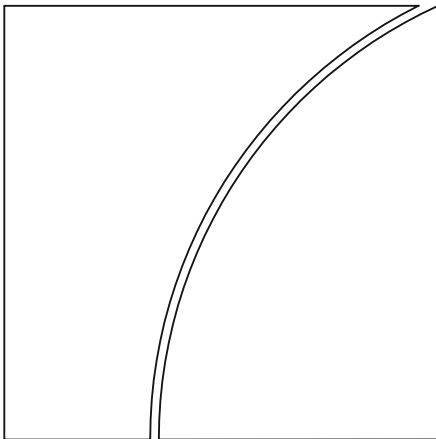


Basel Committee on Banking Supervision

Technical Amendment

Hedging of counterparty credit risk exposures



Technical amendment issued for comment by
31 January 2025



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ISBN 978-92-9259-810-5 (online)

Introduction

To promote a consistent global implementation of the Basel Framework, the Basel Committee on Banking Supervision¹ regularly monitors and reviews issues that arise from the implementation of its standards. Where necessary, it publishes clarifications and interpretative guidance. In some instances, implementation issues can be clarified in the form of answers to frequently asked questions (FAQs), without any changes to the standard. On other occasions, the issue, though minor in effect, cannot be resolved unambiguously without an amendment to the text of the standard itself. In these cases, the Committee has decided to publish the clarification as a proposed technical amendment. Such amendments will be published for a short consultation period, typically 45 calendar days.

The following technical amendment to the rules text is related to the treatment of guarantees and credit derivative protection in the counterparty credit risk (CCR) framework, which is described in the chapter "CRE22 Calculation of RWA for credit risk" of the consolidated Basel Framework. The Committee invites comments on the proposed amendments by 31 January 2025.

Technical amendment

The CCR requirements are set out in chapter CRE51 of the Basel Framework. Under the standardised approach to CCR (SA-CCR), a bank with a derivative exposure may reduce the exposure at default (EAD) to its derivatives counterparty when it takes eligible collateral. However, the way that collateral is recognised in the SA-CCR means that irrespective of how much collateral a bank receives, this will never reduce the EAD for the bank's derivative counterparty to zero. This reflects the fact that irrespective of the amount of collateral received, there is always a residual risk that, at the time of default, the derivative (or collateral) could have changed in value between the last exchange of collateral before default and replacement of the trades in the market to such an extent that the collateral will be insufficient to cover the full value of the exposure to the derivative counterparty. The internal models method (IMM) for CCR is also designed to give a similar treatment to collateral.

CRE51.16 describes when certain transactions are exempted from the general requirements to calculate a CCR charge. In particular, when credit derivative protection is purchased by a bank against a banking book or counterparty credit risk exposure, the bank is not required to calculate a counterparty credit risk charge for the transaction. Instead, *"the bank will determine its capital requirement for the hedged exposure according to the criteria and general rules for the recognition of credit derivatives within the standardised approach or IRB approach to credit risk (ie substitution approach)."*

While the CCR rules include a specific approach for the recognition of collateral, the recognition of guarantees or credit derivatives, such as credit default swaps (CDS), is not explicitly addressed in the CCR framework suggesting that banks may use the substitution approach of the CRM framework (CRE22). The substitution approach would allow the bank simply to substitute its exposure to the original derivative counterparty, with an exposure to the CDS counterparty. From a prudential perspective, this may result in no recognition of a residual exposure to the derivative counterparty. Consequently, the risk that a derivative gains in value and exceeds the fixed value of the protection provided by the CDS is left unaddressed. Allowing banks to fully offset exposures to derivative counterparties as a result of protection provided by CDS or guarantees is inconsistent with the current treatment of collateral under the SA-CCR and IMM.

¹ The Basel Committee on Banking Supervision is the primary global standard setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability.

To address this inconsistency, the Committee proposes amendments to the credit risk and CCR standards, which aim to better align the treatment of guarantees and credit derivative protection with the treatment of eligible collateral in the CCR framework. The proposed amendments do not affect the need for banks to check whether the requirements in CRE22.81 and CRE40 are met and need to be applied accordingly.

The proposed revisions to the Basel Framework text are outlined in Annex 1. Numerical examples illustrating the inconsistency described above can be found in Annex 2.

Annex 1: proposed amendments to the Basel Framework

This annex presents the proposed amendments to the Basel Framework. The proposed amendments are shown in red below.

CRE22 Standardised approach: credit risk mitigation

CRE22.79

The general risk-weight treatment for transactions in which eligible credit protection is provided is as follows:

- (1) The protected portion is assigned the risk weight of the protection provider. The unprotected (ie uncovered) portion of the exposure is assigned the risk weight of the underlying counterparty of the exposure without consideration of the credit protection. CRE51.19 must be taken into account to determine the protected and unprotected portions of counterparty credit risk exposures subject to the SA-CCR or IMM.
- (2) Materiality thresholds on payments below which the protection provider is exempt from payment in the event of loss are equivalent to retained first-loss positions. The portion of the exposure that is below a materiality threshold must be assigned a risk weight of 1250% by the bank purchasing the credit protection.

CRE32 IRB approach: risk components for each asset class

CRE32.22

Under either approach, CRM in the form of guarantees and credit derivatives must not reflect the effect of double default (see CRE36.102). As such, to the extent that the CRM is recognised by the bank, the adjusted risk weight will not be less than that of a comparable direct exposure to the protection provider. Under either approach, CRE51.19 must be taken into account to determine the protected and unprotected portions of counterparty credit risk exposures subject to the SA-CCR or IMM. Consistent with the standardised approach, banks may choose not to recognise credit protection if doing so would result in a higher capital requirement.

