to justify these costs, this would tie up considerably more administrative resources.

*Q2. Is the proposed approach of retaining the general structure of the CEM with respect to replacement cost and the potential future exposure add-on appropriate? Is the division of the broad asset classes appropriate?*

Yes, all three questions are answered in the affirmative.

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*Q3. Are there specific product types that are not adequately captured in the outlined categories?*

In our view, the definition of the asset categories is incomplete. It remains unclear how instruments based on bonds, i.e. on securities, other than shares, should be categorised.

*Q4. Does the above approach reflect the replacement cost of margined transactions? Are there any other collateral mechanics that the Basel Committee should consider?*

No, the method does not reflect the actual replacement costs (RC); instead, it reflects the worst case. We would like to illustrate this by means of an example:

With one customer there is a collateral contract featuring a threshold (TH) = EUR5 million and a Minimum Transfer Amount (MTA) of EUR1 million. This means that the replacement costs will always amount to at least EUR6 million regardless of whether transactions were actually concluded.

In the absence of any transactions:  $V = 0$ ;

No collateral received:  $C = 0$ ,

No collateral provided:  $NICA = 0$

$RC = \text{Max}(V - C; TH + MTA - NICA; 0)$

$RC = \text{Max}(0 - 0; \text{EUR } 5 \text{ million} + \text{EUR } 1 \text{ million} - 0; 0) = \text{EUR } 6 \text{ million}$

As a consequence, this approach does not produce a correct result.

In line with standard market practice collateral master agreements with the counterparty, in the event of an insolvency, a risk position is created. This means that not only positive market values after netting ( $V > 0$ ) are offset against collateral received ( $C > 0$ ), but also negative market values after netting ( $V < 0$ ) with collateral provided ( $C < 0$ ).

Hence, for margined and unmargined transactions, the RC should be calculated as follows:

$RC = \text{Max}(V - C_{\text{rec}} + C_{\text{prov}} - ICA_{\text{rec}} + ICA_{\text{prov}}; 0)$

This shall be subject to the following:

$V =$	Net market value of all transactions that have to be included after netting; this figure can be positive or negative.
$C_{\text{rec}} =$	Collateral received, the actual level depends on $V$ (e.g. variation margins)
$C_{\text{prov}} =$	Collateral provided, the actual level of which depends on $V$ (e.g. variation margins)
$ICA_{\text{rec}} =$	Collateral received, the actual level of which does not depend on $V$ (e.g. initial margins).
$ICA_{\text{prov}} =$	Collateral provided, the actual level of which does not depend on $V$ (e.g. initial margins).

The consideration of TH and MTA takes place implicitly according to the aforementioned formula by means of the adjustment of and depending on the actual value change of the netted transactions.

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*Q5. Of the options under consideration for recognising offset across hedging sets, which treatment is preferred? What number of maturity buckets is appropriate to consider?*

We hold the view that offsetting between hedging sets (Approach 1) is more appropriate due the fact that across the maturity buckets there are a certain number of hedging relations which need to be taken into account. In our opinion, the number of three maturity buckets is appropriate. However, we urgently recommend refraining from the proposed breakdown of the hedging sets into main currencies; as an alternative regulatory choice, we recommend allowing at least certain offsetting rules between the various main currencies in the maturity buckets.

*Q6. Is the proposed approach of using a different methodology for determining the add-on for each asset class appropriate? Is each proposed add-on methodology for each asset class effective at capturing the main risk driver of that asset class?*

Determining the adjusted notional (indent 47):

There is an inappropriately high add-on for transactions with a long maturity when determining the adjusted notional for the instruments of the asset classes, interest rate and credit. Furthermore, compared to the other asset classes, the consideration of the remaining maturity is inconsistent. For instance, it seems counterintuitive why a 10 year interest swap (asset class “interest rate”) sees a 10-fold increase of the notional amount whilst this shall not be the case for a 10 year currency swap (asset class “foreign exchange”). Hence, for the remaining maturity, both a floor and a cap should be introduced.

Supervisory delta adjustments (indent 48):

The definition of  $\delta$  for presenting long positions /short positions is not regulated in a comprehensive and consistent manner. The example of a basis swap (variable vs. variable) where the market value depends on two “primary risk factors” illustrates that in the event of a parallel shift of the two factors (this concerns the two cases c) and d) listed below) the market value change of the basis swap cannot be determined in an unambiguous manner or, moreover, may change over time.

Basis swap example: Receive leg: Euribor and pay side: Libor

Scenario a): Euribor up, constant Libor → Basis swap market value up → Delta = +1

Scenario b): Constant Euribor, Libor up → Basis swap market value down → Delta = -1

Scenario c): Euribor up and Libor up → Constant basis swap market value (?) → Delta = unclear

Scenario d): Euribor down and Libor down → Basis swap market value constant (?) → Delta = unclear

Indent 76 lists the four hedging sets energy, metals, agricultural and other commodities for commodity derivatives. For commodity derivatives, no. 77 specifies that offsetting will be carried out within all hedging sets and thus also in “other commodities”. At this junction, the rationale underlying the different netting approaches is not immediately obvious: Why is netting allowed in “other commodities” whilst it is not allowed between the hedging sets within one netting set?

