

EBF RESPONSE TO THE CONSULTATION BY THE BASEL COMMITTEE ON BANKING SUPERVISION ON A TECHNICAL AMENDMENT CONCERNING HEDGING OF COUNTERPARTY CREDIT RISK EXPOSURES

The European Banking Federation (EBF) is the voice of the European banking sector, uniting 33 national banking associations in Europe that together represent some 3,500 banks – large and small, wholesale and retail, local and international.

The EBF welcomes technical amendments to the Basel framework to provide clarifications where needed to foster a consistent implementation of the rules across jurisdictions and across banks. The EBF also welcomes any amendments which further align economic risks with own funds requirements or simplify operational processes.

Regarding this consultation on CCR exposures hedging, we recognize that, there is usually a residual exposure to the derivatives counterparty risk (CCR) mitigated with a guarantee or a credit derivative.

We would like to highlight that, on there is no systematic understatement of own funds requirements when applying the current Credit Risk Mitigation framework to the CCR exposure at default. Indeed, the technical amendment proposes that the protection amount will reduce the expected exposure (EE) in IMM or the replacement cost (RC) plus potential future exposure (PFE) in SA-CCR, but not on a one-for-one basis. This combined with the subsequent multiplication by alpha ultimately results in an EAD reduction close to the protection amount.

Furthermore, the protected portion of the EAD gives rise to own funds requirements (OFR) as an exposure to the protection provider contrary to the treatment of collateral, with a conservative risk weight being applied.

When considering the above, the current approach is already conservative¹. Attempting to add extra layers of conservativeness would not be economically justified. Also, implementing such a framework, even including the industry proposals to reflect the economic values of the protection, would result in complexifying the CCR computation and adding operational burden. As a result, it may disincentivise banks from hedging their counterparty credit risk exposures in the form of derivatives or guarantees.

For all those reasons, the EBF urges the Basel Committee not to move forward with this technical amendment and leave the current conservative framework as is. It could however be supplemented with a Pillar II monitoring of the residual exposure to the derivatives counterparty risk.

Notwithstanding the above considerations, you will find below our technical answers to the consultation where we highlight its main shortcomings, some being linked to other shortfalls of the CCR framework. Should the technical amendment be maintained, the EBF believes it has to take into account these answers.

¹ See section II for further details

I. Feedback on the proposed amendment:

a) Calculation of the unprotected portion

In the Basel proposal, when calculating the portion of the exposure unprotected by the unfunded credit protection (UFCP), the maximum of the exposure accounting for the UFCP as cash collateral and the original EAD net of the UFCP is used.

We are questioning why, as a result of the unprotected portion flooring at the difference between the EAD and the maximum contingent claim, the exposure reduction of the UFCP is capped to the maximum contingent claim. Similarly to collateral, the effect of the UFCP is on the expected exposure and should take place at that level rather than the EAD.

Indeed, risk mitigants reduce the effective expected positive exposure (EEPE) in IMM (resp. the sum of RC and PFE in SA-CCR), before the application of the alpha multiplier (which is intended to magnify the exposure amount and capture general wrong way risk materialising in stress market conditions or a lack of granularity of the CCR portfolio).

Hence, we see no reason why, the effect of the unfunded credit protection applies at the level of the EAD rather than the EEPE (resp. RC+PFE). We believe that the exposure reduction through a credit derivative or a guarantee should be aligned with the reduction achieved by cash collateral.

Capping the protected portion to the maximum contingent claim takes place only when the replacement cost (RC) is high due to the effect of alpha. Exposures with high RC are typically those for which a bank may choose to acquire a protection. The protected portion capping will be reduced significantly. Where RC is a lot higher than PFE, i.e. for CCR exposures behaving close to a simple loan exposure, the CCR exposure to the original counterparty reduction is limited to $1/\alpha$ or 71% (with alpha equal to 1.4) whereas for a loan the reduction in exposure to the counterparty would be 100%.

Finally, some jurisdictions have chosen under SA-CCR to set alpha to 1 for some counterparties, typically those that are unmargined with potentially high RC. This will lead to an uneven level playing field between jurisdictions that apply an alpha of 1.4 on all counterparties, consistently with Basel, and jurisdictions that apply an alpha of 1 to some counterparties. For the latter jurisdictions, capping the protected part will never happen under SA-CCR and the effectiveness of the UFCP will be higher for the same exposure.

We suggest that the unprotected part of the original exposure is calculated assuming the maximum contingent claim to be cash collateral. This amount should not be floored by the difference of the EAD without UFCP and the UFCP maximum contingent claim.

b) Calculation of the protected portion

If a bank chooses to capitalise the CCR risk of CCR external credit derivatives hedges then, effectively, the part of the exposure that is protected is already capitalised. In such a case, continuing to risk weight the protected part with the hedge provider risk weight as per the substitution mechanism would lead to double count the CCR towards the protection provider. We are of the view that, when a bank chooses to keep capitalising the counterparty credit risk of the external derivative hedges, then the applicable risk weight to the protected part in the substitution approach should be zero. As such, double counting would be avoided and, additionally, it would have the benefit of recognising the risk reduction on the hedge provider of the margining mechanism

in place (through IM and VM) for added risk sensitivity and incentivisation of good risk management.