CRE51 Counterparty credit risk overview

CRE51.16

As an exception to the requirements of CRE51.4 above, banks are not required to calculate a counterparty credit risk charge for the following types of transactions (ie the exposure amount or EAD for counterparty credit risk for the transaction will be zero):

- (1) Credit derivative protection purchased by the bank against a banking book exposure, or against a counterparty credit risk exposure. ~~In such cases, the bank will determine its capital requirement for the hedged exposure according to the criteria and general rules for the recognition of credit derivatives within the standardised approach or IRB approach to credit risk (ie substitution approach).~~
- (2) Sold credit default swaps in the banking book where they are treated in the framework as a guarantee provided by the bank and subject to a credit risk charge for the full notional amount.

Treatment of guarantees and credit derivative protection

CRE51.18

When banks purchase credit protection against a counterparty credit risk exposure, the bank will determine its capital requirement for the hedged exposure according to the criteria and general rules for the recognition of guarantees and credit derivatives within the standardised approach to credit risk (ie the substitution approach) or IRB approach to credit risk.

CRE51.19

When a bank uses a guarantee or credit derivative that is consistent with CRE22.80 to hedge against a counterparty credit risk exposure that is subject to the SA-CCR (CRE52) or IMM (CRE53) and when the protection amount is either fixed or capped (ie it is not an unlimited guarantee or an unlimited contingent credit default swap), the bank is exposed to the risk that the protection amount at the time of default may not cover the full exposure to the counterparty. To address this risk, banks are required to calculate the protected and unprotected amounts of their counterparty credit risk exposure using the following approach: the protected portion is the EAD calculated under the SA-CCR or IMM (ie without taking into account the guarantee or credit derivative) less the unprotected portion, where the unprotected portion is determined as the higher of:

- (1) the EAD calculated using the SA-CCR or IMM, but treating the guarantee or credit derivative as if it was a fixed amount of cash collateral within the netting set equal to the maximum contingent claim on the protection provider of the guarantee or credit derivative; and
- (2) the EAD calculated using the SA-CCR or IMM (ie without recognising the guarantee or credit derivative in the calculation of the EAD), less the maximum contingent claim on the protection provider of the guarantee or credit derivative.

Annex 2: illustrative numerical example

To illustrate the effect of the proposed TA, consider the following example for a bank that uses SA-CCR. Under SA-CCR, the EAD for an unmargined netting set is calculated as follows:

$$EAD = \alpha * (RC + PFE)$$

$$\alpha = 1.4$$

$$RC = \max\{V - C; 0\}$$

V = the value of the derivative transactions in the netting set

C = haircut value of net collateral held

$$PFE = multiplier * AddOn$$

$$multiplier = \min \left\{ 1; Floor + (1-Floor) * \exp \left(\frac{V - C}{2 * (1-Floor) * AddOn} \right) \right\}$$

$$Floor = 5\%$$

AddOn = an amount that represents how much the value of the derivatives in the netting set may change by the time of default, calculated according to a methodology specified in SA-CCR

Case 1: a derivative exposure with no collateral taken and no mitigating CDS

- Assume a bank has a derivative exposure with a current market value of \$0 (ie V = \$0). Since no collateral is taken, C = \$0 and consequently RC = V - C = \$0.
- Assume that when the SA-CCR is applied to the derivative it gives an AddOn of \$10.
- Since V - C = \$0, the multiplier has a value of 1.
- The EAD under the SA-CCR is therefore \$14 (= 1.4 * (\$0 + 1 * \$10)).
- Finally, RWA = \$14 * the risk weight of the derivative counterparty.

Case 2: same as case 1 except the bank hedges the derivative by taking \$14 of cash collateral

- Replacement cost: RC = max{V - C; 0} = max{\$0 - \$14; \$0} = \$0.
- The EAD of the CCR exposure to the derivative counterparty = alpha * (RC + PFE) = 1.4 * (\$0 + multiplier * \$10).
- multiplier = min{1; 5% + 95%*exp[(0-14) / (2*95%*10)]} = 50.5%. Hence, the EAD = 1.4 * (\$0 + 50.5% * \$10) = \$7.1
- RWA = \$7.1 * Risk weight of derivative counterparty

Note that the EAD does not become zero even in the presence of cash collateral equal to the value of the EAD calculated before the recognition of collateral. This is because both the multiplier and the AddOn are greater than zero.

Case 3: same as case 1 except the bank hedges the derivative with a \$14 CDS and applies the substitution approach implied by the existing standard

- Like in case 1, the EAD of the CCR exposure to the derivative counterparty is \$14.
- The EAD of the CCR exposure to the CDS counterparty = \$0 as per CRE51.16 (giving \$0 of RWA).
- The RWA for the CCR exposure to the derivative counterparty = \$14 * Risk weight of *CDS counterparty*

Note that the risk weight of the derivative counterparty in the above final bullet has been substituted with the risk weight of the CDS counterparty, as per the substitution approach.

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

- Application of CRE51.19(1) requires the calculation of the EAD as in case 2 (ie treat the CDS as cash collateral) and results in \$7.1.
- Application of CRE51.19(2) requires the calculation of the EAD of the derivative without any protection (as in case 1) minus the maximum contingent claim on the protection provider. That is, $\$14 - \$14 = \$0$.
- The higher of (1) and (2) is \$7.1. Therefore, applying CRE51.19 results in an unprotected amount of \$7.1.
- Applying CRE51.19 results in a protected amount of the EAD of the CCR exposure to the derivative counterparty as in case 1 minus the unprotected amount, ie $\$14 - \$7.1 = \$6.9$.
- The RWA of the CCR exposure to the derivative counterparty = RWA of protected portion + RWA of unprotected portion
= $\$6.9 * \text{Risk weight of CDS counterparty} + \$7.1 * \text{Risk weight of derivative counterparty}$