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*Q7. Are the proposed minimum time risk horizons for each transaction category (unmargined, non-centrally cleared, centrally cleared) appropriate? Should the Basel Committee consider factors other than the IMM for determining the appropriate time risk horizon for the NIMM (eg harmonising with other international or national legislation)?*

On principle, we should like to welcome a lower add-on which reflects the lower risk horizon of “margined transactions”. More specifically, however, the GBIC would like to understand: Why does the formula contain the factor  $3/2$  if the add-on’s one year scale should merely be adjusted to the margin period of risk? What is the rationale for choosing the conservative adjustment of  $3/2$ ?

*Q8. Do the suggested formula and 5% floor appropriately recognise the benefits of overcollateralization?*

Our main concern over NIMM is owed to the calibration of the multiplier formula during consideration of the overcollateralization. We are of the opinion that this approach is not fit for purpose, it exaggerates risks and is needlessly complex.

The proposed framework only manages to consider a fraction of the overcollateralization. For instance, the mechanics of the formula works as follows: Provided a bank received a level of overcollateralization that is on *a par* with the calculated add-ons of this netting set, this translates into a multiplier of approximately 67 percent. This means that although the complete potential future replacement value would be fully collateralised due to the overcollateralization received, only approximately one third of this collateral could be offset against the exposure. Given that it appears unrealistic to us that the overcollateralization will account for a multiple of the add-on, more likely than not in practice a lower multiplier will never be reached (for instance, a multiplier of 20% would only be achieved if, for instance, the fourfold value of the add-on existed in terms of overcollateralization).

In addition to this, more likely than not, the effect of the (moderate) consideration of overcollateralization will be *de facto* levelled out due to the applicable scaling factor of 1.4.

By virtue of this multiplier approach, the Basel Committee seeks to take into account a putative residual risk in the event of a complete collateralisation of the supervisory exposure. At this juncture, however, we see a clearly exaggerated presentation of risks. To us it is not immediately obvious why only a fraction of the overcollateralization received may be used for the purposes of mitigating the potential future replacement costs. Given the forthcoming collateralisation obligations in OTC derivatives transactions within the framework of EMIR (notably the obligation for mutual provision of initial margins) this exaggerated statement of risks could generate a material effect.

In our view, it would be appropriate if the aggregate amount from the overcollateralization (potentially reduced by means of haircuts) could be used in its entirety for the purposes of reducing the exposure (i.e. the add-on). Also under indent 82, this approach is outlined as a viable option (albeit it is not being pursued further): “One approach might be to allow any amount of collateral to offset directly the positive replacement cost. However, this would reduce the exposure value to zero if sufficient excess collateral is held, although there is still residual counterparty credit risk.” To us, the rationale for this is not immediately obvious: Why should a residual risk exist in the event of counterparty default risk if the amount of

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the obtained collateral completely covers or even exceeds the present and the potential future replacement risks?

*Q9. Is the proposed approach to aggregate across asset classes appropriate?*

To us, the breakdown into the individual hedging sets (above all with reference to indent no. 11, 15 and 88) appears highly detailed and is not immediately plausible. On the one hand, this is supposed to be an attempt to better reflect netting agreements; on the other hand, however, a breakdown of the netting sets into hedging sets on an asset class level is carried out and the proposal says that netting is not envisaged / allowed between such hedging sets. This fails to adequately reflect the economic perspective of netting agreements and thus netting of the exposures within one netting agreement. Furthermore, it is not immediately obvious why the hedging sets were chosen in this form.

*Q10. Are there any risk factors that should be included in their own category or accounted for in another manner?*

N/A

*Q11. Is the proposal to introduce the multiplier in order to allow reduction of the PFE add-on in the IMM shortcut method appropriate?*

N/A

### III. Further aspects beyond the list of questions

#### *Indent 23/30 – Determination of the value of the overcollateralization*

Is it correct that the amount of the overcollateralization which is taken into account under section D will be defined as follows:

- For uncollateralised (non-margined) transactions (indent 23):
  - The amount of the collateral received exceeds the positive market value of the derivative portfolio ( $V > 0$ ,  $C > 0$ ,  $C > V$ , Overcollateralization =  $C - V$ ), and
  - The amount of the negative market value of the derivative market value exceeds the amount of the collateral provided ( $V < 0$ ,  $C < 0$ ,  $C > V$ , overcollateralization =  $C - V$ )?
- For collateralised (margined) transactions (indent 30): Similar to uncollateralised transaction and overcollateralization =  $NICA - TH - MTA$ )?

In the final analysis, from our point of view, the amount would be added to the overcollateralization amount which is not being taken into account given the 0-floor in the replacement costs.

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*Unclear delimitation of “marginated / non-marginated transactions”*

It is unclear whether also indirect, centrally cleared transactions (clearing member and clearing clients) shall be counted under marginated transactions in cases where they feature a regular exchange of variation margins.

*Derivations that are unclear (please elaborate further)*

The intention or, moreover, the derivation of the following formulas is not immediately obvious to us:

- Calculation of the effective notional between maturity buckets (indent 56, approach 1)
- Calculation of the add-on for credit derivatives under consideration of the correlation (indent 70)
- Calculation of the multiplier (no. 85)

*Typos*

Example 3 on page 28 reads: “supervisory factor for oil/gas (16%)”. This should be 15% instead of 16% (in line with table 1 under No. 96 and by way of analogy for the further calculation of the example).

Yours faithfully,

For the German Banking Industry Committee



Dr. Martin Lippert

Dr. Silvio Andrae