The implications of Basel II for Credit Derivatives

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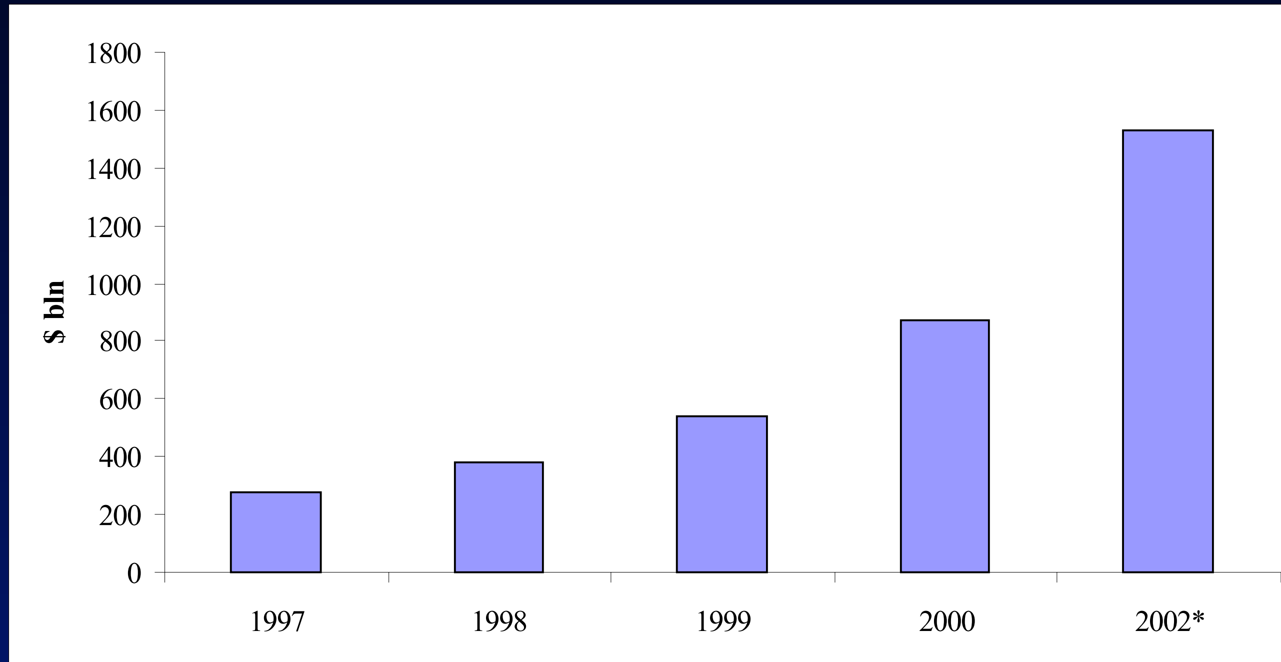
Presentation content

- Credit derivatives in synthetic securitisations, credit risk transfer and capital relief
- Impact of new risk weighting categories
- Credit derivatives and collateralised exposures, credit events and maturity mismatches
- New entrants to market