In effect we are capitalising the default of the guarantor (counterparty of the derivative hedge), i.e. the cost of replacement of the hedge calculated over a margin period of risk (MPoR) of at least 10 business days, or more if hard to replace (HTR). As a result, the hedged part of the initial exposure is always protected, hence justifying a risk weight of zero percent on the hedged part.²

This approach is the one currently applicable under US Basel 3 rules:

- CFR 217 §.132(d)(2)(vi): *"If a [BANK] hedges some or all of the counterparty credit risk associated with a netting set using an eligible credit derivative, the [BANK] may take the reduction in exposure to the counterparty into account when estimating EE. If the [BANK] recognizes this reduction in exposure to the counterparty in its estimate of EE, it must also use its internal model to estimate a separate EAD for the [BANK]'s exposure to the protection provider of the credit derivative."*

On the other hand, guarantees are not capitalised in the CCR framework and the capacity to replace them promptly in the event of the guarantor's default may be doubtful.

The treatment of the protected portion should depend on the nature of the unfunded credit protection:

- **Credit derivative hedges should be assessed in the counterparty credit risk framework. To avoid double counting, the protected portion as calculated in the Basel proposal should not be risk weighted in the credit risk framework.**
- **For guarantees, the exposure to the protection provider should be calculated according to the Basel proposal.**

c) Example

We will illustrate the EBF's proposal with an example more representative of the CCR exposures being hedged, i.e. one with a high replacement cost. The example will be based on SA-CCR as it would be more complicated to illustrate it in IMM.

- CCR exposure to the counterparty:
 - Uncollateralised netting set: $V = \$0.00$
 - Derivatives current market value: $V = \$20.00$
 - Replacement cost: $RC = \text{Max}\{0, V - C\} = \20.00
 - Aggregate add-on: $\text{AddOn} = \$10.00$
 - Multiplier : $\text{mult} = \text{MIN} \{1 ; 0.05 + 0.95 \cdot \text{EXP} ((V - C)/(2 \cdot 0.95 \cdot \text{AddOn}))\} = 1.00$
 - Potential future exposure: $\text{PFE} = \text{mult} \cdot \text{AddOn} = \10.00
 - Exposure at default: $\text{EAD}_{\text{CCR}} = \alpha \cdot (RC + \text{PFE}) = \42.00

² However, some banks, typically smaller and less complex banks, could choose, as an option, to instead risk weight the portion protected by a credit derivative as an exposure to the hedge provider in the credit risk framework and therefore exclude from CCR the derivative hedge itself to avoid double counting. In other words, those banks would capitalize credit derivative hedges in the same way as they would for guarantees.

- Unfunded credit protection maximum contingent claim: UFCP = \$30.00
(often the protection is less than the EAD_{CCR})
- CCR exposure to counterparty accounting for the UFCP as cash collateral
 - Replacement cost: $RC = \text{Max}\{0, V - C\} = \0.00
 - Multiplier : $\text{mult} = \text{MIN}\{1 ; 0.05 + 0.95 \cdot \text{EXP}((V - C) / (2 \cdot 0.95 \cdot \text{AddOn}))\} = 0.61$
 - Potential future exposure: $PFE = \text{mult} \cdot \text{AddOn} = \6.11
 - EAD unprotected portion when treating the UFCP as cash collateral:
 $EAD_{\text{unprotected-first term}} = \alpha \cdot (RC + PFE) = \8.56
- CCR exposure net of the maximum contingent claim
 - EAD unprotected portion when deducting the UFCP to the CCR exposure:
 $EAD_{\text{unprotected-second term}} = \text{MAX}\{0; EAD_{CCR} - \text{UFCP}\} = \12.00

The Basel proposed technical amendment leads to:

- Unprotected portion of the exposure at default:
 $EAD_{\text{unprotect}} = \text{MAX}\{EAD_{\text{unprotected-first term}}; EAD_{\text{unprotected-second term}}\} = \12.00
- Protected portion of the exposure at default:
 $EAD_{\text{protect}} = EAD_{CCR} - EAD_{\text{unprotected}} = 30.00$

The EBF proposed changes to the Basel technical amendment leads to:

- Unprotected portion of the exposure at default:
 $EAD_{\text{unprotect}} = EAD_{\text{unprotected-first term}} = \8.56
- Protected portion of the exposure at default:
 - If a guarantee: $EAD_{\text{protect}} = EAD_{CCR} - EAD_{\text{unprotected}} = 33.44$
 - If a credit derivative, EAD_{protect} is the CCR exposure of the derivative exposure which is likely much smaller than EAD_{protect} for a guarantee if part of a margined netting set

d) Additional considerations

1. Maturity mismatch

The Basel proposal does not address the case of a maturity mismatch between the original CCR exposure and the hedge.

