ASSOCIATION DES BANQUIERS CANADIENS
CANADIAN BANKERS ASSOCIATION

Darren Hannah
Senior Vice President
Financial Stability & Banking Policy

Tel (647) 730-4760
dhannah@cba.ca

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Basel Committee on Banking Supervision
Centralbahnplatz 2
4051 Basel, Switzerland

Re: CBA[1] Comments on BCBS Technical Amendment Hedging of counterparty credit risk exposures

CBA members appreciate the opportunity to comment on the Basel Committee on Banking Supervision (BCBS) *Technical Amendment Hedging of counterparty credit risk exposures* (amendment). Our members appreciate that this proposal aims to improve consistency in the treatment of collateral vs credit protection for derivatives transactions. However, from a prudential standpoint, we are concerned that the proposed amendment introduces an overly complex calculation framework and creates new inconsistencies in the risk mitigation treatment compared to securities financing transactions (SFT) and loans.

The proposal introduces additional conservativism and may restrict banks' ability to efficiently manage and mitigate idiosyncratic and concentration risks associated with counterparty credit exposures. It also possibly introduces adverse incentives for increasing contagion and systemic risk. Our primary areas of concern are outlined below.

The use of mitigation tools as a source of residual risk
Guarantees and credit derivatives serve as essential tools for institutions to transfer risk to more creditworthy counterparties. In particular, banks use credit default swaps (CDS) as credit mitigants where they would like to reduce their concentration risk to a single counterparty, or when the contract does not allow the use of collateral as a mitigant. Consequently, we do not concur with the assertion that the use of credit mitigants, as currently applied in the framework, introduces residual risk.

Under the current framework the estimation of the exposures at default (EAD), whether modeled using the SA-CCR or IMM approach, is calibrated with a prudent level of conservatism to minimize this residual risk. The current standards have multiple levels of conservatism incorporated: first, the application of the alpha factor of 1.4 for the exposure and corresponding protection amount; and second, a double default assumption: since the substitution approach treats the protected amount as a direct exposure to the protection provider. The implication is that the derivative counterparty has already defaulted, thus introducing a further layer of conservatism in the capital calculations.

We acknowledge that, at the time of default, the realized exposure could potentially exceed the estimated exposure in tail scenarios, however, this is true regardless of whether a credit mitigant or risk transfer mechanism is in place. Therefore, we do not believe that the presence of mitigants leads to undercapitalization under the current framework. Finally, as SFT and loan exposure risk mitigation are not impacted, new inconsistencies between asset classes are introduced.

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[1] The Canadian Bankers Association is the voice of more than 60 domestic and foreign banks that help drive Canada's economic growth and prosperity. The CBA advocates for public policies that contribute to a sound, thriving banking system to ensure Canadians can succeed in their financial goals. www.cba.ca

Conflation of concepts
The proposed amendment to treat guarantees or credit derivatives as cash collateral for determining the covered amount is a primary concern. In the context of counterparty credit risk (CCR), cash versus guarantees or CDS, as credit mitigants, serve fundamentally different purposes and possess distinct characteristics. Collateral, typically derived from variation margin or from initial margin, is designed to be and is inherently ephemeral in nature. In contrast, a guarantee, or CDS or any independent collateral amount, as referred to by the industry, represents a fixed amount that remains unchanged and can have maturity matching that of the netting set.

We believe that this distinction should be considered in determining the capital adequacy requirement. We strongly encourage the BCBS, should it decide to proceed with this amendment, to also consider the permanence and maturity of the protection provided by guarantees and credit derivatives when assessing their treatment within the framework.

Increase the cost of credit mitigation
The new approach disincentivizes credit risk mitigation for over-the-counter (OTC) transactions. The proposed amendment if implemented, would significantly diminish the effectiveness of purchased protection, misalign the framework with the underlying economic risk, and reduce the associated capital saving benefits. To address the inefficiencies introduced, banks would be compelled to increase the notional amount of guarantees or credit derivatives to possibly unlimited levels where the cost of protection would likely exceed the capital cost of the exposure.

We note that limiting protection for credit is important for limiting the protection provider's risk. Unlimited protection would increase systematic risk and contagion from transferring extreme tail risks between financial institutions. Furthermore, under a look-through approach to capital, the protection provider would not face any additional capital consequences from limiting or providing unlimited protection - introducing capital arbitrage opportunities.

As a result, banks would lose access to an efficient tool for risk mitigation for OTC transactions, particularly in scenarios where institutions aim to manage and reduce concentration risk effectively. We believe this could undermine the intended objectives of prudential risk management and capital efficiency and be inconsistent with industry use of these instruments as a credit risk mitigant.

Increased operational complexity

We appreciate that the BCBS is attempting to provide guidance on the recognition of guarantees or credit derivatives, as this is not explicitly addressed in the CCR framework and is concerned about appropriate measurement of residual risk for mitigated exposures. Given our concerns above, we believe the amendment proposals are significant policy changes, which should not be done by way of the technical amendment process. Rather, they should be agreed on by all member jurisdictions as part of revisions to the BCBS CCR framework.

We believe that the proposal introduces several layers of additional complexity in the capital calculation as well as, potentially, in other part of the regulatory framework. The net effect is an increase in the operational cost for banks of setting up a process for the complicated proposal in paragraph *CRE 51.19 Treatment of guarantees and credit derivative protection*, with minimal benefit. We believe that the existing framework adequately reflects the objective of mitigation, while maintaining sufficient conservatism in the capital calculation.