Growth in credit derivatives



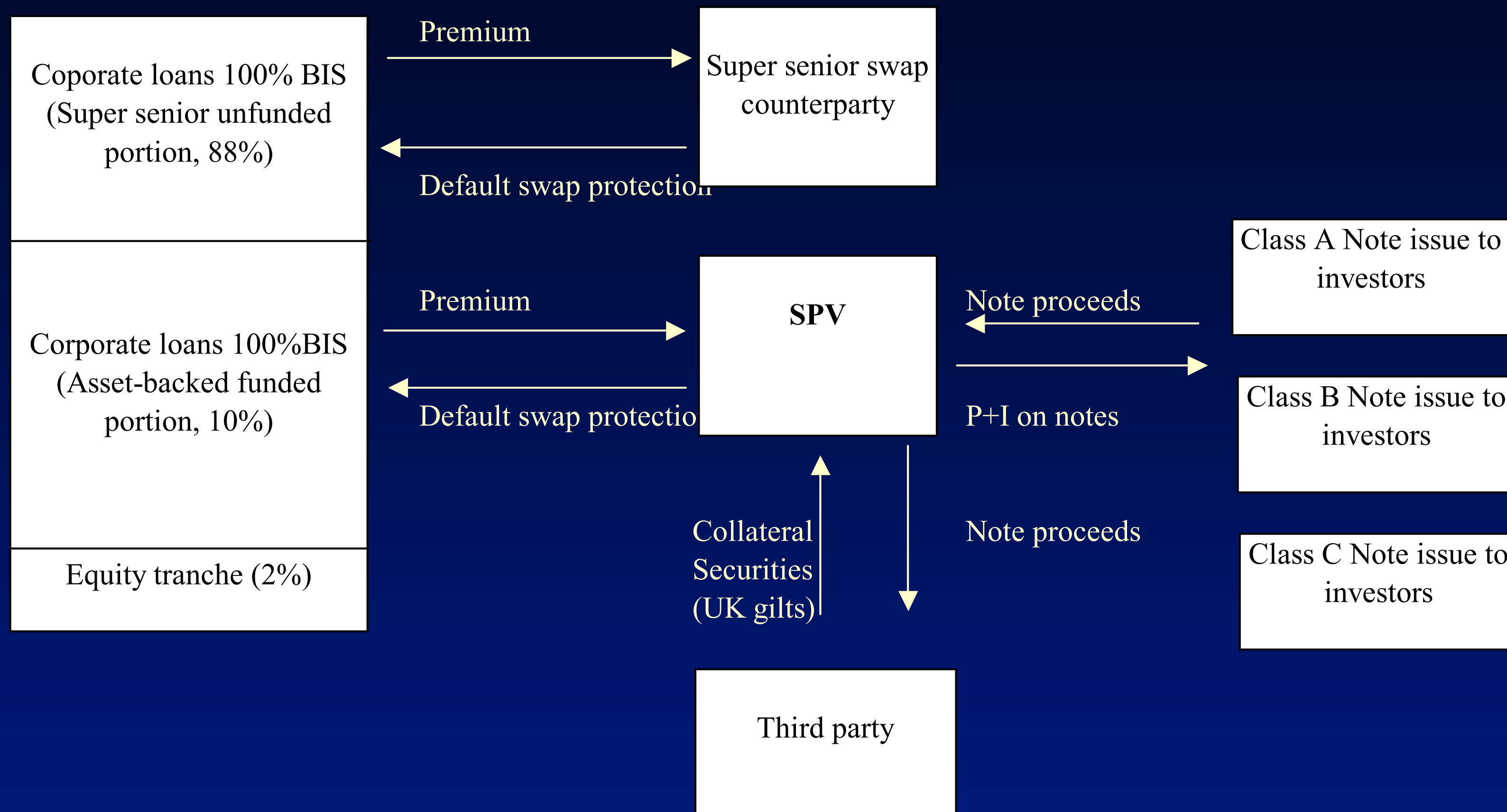
* Forecast. Source: BBA

Synthetic CDOs and capital relief

A principal use of Credit Derivatives in synthetic CDOs to obtain capital relief and transfer risk

- Consider £1bln synthetic CDO, reference portfolio on bank balance sheet
- Portfolio risk in 3 parts, “super senior”, mezzanine and equity tranche
- Assuming original assets (loans) fully drawn and 100% RW, capital charge is £80m
- Reduced to £34.08m under CDO, comprised £20m for equity, £0 for mezzanine and £880m x 1.6% [£14.08m] for super-senior

Partially funded synthetic CDO structure



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Synthetic CDO structure

- The capital treatment differs according to jurisdiction
- Certain regulators view investment in note tranches as investment in corporate equivalent and RW is 100%
- Other treatment: less onerous RW for higher rated classes, or (Italian regulators) the original level of capital must be retained as aggregate total in new structure, albeit in repackaged form
- How will treatment differ under Basel II?

Basel II new category risk weightings

Basel II proposals of “standardised” or “internal” risk-based approach

- Object of Basel II to align regulatory capital more closely in line with economic capital
- Risk weight of 150% added to weights of 0%, 20%, 50%, 100%
- RW of exposure determined by external assessment or internal ratings-based approach
- IRB approach bank uses own models to slot exposures in probability-of-default bands
- Effect is likely to change motivations to securitisations…

Basel II new category risk weightings

Likely impacts….

- The incentive to securitise OR purchase credit protection on asset exposures above certain rating reduced…
- … current RW of 100% for corporate and non-OECD sovereign exposures reduces to 0%, 20% or 50% if rated above A-
- … under IRB approach probably more favourable treatment
- BUT opposite effect for lower-rated assets, and more so if using IRB approach

Impact on credit derivatives

Collateralised exposures

- Under Basel I only cash or OECD sovereign debt could be used to reduce risk weight of underlying position
- Basel II adds:

  government bonds rated BB- and higher

  bank and corporate bonds rated BBB- and higher

  equities forming part of certain indicies

  gold

  (section 76)

Impact on credit derivatives

Collateralised exposures…

- Collateral adjusted with haircut to account for market volatility
- Minimum *w* factor of 15%, (section 142-145) that is:
- Irrespective of collateralisation, RW cannot fall below 15%
- One effect: corporate of 100% RW can reduce RW of an exposure to 15% by selling protection against it, given sufficient collateralisation
- *w* applies to all credit derivatives: a limiting factor….

Impact on credit derivatives

Credit derivatives…

- ….in effect

  … the *w* factor is the minimum part of the transaction still risk-weighted at original weight

  … this is irrespective of RW of seller of protection

  So for EXAMPLE:

  an asset of original RW of 100%, risk transfer by purchase of credit default swap from AA-rated bank, has reduction in RW to:

  (88% x 20%) + (12% x 100%) = 29.6%

  ….but this is 20% under Basel I

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Impact on credit derivatives

Contradictions in treatment?

- Is the *w* factor due to worries on enforceability of credit derivatives?
- Is this not then captured by new “operational risk” risk factor?
- Possible “double counting”?

Impact on credit derivatives

Further issues to ponder…

- Definition of a "credit event"…compare with ISDA definition
- Treatment of maturity mismatches…
- … full capital relief, "add-on" factors, pro-rata treatment

Impact on credit derivatives

New entrants to market

- Supra-national banks have RW of 0% under standardised approach – likely to become sellers of protection?
- Higher-rate corporates – previously 100% RW – so no motive to sell protection, now up to 20% RW if rated AA- and higher…
- … increases attraction of corporates to buyers of protection
- Definition of “corporate” to be clarified…hedge funds?

Basel II proposals

Conclusions

- Major change in reg cap calculation
- IRB approach incentive to banks
- Clarifications for credit derivatives
- Reduction in use in some transactions, increase in others

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