Counterparty credit exposures are calculated over a one-year horizon. Hence:

- Unfunded credit protections of over 1 year residual maturity do not give rise to a maturity mismatch.
- Unfunded credit protections of below 1 year residual maturity give rise to a maturity mismatch if the residual maturity is below that of the CCR exposure.

When there is a maturity mismatch:

- The UFCP, consistently with CRE22.12, is recognised only if of a maturity exceeding 3 months and an original maturity greater or equal to 1 year.

- The UFCP maximum contingent claim is scaled down as in CRE22.13 before entering the calculation of the unprotected portion.

2. Currency mismatch

Basel proposal does not focus on the effect of currencies where the UFCP is denominated in a currency different from that in which the exposure is denominated. Given that the effect of currency is already considered in the EAD computation, we suggest removing the volatility adjustment to avoid double counting (see CRE 22.82).

3. Maturity

The Basel proposal is silent on the effect on maturity of the UFCP to the residual exposure to the CCR counterparty. For simplicity, and consistently with the credit risk framework, we suggest that the maturity to the CCR counterparty is left unchanged, i.e. remains that of the exposure without the credit risk protection.

For the protection provider, the maturity used is that of the guarantee or of the netting set to which the credit derivative belongs.

4. Perimeter

The current consultation seems to focus only on exposures on derivatives and do not refer to exposures on SFTs. A clarification should be made to confirm that the same treatment applies to CCR exposures on SFTs.

Also, the Section 0 proposal to calculate the exposure on the unfunded credit protection provider in the CCR framework for credit derivative hedges could be extended to all protected credit exposures, i.e. it should not be limited to protected CCR exposures.

For instance, a listed equity in the Banking Book protected with an eligible total return swap (TRS) should, on the protection provider, attract risk weighted assets consistent with that of the TRS CCR exposure.

This approach is justified identically than in the case of CCR exposure derivative hedge and have the same benefits of a higher risk sensitivity through the recognition of margining mechanism and of operational simplicity.

5. Complexity and operational burden

Implementing the technical amendment, even when taking into account the EBF feedback above, results in the need to compute the CCR metrics twice: without and with the protection. This, added to the complexity of the CCR models and IT chains and the resulting development and run costs, would further disincentive banks to opt for such risk mitigation.

II. Conservativeness of the current substitution framework

As expressed in the introductory part of this note, there is already a lot of conservativeness in the Basel framework on top of which the Basel Technical Amendment will add another layer. Should the technical amendment be maintained, those features have to be reviewed jointly.

a) Calculation of the Risk Weights on the protected part

Industry members appreciate the efforts to align the regulatory approach with economic reality, however the calculation of risk weights for the protected part is left unaddressed by the existing consultation.

Indeed, the Risk Weight computation of the protected part is already very conservative as it can only be done through a substitution approach, which is far from the economic reality. If we aim to improve the overall treatment of UFCPs, the following adjustments should be made:

- Double default: the probability of default should take into account the fact that a bank will incur a loss only in the event of a concomitant default of both the obligor and the guarantor. A double default probability can then be calculated by considering the regulatory correlation (see CRE 31.5). This probability of default should not be subject to the 5-bps floor.
- LGD benefit: if a double default occurs, the final economic loss will be the product of $LGD_{guarantor} * claim_{obligor} * LGD_{obligor}$. Hence, the LGD should be adapted to be $LGD_{protected_part} = LGD_{guarantor} * LGD_{obligor}$. It has to be noted that the current treatment is overly conservative as it substitutes the LGD between obligor and guarantor even if the guarantor's LGD is higher.
- Maturity and currency mismatch, as highlighted in the previous sections, add another layer of conservatism that needs to be lifted.

b) Limited recognition of potential future exposure reduction

We would like to recall a longstanding issue with SA-CCR, specifically that the multiplier that accounts for overcollateralization or negative marked-to-market in the potential future exposure (PFE) is calibrated too conservatively. This is partly stemming from the conservative approach used for the calculation of the Add Ons. As a result, the protection offered by the UFCP will be underestimated. We believe that a review of SA-CCR is long overdue.

The conservativeness of the current approach is proven, we recommend keeping the global substitution framework as is.

Should the technical amendment be kept, these layers of extra conservatism must be lifted.

- **The risk weight of the protected part has to be adjusted to reflect the economic impact of the protection of the protected part.**
- **The impact of the protection on the potential future exposure has to be recalibrated.**
