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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

27 September 2013

Dear Sirs

BCBS consultation document on the Non-Internal Model Method for capitalising counterparty credit risk exposures

We welcome the initiative undertaken by the Basel Committee on Banking Supervision (BCBS) to develop a single Non-Internal Model Method (NIMM) for calculating counterparty credit risk exposures. We appreciate the key objectives of the NIMM addressed in the consultative document: calibration to a recent stress period, recognition of the benefit from collateralisation and better reflection of legal netting arrangements. We believe that the proposed framework could provide an enhanced alternative to the current exposure method. We support the joint industry response prepared by the International Swaps and Derivatives Association, the Institute of International Finance, the International Banking Federation and the Global Financial Markets Association, which covers the wide spectrum of the consultation. In our response, we have limited our comments to particular areas of concern in the proposed methodology. The main comments are highlighted below, with details provided as responses to the questionnaire, attached in the Appendix.

Calibration

NIMM is intended to address the main shortcoming of the Current Exposure Method (CEM) and the Standardised Method, namely lack of risk sensitivity. The objectives of the proposed reform, as stated in the consultative document, do not include increasing the absolute amount of capital required for the exposures covered by this method. According to our preliminary estimates, the proposed NIMM approach would double the risk weighted assets arising from CEM, and would produce higher risk weighted assets even without application of the alpha multiplier intended to cover wrong way risk. We urge the BCBS to consider very carefully the results of the QIS associated with this consultation, so that the resulting capital charge is proportionate to the risk involved.

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Wrong-way risk

We understand that the proposed alpha multiplier is used to adjust wrong-way risk, and it is an integral part of the Internal Modelling Method (IMM) framework. However, we do not see a natural fit of this multiplier into the add-on based approach still retained in NIMM. In particular, if alpha is used for Central Counterparties (CCPs), it could work against the principle of making central clearing more attractive compared to bilateral trades. We recommend that BCBS consider removing alpha from the NIMM framework.

Replacement cost calculation for margined transactions

We are concerned about the different perspective considered on the replacement cost (RC) between margined and unmargined calculation. The unmargined RC captures the current net exposure taking into account the net independent collateral position posted or received by the bank. However, the RC for margined netting sets tries to capture the 'potentially maximum' exposure by taking into account threshold and minimum transfer amount. We believe this creates inconsistency with what the RC should be calculating with unintended consequences. We are proposing a modification of the formula (ref. to our response to Q4 in the Appendix).

Add-on calculation methodology for interest rate and FX derivatives

We support the differentiation between asset classes for the add-on calculation. We are concerned about the methodologies proposed for interest rate and foreign currency derivatives, as these will result in overstating the risk.

Margin Period of Risk

We believe that the use of the 3/2 factor in conjunction with alpha under the Margin Period of Risk adjustment for margined transactions would result in an incorrect application of the adjustment. We recommend either application of the adjustment on Effective EPE with alpha, or on Effective EE without alpha.

Recognition of diversification benefits across asset classes

The proposal not to allow any diversification benefit across asset classes seems to be overly conservative. We believe that a certain degree of diversification benefit should be recognised based on the correlation across different asset classes.

Yours faithfully



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Appendix

Non-internal model method for capitalising counterparty credit risk exposures – BCBS cp 254

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?

The Current Exposure Method (CEM) rules are overly conservative relative to other traditional risk measurement methodologies. We believe that introducing an even more conservative approach would be counterproductive, and therefore the NIMM approach should not systematically increase RWA relative to the CEM. A preliminary impact analysis was conducted based on the Group's overall counterparty credit risk exposure and the results suggest that the NIMM would increase RWA by a factor of two relative to the CEM. This indicates that NIMM RWA, even in the absence of alpha, would still be higher than CEM RWA for the Bank's exposures.

We understand that the alpha multiplier is a conservative wrong-way risk adjustment and is an integral part of the IMM framework. However, we do not see a natural fit of this multiplier into the add-on based approach. In particular, if alpha is used for Central Counterparties (CCPs), it could work against the principle of making central clearing more attractive compared to bilateral trades. Therefore, we propose considering the removal of alpha from the NIMM framework.

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?

We believe that it is appropriate to retain the general structure of the CEM as it helps banks understand the new methodology without much difficulty based on the current rules. It also looks conceptually appropriate to have two components separately to quantify the risks involved – (i) replacement cost, which reflects the net current exposure of all contracts with a counterparty subject to a legally enforceable netting agreement, and (ii) the potential future exposure add-on to account for the potential movements in its value.

