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Press Release

TCH Study Highlights Problematic Aspects of Basel Committee's Proposed Large Exposure Limits

Study Finds That Use of New "Non-Internal Model Method" Would Mitigate Impact on OTC Derivatives Business

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New York – November 26, 2013 – The Clearing House Association (TCH) today released a quantitative study on the Basel Committee's proposed standard to regulate large counterparty exposures, which finds that the proposal would impose significant constraints on important bank counterparty relationships, thereby impacting the ability of banks to service their customers. The results are broadly consistent with those found in a similar study that TCH conducted in 2012, which evaluated a comparable U.S. proposal to regulate large single counterparty exposures under Section 165(e) of the Dodd-Frank Act, generally referred to in the U.S. as "single counterparty credit limits."

The study provides new analysis using 2013 data from seven large U.S. bank holding companies based on a standardized data collection. The study found that the Basel Committee proposal would lead to a significant number of instances in which existing counterparty exposures across the participating companies would exceed the prescribed limits. On an aggregate basis, these limit excess incidents were found to represent total limit overages of $732 billion assuming a 10% G-SIB to G-SIB limit and a Common Equity Tier 1 capital base (called the "base case" in the study).

"The Clearing House is supportive of large exposure standards to address counterparty exposures and supports an internationally consistent approach to quantitative limits on counterparty credit exposure," said Sridhar Iyer, Senior Vice President and Director of Research at The Clearing House. "However, TCH's study indicates that the proposal would lead to a substantial number of instances in which existing counterparty exposures would exceed the prescribed limits. As a result, impacted banks may have to reduce the scope of services they provide to customers and associated risk-mitigating activities, especially in credit derivatives and securities financing markets."

The Basel Committee proposed its standard in March 2013 in order to establish a framework for international consistency in large exposure rules, which are intended to cap the maximum possible loss a bank could incur (expressed as a percentage of its capital) if a single counterparty or group of connected counterparties were to suddenly fail. The proposal considers a 10% to 15% exposure limit for exposures of one global systemically important bank (G-SIB) to another G-SIB and a 25% limit for all other bank counterparty exposures. TCH filed a comment letter to the Basel Committee on its proposal in June.

As a component of the analysis, the study preliminarily assesses the impact of employing the Non-Internal Model Method (NIMM), a risk-measurement methodology proposed by the Basel Committee in June, instead of the Federal Reserve's proposed Current Exposure Method (CEM) for the measurement of exposures to OTC derivatives counterparties. The limit excess incidents and limit overages were found to be only moderately higher when using NIMM as compared to the risk-sensitive Internal Models Method (IMM). Accordingly, the study suggests that NIMM would be a clear improvement over CEM for measuring exposures on OTC derivatives due to NIMM's greater risk-sensitivity and granularity.

"While the large exposures proposal itself should be revisited in certain areas – particularly with regard to the treatment of purchased credit protection and securities financing transactions – the study suggests that the NIMM would be a clear improvement over CEM," said Iyer.

The study also found that the "risk-shifting" requirement for credit derivatives is, by a significant margin, the particular aspect of the Basel proposal most responsible for limit excesses. When comparing a scenario where risk-shifting is not applied to the base case where it is applied, over 50% of the difference in the dollar amount of limit overages is attributable to the risk-shifting requirement. Under the requirement, a bank that buys credit derivative protection to hedge an exposure to an obligor is required to treat the full notional value of the derivative as an exposure to the protection provider rather than to the original obligor. The substitution of the risk to the protection provider implicitly assumes the highly unlikely outcome of simultaneous defaults of the obligors as well as the protection provider. As described in detail in TCH's June 2013 comment letter on the Basel Committee proposal, this requirement significantly overstates true economic risk.

In addition to the “risk-shifting” requirement, key drivers of limit overages were found to include the requirement for a tighter limit for exposures between G-SIBs, the inclusion of central counterparties as subject to large exposure limits, and the use of a Common Equity Tier 1 denominator (rather than total capital as a measure for the capital base) in computing exposure limits, among others.