Regulatory Blog

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Credit Derivatives in Focus

BCBS releases technical amendment for application of the SA-CCR

Navigating the complex landscape of counterparty credit risk (CCR) is critical for banks, especially when dealing with derivative counterparties. The current framework, known as the standardized approach for measuring counterparty credit risk exposures (SA-CCR), provides mechanisms to mitigate exposure at default (EAD) through eligible collateral. However, this methodology is not without its flaws. The Basel Committee regularly reviews the implementation of its standards to identify and resolve any ambiguities or inconsistencies. The current amendment focuses specifically on the treatment of guarantees and credit derivatives like credit default swaps (CDS) and their use for collateralizing derivative exposures.

Inconsistencies in CCR Framework

Under the current counterparty credit risk (CCR) framework, specifically the standardised approach (SA-CCR), banks can reduce their exposure at default (EAD) to derivative counterparties using eligible collateral. However, this reduction does not eliminate the exposure entirely due to residual risks. These risks arise from potential changes in the value of derivatives or collateral between the last collateral exchange and default, making the collateral insufficient to cover the full exposure. Additionally, the framework does not explicitly address the recognition of guarantees or credit derivatives, such as credit default swaps (CDS), which suggests that banks may use the substitution approach from the CRM framework. This approach could result in no recognition of residual exposure to the original derivative counterparty, creating an inconsistency with the treatment of collateral under SA-CCR and the internal model method (IMM).

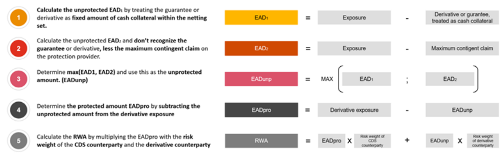
To resolve this inconsistency, the Committee suggests revisions to the credit risk and CCR standards. These revisions are intended to harmonize the treatment of guarantees and credit derivative protection with that of eligible collateral within the CCR framework.

Key Aspects of the Amendment

- **Capital Requirement Determination:** When banks purchase credit protection for counterparty credit risk exposures, they must determine their capital requirements based on the criteria and rules for recognizing guarantees and credit derivatives under the standardised or IRB approach, specifically using the substitution approach.
- **Risk of Incomplete Coverage:** For guarantees or credit derivatives with fixed or capped protection amounts under the SA-CCR or IMM frameworks, banks must consider the risk that the protection might not fully cover the exposure at default. This is because the protection amount is limited and may not match the full exposure.
- **Exposure Calculation Method:** Banks need to calculate both the protected and unprotected portions of their exposure. The unprotected portion is determined by the higher value from two approaches: (a) calculating the EAD while treating the guarantee or credit derivative as if it were a fixed amount of cash collateral, or (b) calculating the EAD without recognizing the guarantee or credit derivative, then subtracting the maximum contingent claim on the protection provider. This ensures a comprehensive assessment of potential exposure despite the presence of protection.

Calculation Steps

Assumption: A credit derivative exposure which is secured by a CDS



Implications for Banks

While currently this amendment is on the level of BCBS standards, the translation into the local jurisdictions will take place. For banks, these amendments mean a more rigorous approach to calculating capital requirements for hedged exposures. The amendment is particularly relevant for banks with subsidiaries that hold significant derivative exposures and the parent institution hedges these risks using credit default swaps (CDS).

We provide guidance on understanding and applying the BCBS paper's guidelines related to credit risk and counterparty credit risk standards. Our services help you comprehend the criteria for recognizing guarantees and credit derivatives, ensuring your exposures are correctly evaluated. Our team conducts thorough analyses to assess current risk management practices and determine necessary adjustments. This assistance ensures compliance with regulations and precise calculation of risk exposures according to BCBS recommendations.

Get ongoing updates on the topic via regulatory horizon scanning in our research application, PwC Plus. Read more about the opportunities and offerings here.

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