Although the division of the asset classes into five categories seems appropriate and broadly in line with the CEM methodology, we believe that it would be more appropriate if further guidance is provided in terms of the treatment of some specific products. For example, cross-currency swaps have both elements of interest rate derivatives and FX derivatives, and it is unclear how to calculate a NIMM-compliant EAD for such kind of products.

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

We note that there is an industry-wide initiative to define a list of products which should be more adequately captured in the outlined categories, with respect to lack of clarity on:

- Notional: the definition of notional for products such as amortising swaps, derivatives with a digital payoff, derivatives with callability features, and options in general;
- Maturity: how the notional is adjusted for FRAs for the fact that the interest period is often 3M or 6M;
- Multi-asset products: how the add-on is calculated for the fact that there are multiple assets in a single contract.

We also believe that it would improve the industry understanding of the NIMM if more transparent and clear definitions were provided.

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

We are concerned about the different perspective considered on the replacement cost (RC) between margined and unmargined calculation. We believe that the unmargined RC tries to capture the current net exposure taking into account the net independent collateral position posted or received by the bank. This seems consistent with the intention of the RC as we see it - the net current exposure of all contracts with a counterparty subject to a legally enforceable netting agreement.

However, the RC for margined netting sets looks to capture 'potentially maximum' exposure by taking into account threshold (TH) and minimum transfer amount (MTA). We believe this creates inconsistency with what the RC should be calculating (i.e. the net **current** exposure), with the following potential issues:

- One-way CSA: if the bank has ISDA and CSA in place with a counterparty whereby the terms of CSA is a one-way in favour of the counterparty, it is unclear how to calculate the RC because TH is mathematically infinite in this case.
- Unintuitive treatment of some margined netting sets against unmargined netting sets: all else being equal, an unmargined netting set will normally result in a lower RC compared to a margined netting set with a very high threshold amount. In such case, having an ISDA and CSA works as a disadvantage compared to the absence of such master agreement, while from a risk point of view these should be at least considered equivalent.
- Capital charge even in the absence of actual exposure: if the bank has a margined counterparty with TH = USD1m, MTA = 0, NICA = 0, the minimum RC will always be USD1m irrespective of whether there is a trade executed with the counterparty or not. This may imply significant capital charge over counterparties even without actual trades executed.

Therefore, we propose considering a modification of the replacement cost for margined trades as follows:

$$RC = \max(0; \min(V - C; TH + MTA - NICA))$$

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?

On interest rate products, we consider that partial offsetting across maturity buckets is more appropriate and therefore preferred. No offsetting across maturity buckets despite same currency appears to be overly conservative.

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We also consider that the segmentation of interest rate derivatives into three maturity buckets (less than one year, between one and five years and more than five years) is appropriate. The three time buckets seem broadly aligned to what most banks are currently using and therefore we do not anticipate much additional operational burden from this treatment.

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?

We believe that it is appropriate to use a different methodology for determining the add-on for each asset class as this will allow capturing and assessing different risk elements which are specific to different asset classes. However, there are some issues which we would like to highlight in the proposed add-on methodology.

- Interest Rate Derivatives

We are concerned that scaling notional by maturity for interest rate derivatives will overstate the risk, especially for swap contracts – the most common product type among interest rate derivatives with generally longer tenor. We note the explanation in the consultative document stating that the linear dependence on maturity is a conservative assumption based on the fact that Effective EPE for interest rates is approximately proportional to duration, which is always less than the remaining maturity. There is an industry-wide proposal being formulated arguing that the maturity adjustment scaling should be based on DV01, which is a significantly more accurate and risk-sensitive measure than the outright maturity. We support this argument and therefore recommend that DV01, or another set of adjustment parameters closely calibrated to DV01, be used instead of outright maturity.

Additionally, the proposed maturity adjustment would have a significant impact on both margined and unmargined netting sets containing long-dated transactions (especially if the benefit of offsetting is minimal). We believe that the supervisory factor of 0.5% remains overly conservative for these netting sets. The industry estimate of a more appropriate add-on seems to be 0.2% per year and this is broadly aligned with our estimated IMM add-ons. Therefore, we recommend using an add-on of 0.2% instead of 0.5% per year for interest rates derivatives.

We also recommend that partial offsetting should be allowed among interest rate derivatives with different currencies.

- FX derivatives

We are of the opinion that to disallow offsetting across different currency pairs is an overly conservative treatment. We suggest that a diversification benefit be allowed across hedging sets with different currency pairs considering correlation between currency pairs.

