

Prudential Regulation applying to OTC Derivatives

Basle Accord – July 1988

- This was the first attempt by the major world economies to create a level playing field for international banks by imposing the same regulatory capital rule set
- Even for this original Accord, when derivative volumes were still quite modest, the Counterparty Credit Risk (CCR) relating to derivatives was identified as an important category of credit risk requiring measurement and two simple approaches to calculating the exposure were permitted
- The two permitted approaches were the original exposure method (OEM) and the current exposure method (CEM). The CEM is more intuitive in that it comprises the sum of the replacement cost + add-on for potential future exposure – where the PFE for interest rates was simply 0.5% of the notional for swaps with a residual life of more than 1 year
- The OEM was even simpler and was simply 0.5% of notional for swaps with a residual life of less than 1 year, 1% for swaps greater than 1 but less than 2 years and then a further 1% for each additional year (so a swap with 10 years to run would have an exposure amount of 9% of notional, whatever the current market value)
- Basel rules were applied to all UK banks, not just those internationally active

Basel 2 – June 2006 (final consolidated version)

- By the time we get to 2006, Basle has changed to Basel! Also the regulation for calculating Counterparty Credit Risk (CCR) with respect to derivatives has expanded from 3.5 pages to 24 pages in Annex 4 of the new Accord. It was implemented in the UK through BIPRU.
- Three methods are now permitted with the largest banks expected to use sophisticated internal models to measure the potential future credit exposure. The other two permitted methods are Standardised Method and Current Exposure Method. The CEM was identical to Basel 1 except the add on had increased to 1.5% for derivatives with a residual life of greater than 5 years
- These new capital rules formally came into force on 1/1/2007 but the proposed rule set had been in the public domain for years and banks would have been pricing new transactions with these rule changes in mind throughout 2006, if not earlier

Basel 3 – CRR2 (July 2013)

- One of the major lessons from the financial crisis was that Counterparty Credit Risk (CCR) is a major source of systemic risk due to the interconnectedness between banks
- The legislators drafted EMIR to solve the interconnectedness issue by forcing collateralisation and movement to Central Counterparties for interbank OTCs
- CCR itself is dealt with in Capital Requirements Regulation No 575/2013 (this regulation still applies as the UK has retained this post Brexit)
- In CRR2 there is a whole Chapter on CCR (Articles 271 to 311). 4 Methods permitted namely Internal Model Method, Original Exposure Method, Standardised Approach and Simplified Standardised Approach (OEM and SSA are only allowed for banks with smaller absolute and relative derivative exposures)
- The add-ons are materially higher than those calculated under Basel 2

Putting to bed certain 'mistruths' and diversions

- When a judge ruled that “The CLU, as the experts agreed, is a bank’s internal and subjective estimate of the near worst-case risk to the bank, at any given time, of default by the customer under the IHRP” this is simply not true in law
- CCR arising from derivatives has been a formal regulatory requirement since 1988 and banks are legally required to calculate the amounts, using one of the agreed methods/approaches and report it to their regulator, disclose it in their Pillar 3 disclosures and hold bank capital against both the on-balance sheet and off-balance sheet risks. Goldman Sachs UK disclosed \$100bn of RWAs relating to CCR as at 31 March 2023
- The regulatory requirement is to calculate the potential future credit exposure. As this amount varies daily due to movements in interest rate expectations, banks typically mark credit limits on their systems significantly higher than the PFCE. These derivative limits are hard credit limits and treated exactly the same as loans and overdrafts – we have a Magic Circle law firm’s answer to a question that confirms that derivative limits are hard credit limits. Thus, it is absolutely the norm for banks to include derivative credit limits in the numerator of any LTV covenant ratio. As well as my own personal experience as a lending banker, we also have access to numerous credit sanction documents that attest to this
- The same judge also ruled that “Since the CLU is the bank’s estimate of the risk of default to the bank, the experts agreed that the CLU is not a contingent liability of the customer.” This is also wrong as the CLU is the best estimate of the maximum exposure, which is the precise definition of what a contingent liability is!

Any questions?

- Any questions relating to either capital regulation or counterparty credit risk management?