ABI comments on the consultative document on "The non-internal model method for capitalising counterparty credit risk exposures"

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POSITION PAPER

General remarks

The Italian Banking Association (ABI) welcomes the opportunity to comment on the consultative document of the Basel Committee, proposing a new non-internal model method (NIMM) for capitalising counterparty credit risk exposures.
The observations of the Italian banking industry are presented below.

ABI appreciates the initiative of the Basel Committee, aimed at enhancing the risk sensitivity and consistency of the framework. The envisaged method seems to be suitable to meet these goals. Therefore, ABI broadly agrees with the proposed approach. Nevertheless, some fine-tuning work would be useful.

To this end, the results of the QIS should be given the utmost consideration, especially with respect to the calibration of the method.

ABI also appreciates that the Committee cares about the costs induced by implementing the NIMM, and the attempts to keep the proposed method as simple as possible, while preserving risk sensitivity.

At present, it is not possible to quantify the overall costs of implementing the proposed framework; nevertheless, some considerations are possible.

It is worth noting that the proposed approach requires the use of data already available to banks, and this helps to contain the implementation costs. Nonetheless, this data has to be rearranged and managed for the NIMM, so it appears clear that the burden would be heavy.

Actually, the greatest part of the expected costs relates to first-time adoption of the NIMM, which will involve setting up the necessary databases and procedures. In this regard, ABI highlights that the time available to banks for the implementation of the NIMM will greatly affect the burden. To avoid unnecessary costs for banks, it is therefore essential that an appropriate time interval, of at least one year, be set between the definition of the final detailed discipline and its entry into force. In determining the appropriate deadline for the NIMM, it must be remembered that many other reforms in the same field will come into force over the next few years, thus requiring great effort from banks in order to comply with every new regulation.

Anyway, in ABI’s opinion the benefits of the NIMM, in terms of enhanced risk sensitivity compared with current approaches, outweigh the costs linked with its adoption.

Answers to the questions posed in the consultative document

The consultative document focuses on the proposed methodology, while the scope of the new approach is always referred to simply as "derivative transactions". An explicit definition of the transactions that fall within the scope of the NIMM would be welcomed. In particular, doubts arise with reference to the so-called "long settlement transactions". At present these transactions are given the same capital treatment as derivatives, even though they are considered to be a separate category. In ABI's opinion, it would be appropriate to keep their capital treatment in line with the treatment of derivatives, since the development of a different approach, or the retention of the current one, would be neither justified from a methodological point of view, nor cost effective for banks. ABI therefore suggests that the scope of the NIMM should encompass long settlement transactions.

ABI's observations with reference to the questions proposed in the consultative paper are presented below.

1. **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 ABI's opinion, if a new approach is adopted for capitalising counterparty credit risk exposures, it should replace the CEM and SM in all areas of the capital framework.

In fact, if the current methodologies were maintained for some areas of the capital framework, this would jeopardize the consistency of the framework as a whole.

Besides, maintaining the CEM and SM methodologies (for purposes other than the CRR exposure) alongside the new approach would entail significant costs for banks, due to the duplication of databases and calculation procedures.

Moreover, in ABI's opinion the quantitative impact of using the output of the NIMM in other areas of the capital framework should be assessed.

Should the NIMM, following the impact assessment, prove inappropriate for application to certain instruments or situations in other areas of the capital framework, specific amendments are expected to be made.

2. **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?**

In ABI's opinion, the structure based on replacement cost and the potential future exposure add-on is appropriate.

The division of the asset classes is considered appropriate as well.

However, ABI observes that in the consultative paper, the Committee considers gold among other metals, hence including transactions referencing to gold within the "commodity derivatives" asset class (see Example 3 in Annex II). Instead, gold is treated as a foreign currency under the CEM and under the current market risk framework. In ABI's opinion, the treatment of gold should be the same, either as a commodity or as a foreign currency, under both the market risk and the counterparty risk frameworks.