We provide detailed comments to the BCBS' questions in the attached Comment Template. Please feel free to contact me with any questions.

Sincerely,

cc: Patrick Tobin, Office of the Superintendent of Financial Institutions

CBA Members' Comments
Annex 1: proposed amendments to the Basel Framework **Counterparty credit risk overview** **CRE51.19**

The premise of CRE51.19 is that collateral mitigation is similar to the bought credit protection. In the collateral mitigation scenario, without the floor effect in the potential future exposure (PFE) multiplier, the entire exposure will be extinguished, yielding zero risk-weighted assets (RWA). Conversely, in the case of bought credit protection, the exposure is shifted to the risk weight of the guarantor, thus still capitalized.

- The exposure at default (EAD) to the underlying counterparty is independent of the credit protection. The effect of credit protection is reflected in the credit component of the RWA. The proposed regulation is comingling the exposure framework with that of credit obligor mitigation.
- We believe the new approach disincentivizes credit risk mitigation.

To elaborate:

- The bought protection is provided against jump to default (JTD), thus, the amount covered is independent of the EAD calculation as of a given time.
- The full exposure is always capitalized, albeit against different risk weights. If the protection bought covers the entire EAD, the RWA is reflected under the guarantor. In the case of collateral for SA-CCR, without the floor effect in the PFE multiplier there will be zero capital.
- EAD calculation accounts for the variability of the exposure, regardless of credit protection purchased. The exposure not covered by the protection provider is captured under the counterparty credit risk (CCR) itself.
- Capital calculation at a future time, can have two cases under the counterparty default:
    - The future exposure declines. The amount covered by the protection provider remains unchanged providing for a greater coverage of the EAD, bringing the resulting capital calculation lower.
    - The future exposure increases. The incremental exposure may not be covered by the protection provider (given the protection provided is set). This increment will be capitalized under the original counterparty. This is the case for any calculated EAD with protection or without.

As highlighted in our other comments we think that a guarantee or bought credit protection, which has a fixed maturity, should not have the same treatment as cash or collateral which can usually vary daily. We also note that the Technical Amendment does not discuss the

CBA Members' Comments
impact of the maturity of the guarantee or credit derivative on the determination of the protected and unprotected portions of the exposure. Therefore, we believe the Technical Amendment is not necessary. However, should the BCBS still proceed with the changes, we would recommend that, in the calculation of the unprotected portion, in the point (1) of this updated paragraph (CRE51.19), the amount used should not be set to the "*maximum contingent claim*", but should be set to a "*multiple of the maximum contingent claim*" to account for the longer maturity of the guarantee or credit derivative compared to variation margin cash, or collateral which can change on a daily basis. A similar approach could also be applied to long-term collateral, such as the independent collateral amount, to align the approaches if consistency is desired. This change would reflect the difference between collateral that varies on a daily basis (such as variation margin and ISDA initial margin), and long-term collateral with a known maturity such as the independent collateral amount and the credit default swap (CDS) amount reflected as collateral. The proposed amendment introduces an overly complex calculation framework to improve inconsistencies in the treatment of collateral vs. credit protection. However, it also creates new inconsistencies in the risk mitigation treatment compared to securities financing transactions (SFT) and loans. Risk mitigation for purchased protection for over-the-counter (OTC) is reduced, while purchased protection for SFT and loans is still applied on a 1-1 basis although similar collateral / protection inconsistencies exist in that context. The proposal disincentivizes protection for OTC and would encourage institutions to purchase protection for loan and SFT exposure before applying any in the OTC space (which is coincidentally the one that is typically the most active for managing exposure, CVA risk, and concentration risks). Finally, to address the reduced protection coverage for capital, banks would be compelled to increase the notional amount of guarantees or credit derivatives to, possibly, unlimited protection. This, we believe, may have unintended consequences for contagion risk and even introduce arbitrage or incorrect incentives for protection providers. Limiting protection is important for limiting the protection provider's risk. Unlimited protection would increase systematic risk and contagion from transfers of extreme tail risks between financial institutions. We also note that under a look-through approach the protection providers typically would not necessarily face additional capital consequences from providing unlimited protection. For example, if under a look-through approach for a contingent credit protection, the EAD for the protected portfolio is 100 million, and the protection provider capitalizes exposure at 100 million EAD x RW, limiting protection at say 120 million, 150 million or 1 billion would not impact the capital requirements for the provider - thus providing skewed arbitrage incentives for increasing the tail-protection that this Technical Amendment tries to address.

CBA Members' Comments
Annex 2: illustrative numerical example **Case 4: same as case 1 except the bank hedges the derivative with a $14 CDS and applies the proposed new TA set out in CRE51.19**
We believe the implementation proposed is too conservative in the case of significant protection being provided. The amount that will be covered by the protection will always be the same. Using the collateralized exposure approach as a way to limit protection covered is unnecessarily conservative. • The Technical Amendment acknowledges the unlimited protection as being binding, in which case full transfer is allowed. • The unlimited protection is equivalent with significant protection – imagine EAD of $25 to $100 protection – this will still minimize what can be capitalized under the protector. • The excess protection is partially reflected in the EAD (collateral), however, the approach is too conservative.