Lehman Brothers: How Good Policy Can Make Bad Law

By Kathryn Judge

What Really Drives "Short-Termism"?

By John C. Coffee, Jr.

Quarterly Reporting and Market Liquidity

By Joshua R. Mitts

Editor-At-Large
Reynolds Holding

Editorial Board
John C. Coffee, Jr.
Edward F. Greene
Kathryn Judge

Skadden Discusses Proposed Updates to Banking Rules for Derivative-Contract Exposure

By William J. Sweet, Jr., Mark D. Young, James A. Frazer, Collin P. Janus and Rachel Kaplan Reicher December 11, 2018

Comment

On October 30, 2018, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (collectively, the agencies) jointly invited comment on a proposed regulation that, if adopted, should provide regulatory capital relief for certain derivative exposures. If adopted, the regulation would amend the agencies' risk-based and leverage capital requirements for banking organizations. The proposal is subject to public comment for 60 days following its publication in the Federal Register.

The proposal would implement a "standardized approach for counterparty credit risk" (SA-CCR) to replace the current exposure methodology for calculating the exposure amount of derivative contracts under the agencies' regulatory capital rules. The SA-CCR is intended to respond to industry concerns that the current exposure methodology does not appropriately recognize collateral, including margin collateral, and does not allow adequate netting of derivative contracts.

The capital rules also currently permit a so-called internal models methodology that is more risk-sensitive than the current exposure methodology but is also complex and requires prior supervisory approval. The SA-CCR is intended to provide a standardized approach that is more sensitive but can be more widely used.

For large banking organizations,' use of the SA-CCR to determine derivative contract exposure amounts would generally be (i) required under the standardized approach to calculating risk-based capital; (ii) permitted under the advanced approach to calculating risk-based capital; and (iii) required (in modified form) under the supplementary leverage ratio requirement. Large banking organizations would be required to implement the SA-CCR by July 1, 2020.

Smaller banking organizations would generally be permitted, but not required, to use the SA-CCR.

The agencies stated that the current exposure methodology does not reflect recent market conventions and regulatory requirements that reduce the risks of derivative contracts. Among other changes, the SA-CCR would improve collateral recognition and allow netting of certain types of derivatives contracts with similar risk factors.

The SA-CCR would improve collateral recognition in several ways, including the following. First, it would decrease the amount of capital required for derivatives subject to variation margin but increase the amount of capital required for unmargined derivatives. Second, it would allow a banking organization that is a clearing member to recognize a client's noncash collateral posted to a central counterparty if, among other things, the banking organization's security interest in the client collateral is first in priority after the central counterparty (thus recognizing that the central counterparty's exercise of its security interest would reduce the banking organization's exposure to the central counterparty). Third, the proposal would reduce the supervisory haircut for collateral that is received from a client for which a banking organization is acting as clearing agent with a central counterparty — thus decreasing the banking organization's exposure amount (and, as a result, the amount of capital required) for the client-facing portion of such a derivatives contract.

The SA-CCR would also allow full or partial netting of derivative contracts within a "netting set" if the contracts share certain similar risk factors. For example, a banking organization may be able to fully net interest rate derivative contracts that reference the same currency and are within the same tenor category. A banking organization may also be permitted to fully or partially net long and short derivative contracts that share similar risk factors.

The agencies also proposed a modified form of the SA-CCR for the supplementary leverage ratio requirement. The modified SA-CCR would replace the current exposure methodology for calculating the on- and off-balance sheet amounts of derivative contracts for the total leverage exposure *(i.e.,* the denominator of the supplementary leverage ratio). The modified SA-CCR would generally increase a banking organization's supplementary leverage ratio and thereby reduce the amount of tier 1 capital needed to satisfy the supplementary leverage ratio requirement. Like the SA-CCR for risk-weighted capital, the modified SA-CCR would reduce the total leverage exposure for margined derivatives. Unlike the SA CCR, however, the modified SA-CCR would not allow initial margin to reduce the potential future exposure multiplier and would recognize only certain cash variation margin in the replacement cost calculation. Nonetheless, in light of efforts to promote the migration of derivative contracts to central clearing frameworks, the agencies are seeking input on the consequences of these two limitations with respect to collateral received from clients of a clearing member.

If adopted, the proposed rule should provide banking organizations with some relief when calculating both their risk-based capital ratios and their supplementary leverage ratio.

ENDNOTE

[1] In a separate proposal, the agencies have proposed to narrow the definition of such a large banking organization to one that has at least $700 billion in total assets, $75 billion in cross-jurisdictional activity or is designated as a global systemically important banking organization.

This post comes to us from Skadden, Arps, Slate, Meagher & Flom LLP. It is based on the firm's memorandum, "Federal Banking Agencies Propose Updating Calculation of Derivative Contract Exposure Amounts, " dated December 5, 2018, and available here.

Leave a Reply

Your email address will not be published. Required fields are marked *

Comment

Name *

Email *

Post Comment

© Copyright 2018, The Trustees of Columbia University in the City of New York.