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

ABI has not identified any product types not captured in the outlined categories. However, the document is not explicit about the asset class for the instruments referencing the inflation rate as the primary risk factor. In ABI's opinion, it should be specified that these instruments are to be included within the "interest rate" asset class.

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

In general terms, ABI agrees with the proposed approach.
However, it could sometimes lead to inconsistent results since, all other things being equal, the replacement cost for a margined trade can be higher than that for the same trade in the absence of margin agreements, due to the TH+MTA-NICA element. Ideally, this difference should be more than balanced by the reduction in the PFE for margined trades. ABI suggests that a cap be introduced in order to ensure that, should the reduction in PFE not balance the higher RC, the NIMM exposure for the margined trade cannot exceed the NIMM exposure of the same transaction in the absence of margin agreements.
The proposed approach overcomes a shortcoming of the current capital framework with respect to the treatment of cash collateral. At present, the cash collaterals received and posted by a bank are subject to asymmetric treatment. In fact, received cash collateral is considered for the purpose of

determining the counterparty credit risk exposure of the collateralised transaction, while cash collateral posted by a bank is considered as a simple credit towards the counterparty (and hence falls under the ordinary credit risk regime). In our understanding, under the proposed framework both the collaterals received and posted by the bank are considered for the purpose of determining the CCR exposure. In ABI's opinion, it would be useful to clarify that, in the forthcoming regime, the cash collateral posted by a bank will always fall under the NIMM framework and will no longer be subject, under any circumstances, to the ordinary credit risk prudential treatment.

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

As to the approach for recognising offset within the asset class, in ABI's opinion Approach 1 is the most appropriate, since it allows a partial offset across maturity buckets. In fact, recognition of the existing correlation between transactions with different maturities justifies the slightly greater complexity of the formula.
The proposed structure of three maturity buckets (less than one year, between one and five years and more than five years) is considered appropriate, not least because a greater number of buckets would lead to a formula for the aggregation across maturity buckets that is too complex.

6. 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?

ABI agrees with the use of different methodologies for determining the add-ons for the different asset classes.
The methodologies are in general terms considered effective, even though some shortcomings with reference to the treatment of certain categories of transaction have been identified.
First, the one-year floor for maturity excessively penalises some categories of trade that reference interest rates (such as those referencing EONIA). Therefore ABI suggests that this minimum maturity be shortened.
Again on the topic of maturity, the treatment of some categories of instrument should be clarified. For so-called amortizing transactions (e.g. amortizing swaps) reference should be made to the final maturity of the transaction - if not specified otherwise. In ABI's opinion, these transactions should be broken down and the specific maturity of each component should be taken into account.
The proposed methodology also appears to be too penalising when applied to basis swaps. To this end, in ABI's opinion the application of a supervisory

delta lower than one to calculate the effective notional would be appropriate.
Finally, ABI observes that, with reference to the credit derivatives asset class, a criterion should be introduced for determining the applicable supervisory factor (SF) for basket credit derivatives.

7. 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)?

ABI has no observations with respect to the minimum time risk horizons.

8. Do the suggested formula and 5% floor appropriately recognise the benefits of overcollateralisation?

Yes, in ABI's opinion the suggested formula and floor are appropriate.

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

The proposed approach, based on simple summation, appears appropriate. Anyway, this should be confirmed once the results of the QIS are available.

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

ABI considers the proposed classification appropriate.

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

In ABI's opinion, the introduction of the multiplier in the IMM shortcut method is appropriate, as it enhances the consistency between the internal model and the non-internal model methods.

Anyway, clarification is needed on whether, in order to apply the multiplier in the shortcut method, it is appropriate to determine the add-on using the

formula $E[\max(\Delta MtM; 0)]$, contained in paragraph 41 of Annex 4 of the Basel II rules[1] (as modified in Basel III[2]).

Finally, it would be helpful to provide practical examples of applying the multiplier in the shortcut method.

[1] BCBS, International Convergence of Capital Measurement and Capital Standards, June 2006.
[2] BCBS, Basel III: A global regulatory framework for more resilient banks and banking systems, June 2011.