Banking and Finance Law Daily Wrap Up, CAPITAL AND BASEL ACCORDS —Agencies adopt standardized approach for calculating counterparty credit risk, (Nov. 19, 2019)

Banking and Finance Law Daily Wrap Up

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The FDIC, Fed, and OCC believe the alternative approach for measuring counterparty credit risk will better reflect the current derivatives market.

The Federal Deposit Insurance Corporation, Federal Reserve Board, and Office of the Comptroller of the Currency have issued a joint final rule revising the standards for how firms measure counterparty credit risk posed by derivative contracts under the agencies' regulatory capital rules. The standardized approach for measuring counterparty credit risk (SA-CCR) replaces the current exposure methodology (CEM) as an alternative method for purposes of calculating advanced approaches total risk weighted assets under the capital rule. The final rule takes effect April 1, 2020, with a mandatory compliance date of Jan. 1, 2022, for advanced approaches banking organizations.

Alternative method for calculating CCR. According to the agencies, the SA-CCR better reflects the current derivatives market and would provide important improvements to risk sensitivity, resulting in more appropriate capital requirements for derivative contracts exposure. The SA-CCR capital treatment for derivative contracts is more risk-sensitive than the CEM and less complex and model-dependent than the internal models methodology (IMM) that could be used by advanced approaches banking organizations, subject to regulatory approval.

The advanced approaches banking organizations—banking organizations with $250 billion or more in total consolidated assets or $10 billion or more in on-balance sheet foreign exposure—will be required to use SA-CCR to determine the exposure amount for a derivative contract for purposes of calculating its standardized total risk-weighted assets and total leverage exposure in the supplementary leverage ratio by Jan. 1, 2022.

The final rule also revises the advanced approaches in the capital rule by replacing CEM with SA-CCR. Therefore, an advanced approaches banking organization has the option to use SA-CCR or IMM to determine the exposure amount for a derivative contract. However, if an advanced approaches banking organization elects to use SA-CCR to determine the exposure amount for its non-cleared derivative contracts, it also would be required to use SA-CCR to determine the trade exposure amount for a cleared derivative contract.

Non-advanced approaches banking organizations would be allowed to use either CEM or SA-CCR to determine the exposure amount for derivative contracts. However, non-advanced approaches banking organizations that elect to use SA-CCR must use SA-CCR to determine the trade exposure amount for its cleared derivative contracts and for purposes of calculating the risk-weighted asset amount of the default fund contribution of a central counterparty or qualifying central counterparty.

Other amendments. The final rule updates other parts of the capital rule to account for the implementation of SA-CCR by: (1) requiring Category I and Category II banking organizations to use SA-CCR to determine the exposure amount of derivative contracts for purposes of total leverage exposure (the denominator of the supplementary leverage ratio); (2) incorporating SA-CCR into the cleared transaction framework under the capital rule; and (3) making other technical amendments with respect to cleared transactions.

Feedback affected final requirements. The FDIC said that, in response to the proposed rule, it received approximately 58 comments on the proposal from interested parties, including banking organizations, trade groups, members of Congress, and advocacy organizations.

According to a FDIC staff memo, the final rule contains a number of modifications to address concerns raised by commenters: (1) the final rule changes certain of the supervisory factors for commodity derivative contracts to coincide with the supervisory factors in the Basel Committee standard; (2) the final rule removes the alpha factor for exposures to commercial endusers; (3) the final rule allows a banking organization to treat settled-to-market derivative contracts as subject to a variation margin agreement, allowing such contracts to net with collateralized-to-market derivative contracts of the same netting set; (4) the final rule allows clearing member banking organizations to recognize client collateral under the supplementary leverage ratio, to the same extent a banking organization may recognize collateral for risk-based capital purposes; and (5) in order to capture the longer close-out period required in the event of a central counterparty failure, the final rule provides that margin period of risk cannot be less than ten business days for transactions subject to a variation margin agreement that are not client-facing derivative transactions.

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