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RISK MANAGEMENT

CORPORATE HEDGERS TO BE HIT HARD BY NEW SA-CCR CAPITAL RULES

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Basel's new Standardized Approach for Counterparty Credit Risk (SA-CCR) will have the contentious effect of penalizing corporate hedging, according to analysis by FIS. This is due to the higher capital requirements that will be imposed on banks' derivative activities, especially on non-diversified, non-margined, non-cleared transactions such as those undertaken with corporate hedgers. Banks are expected to either pass on the additional cost of capital to their corporate clients, or force them into bilateral margining arrangements, possibly requiring upfront initial margin, or exit this type of business altogether which would diminish the liquidity of the corporate hedging markets.

Corporate hedgers are sometimes referred to as 'end-users' of derivatives. They enter into derivative transactions to protect their business against fluctuations in interest rates, exchange rates, commodity prices, etc. These are perfectly legitimate uses of derivatives, unlike the perceived speculation or arbitrage associated with interbank proprietary trading.

Corporate hedging transactions are usually concluded on a non-margined, uncleared basis, and sometimes without even a netting agreement. Banks capture the resulting counterparty exposure under extended credit facilities. Dodd-Frank and EMIR regulations have exempted corporate hedging transactions from mandatory central clearing. The recent Basel/IOSCO proposals to impose bilateral margining on non-centrally cleared derivatives also exempt corporate hedgers from such margin requirements.

But the exemption from central clearing and bilateral margining may well have been a pyrrhic victory for corporate hedgers.

As banks are being hit with higher capital charges on unsecured, uncleared, one-directional counterparty exposures, they will inevitably pass on the associated costs to their counterparties, or may even exit that type of business altogether. Hence corporate end-users of derivatives could be hit with a double-whammy of higher costs and lower liquidity.

Centrally cleared derivatives already have a significant advantage over non-cleared transactions, as they benefit from a much lower risk weight for capital adequacy purposes.[1]

But now the banks' capital squeeze is being exacerbated by a new method of calculating counterparty exposures, namely the SA-CCR standards recently proposed by the Basel Committee.

While the new measure has been heralded as being more risk sensitive than the existing "Current Exposure Method" (CEM), it is also more conservative in many respects. Three core features will make the new SA-CCR more onerous than the CEM, in terms of banks' regulatory capital requirements:

- The SA-CCR has been calibrated to a period of high volatility, resulting in weighting factors (representing potential future exposure) that are generally much higher than under the CEM. For example, FX derivatives up to one year will attract a weighting factor of four percent, compared to a one percent factor under the CEM.
- The SA-CCR measure is increased by an 'Alpha' multiplier of 1.4, which does not apply under the CEM.

[1] EXPOSURES WITH CENTRAL COUNTERPARTIES HAVE A RISK WEIGHT OF TWO PERCENT UNDER THE BASEL CAPITAL ADEQUACY RULES, WHEREAS EXPOSURES ON NON-CLEARED DERIVATIVES COULD HAVE A RISK WEIGHT OF 20 PERCENT-100 PERCENT DEPENDING ON THE COUNTERPARTY TYPE OR RATING.

- The netting of Potential Future Exposure (PFE) add-ons will only be allowed within the narrow confines of 'hedging sets'. Transactions in different hedging sets (e.g. interest rate derivatives in different currencies, or FX derivatives in different currency pairs) will bear the full weight of PFE add-ons, hence overstating exposure if there were any correlation between them. The CEM, on the other hand, would allow the partial offsetting of add-ons, based on the Net-to-Gross Ratio (NGR) of the transaction market values, within an entire netting set.[2]

The only case where the SA-CCR results in lower exposure than the CEM for un-margined transactions, is when they offset each other within hedging sets.

The SA-CCR has provided important capital concessions for margined transactions, including those with central counterparties.[3]

The upshot is that one-directional non-margined counterparty portfolios, such as those with corporate hedgers, will be seriously penalized by the SA-CCR methodology; for example:

- A five-year interest rate swap will attract 6.2 times more capital under the SA-CCR than under the CEM.
- A one-year FX forward will attract 5.6 times more capital.
- A six-month FX forward will attract four times more capital.
- A 1-year commodity swap or forward will attract 2.5 times more capital.

As a result of the higher costs being passed on to them, and despite their initial resistance, corporate hedgers may well be forced into the world of central clearing and/or bilateral margining, in order to maintain their access to OTC derivative markets and be treated equally with other derivative counterparties. However, this would come with some significant costs: the operational and legal setup of clearing or margining arrangements are onerous processes, and the need to provide initial and variation margins will put significant strains on the corporate entity's liquidity and funding costs. For instance where a corporate uses a derivative to hedge away the price of purchasing commodities, they are fixing their future cash flows. Under a margining agreement, new initial and variation margin calls will put liquidity risk back in the frame, increasing the complexity of the funding risk corporate treasurers need to manage.

So corporate hedgers will be damned if they do and damned if they don't embrace clearing or margining. The end result could be that corporate entities may reduce or even discontinue their hedging activities as they are deemed to be too expensive, preferring to 'self-insure' against market fluctuations. This may in turn increase the risk profile of such entities.

The irony of this situation, which may not be lost on the corporate treasurer, is that corporate hedging deals actually represent 'right-way risk' for banks. Right-way risk exists where the bank's exposure to a counterparty decreases as the probability of default of that counterparty rises. Take the example of a gold producer selling gold forward to hedge against the gold price; where the price of gold drops, the gold producer is more likely to default, but in exactly this situation the credit exposure of the bank to the producer is also decreasing (the bank is receiving floating price and paying fixed). This is a good credit situation for the bank to be in, and dramatically reduces the 'real world' risk of such transactions. It is therefore understandable that corporate hedgers would feel aggrieved when they are bearing increased costs for giving banks the "right" type of credit risk.

While regulators have clamped down on the opposite wrongway risk situations, they have offered no concessions on the capital treatment of right-way risk positions such as those with corporate hedgers. While we respect that it is necessary to impose capital requirements on banks to protect the industry, we think it is time that regulators provide capital relief for end user credit exposures and right-way risk, i.e. the legitimate use of derivatives by a corporate entity to protect its own business. Alternatively central counterparties could provide incentives for corporate hedgers to use their services, by offering concessions on initial margin requirements, again recognizing the lower risk of exposures resulting from corporate hedging.

[2] THE CEM NGR IS OF COURSE A FLAWED METHODOLOGY, WHICH MAY LEAD TO EXPOSURES BEING OVERSTATED OR UNDERSTATED.

[3] IT SHOULD BE NOTED THAT, DESPITE THESE CONCESSIONS, IN MANY CASES MARGINED TRANSACTIONS WILL STILL HAVE A HIGHER UNDER THE SA-CCR THAN UNDER THE CEM; THAT IS, THE COMBINED EFFECT OF THE 3 POINTS MENTIONED ABOVE WILL OFTEN OUTWEIGH THE EXPOSURE REDUCTION ATTRIBUTED TO MARGINING.

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