In addition, we seek clarification as to whether onshore and offshore currencies can be included in the same hedging set, since they are highly correlated (often 100%). Examples of such currencies are those which are traded in the non-deliverable forward (NDF) markets.

We note that the proposed NIMM approach for FX derivatives suggests that the adjusted notional amount is maturity-independent, i.e. time bucketing as under the CEM for this asset class is eliminated. We think that this might not encourage institutions to adequately balance FX derivatives risk across tenors. In this context, it may be appropriate to maintain a time bucketing mechanism for

this asset class, in which case the supervisory factor (currently 5% flat) should be readjusted to adequately incentivise short-term and penalise longer term trades.

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)?

We believe that the proposed minimum time risk horizons for each transaction category (one year for unmarginated, 10 business days for non-centrally cleared, 5 business days for centrally cleared) are appropriate. They are consistent with supervisory floors as set out in the Basel III rules regarding the implementation of the increased margin period of risk (MPOR). We understand that the application of MPOR will help reflecting the reduced exposure more appropriately for margined trades, whereas CEM does not take MPOR into account.

However, we are concerned about the application of 3/2 factor in conjunction with the alpha of 1.4. We understand that the 3/2 factor converts the calculated add-on from Effective EPE to Effective EE at one year, and this is then scaled back to Effective EE at MPOR through the square-root-of-time conversion. The proposed method uses Effective EE at MPOR as a final add-on measure for margined netting sets, without converting it back to Effective EPE, although from our understanding from BCBS116 the alpha of 1.4 is supposed to be applied to Effective EPE.

This approach appears therefore overly conservative, and we recommend using either 1.4*Effective EPE (at MPOR) or Effective EE at MPOR without alpha.

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

Although we understand that the 5% floor is introduced with prudential conservatism, we think no floor should be applied in order to fully recognise either overcollateralisation or deep negative mark-to-market positions. We noted from the graph in the consultative document that the multiplier without the floor itself worked conservatively compared to the IMM multiplier. The introduction of a floor to the multiplier adds an additional degree of conservatism, and this will over-proportionally impact smaller add-ons coupled with a high over-collateralisation level or a deep negative mark-to-market position. This may be perceived as moving against the direction to which new regulations are heading, whereby higher collateralisation levels are encouraged in order to mitigate counterparty credit risk.

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

The proposal not to allow any diversification benefit across asset classes seems to be overly conservative. There are certain products where the level of correlation with another asset classes is high; for example, forward FX rates are determined by a parity relationship between the spot exchange rate and difference in interest rates between two countries (FX forward and the interest rate of the base currency tend to move with high correlation to different direction). On this basis, a certain degree of diversification benefit should be recognised based on the correlation factors across different asset classes.

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

- Treatment on Repos

We would like to know how the NIMM rules would treat the calculation of counterparty credit risk for Repo transactions. It is a distinct asset class that should have a similar capital treatment as derivatives. We understand that, at the moment, Repos are subject to the Banking book capital rules (applied to their underlying securities). However, under the IMM rules, Repos enjoy derivatives-like treatment though no netting is allowed between GMRA and ISDA trades (unless there is a Global Netting Agreement). It would be beneficial for the NIMM rules to clarify whether Repos can be subject to the same "replacement cost + add-on" rules as other types of derivatives.

- Margined and unmarginated trades within a netting/hedging set

Under the NIMM rules, there are calculations applied differently dependent on whether trades are margined or unmarginated – Supervisory Factors, MPOR co-efficient and calculation of RC. The Supervisory Factors are applied to the Effective Notional at each hedging set level. The MPOR co-efficient is applied at netting set level to allow scaling down margined netting sets. The RC is calculated at netting set level using a different formula to differentiate margined and unmarginated netting sets.

Through the applications addressed above, the NIMM rules naturally assume that all trades within a single netting set/hedging set will be uniformly margined or unmarginated. However, there can be a combination of margined and unmarginated trades within a single set. This can arise because terms of a CSA agreement allow a counterparty to exempt certain trades from margining at the trade-entry stage despite the trades being still governed by the CSA.

Therefore, in order to deal with the fact that a single netting set/hedging set may have a combination of margined and unmarginated transactions, we are of the view that calculation for the three parameters addressed above should be applied at each trade level rather than at netting set/hedging set level to differentiate margined and unmarginated trades more appropriately.

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

As addressed in our comments for Q8 above, we believe that the 5% floor should be removed in order to fully recognise either over-collateralisation or deep negative mark-to-market positions.