

February 17, 2012

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland
baselcommittee@bis.org

Dear Sir/Madam,

Re: Comments on the BCBS's Consultation Document: *Application of own credit risk adjustments to derivatives*

This letter sets out comments from the Bank of Montreal (BMO) on the Basel Committee on Banking Supervision's (BCBS) document: *Application of own credit risk adjustments to derivatives* (Consultation Document). BMO is a member of the Canadian Banker's Association (CBA) and this letter is supplementary to the CBA comment letter. We generally support the CBA comment letter, but because of the importance of this matter and its complexity, we thought our straightforward suggestions would assist BCBS.

To summarize our views, and to reiterate and reinforce key points from the CBA letter:

1. Common equity increases from debt valuation adjustment (DVA) reflect an increase in a bank's own credit risk – i.e., the market judges that the bank's creditors should receive more for taking on the bank's risk (which is an unrealized fair value gain for the bank and an unrealized fair value loss for its creditor).
2. We agree that banks should not be able to rely on common equity resulting from their increased riskiness to meet capital requirements.
3. However, the methodology proposed in the Consultation Document is inappropriate as it does not achieve the purpose of para. 75 of *Basel III: A global framework for more resilient banks and banking systems* (Basel III)¹ – in fact, it goes far beyond neutralizing the impact of derivative DVA and will have material and unintended consequences.
4. There is significant diversity in the manner in which banks around the world calculate and manage their DVA as such activities are driven by business, accounting and risk management considerations. To implement para. 75 in respect of derivatives, the objective should be to deduct, when calculating CET1, the actual increase in common equity resulting from a bank's actual DVA practices – it should not be to force uniformity in DVA practices. Given this diversity, it is not practicable to create a rule

¹ Basel III provides in para. 75 that banks are required to "derecognize in the calculation of Common Equity Tier 1 (CET1), all unrealized gains and losses that have resulted from changes in the fair value of liabilities that are due to changes in the bank's own credit risk."

that requires such deduction to be calculated using a uniform methodology – and provided such deduction results in the removal of any material accretion to common equity from DVA, it is not necessary for the deduction to be calculated in the same way. In fact, a mechanical rule that does not respect the current diversity of DVA practice, will not result in the deduction of the correct amount.

5. The pricing of a derivative incorporates the creditworthiness of both parties entering into a contract. While it possible to use a risk-free rate to calculate both a credit valuation adjustment (CVA) and DVA at inception², with an arms'-length "on-market" derivative, taking into account the asset and liability cash flows (e.g. pricing) and the other terms of the derivative (e.g. collateral posted) which should adjust for credit strength, inception DVA does not increase a bank's common equity.
6. Where the increase in a bank's own credit risk – which creates a DVA accretion to such bank's common equity – is offset by an increase in its counterparty's credit risk – which creates a CVA reduction of such bank's common equity – such bank's change in common equity is the net amount. As such, an increase in a bank's common equity only occurs to the extent its DVA is not offset by its counterparty's CVA.
7. Further, derivatives are completed within netting sets between a bank and its counterparty. If a bank terminates its derivative relationship with a counterparty, or if a bank is insolvent, it is the net CVA/DVA position that will be realized. As such, it is only the post-inception net positive DVA in a netting set that increases a bank's common equity.
8. The BCBS proposes that the gross DVA on each derivative (i.e. the DVA based on current credit spreads rather than the change in credit spreads since inception, without netting against a counterparty's CVA) should be deducted in the calculation of CET1. As this would include DVA priced into a transaction at inception and would include DVA that is offset by post-inception counterparty CVA, this would result in a significant deduction from CET1 which does not reverse an increase in a bank's common equity.
9. As noted by the BCBS³, the proposed approach fails to reflect the intent of para. 75 in the Basel III document which stipulates that only unrealized gains/losses "*due to changes in the bank's own credit risk*" should be derecognized in the calculation of CET1. Such treatment is inconsistent with the methodology for other Basel III regulatory deductions – i.e. it goes far beyond deducting an asset with questionable value when under stress and does not provide credit for DVA which has value as an offset to CVA.

While we appreciate the complexities with implementing para. 75, most of these complexities arise because accounting practices and practical calculation methodologies differ and because information systems for derivatives do not capture necessary information (e.g. historic credit spreads). If a bank is willing to do the work to calculate the actual increased common equity that has resulted from DVA, the rules should reward that effort and only require the deduction of such amount. The rules should not, even if the complexities are difficult to overcome and banks are differently situated, preclude the calculation of the correct deduction.

² DVA is typically defined as the difference between the value of a bank's payment obligations under a derivative assuming a bank is default risk-free, and the value of such payments taking into account the default risk of that bank.

³ Page 3 of the Consultation Document: "*The Basel Committee recognizes that this option is generally more conservative than paragraph 75, as it generally leads to a CET1 deduction at trade inception equal to the credit risk premium of the bank, rather than the change in value of derivative contracts occurring [sic] as a result of changes in the reporting bank's own credit risk.*"

Further, rather than seeking to apply a particular methodology for the calculation of the DVA deduction (e.g. discounting cash flows at a risk-free rate vs. the bank's cost of funds), it is important that the deduction of DVA is calculated in the same manner as the DVA that increased a bank's common equity. For example, if a bank uses its internal risk assessment (rather than credit spreads) to calculate DVA, it should use that same methodology to calculate the deduction from common equity.

Finally, for some banks deducting gross DVA may not be material and if they decide, based on a cost-benefit analysis, that the benefits from only deducting post-inception net DVA⁴ do not justify the cost of implementing a more sophisticated solution, a simple approach (like the one proposed in the Consultation Document) can be kept as a fallback.

Therefore, to allow banks to use the correct deduction when able, to encourage banks to transition to such solution and to allow other banks to choose a more conservative and simple method, we suggest a graduated approach. Note that this is not an "advanced" approach (in the sense of allowing for sophisticated models with the need for development, validation, approvals and supervision), it is a set of graduated rules that supports the optimal solution of only deducting post-inception net DVA (i.e. DVA which actually increased common equity), but allows for less optimal solutions that will result in a larger, more conservative deduction.

The rules to implement such a graduated solution can be straightforward. For example such rules could provide as follows:

In giving effect to paragraph 75 in respect to OTC derivatives, a bank shall calculate the debit valuation adjustment (DVA) arising from its own credit risk on such derivatives and must, when calculating its CET1, at a minimum, deduct the amount such DVA has increased its retained earnings. A bank shall calculate such DVA deduction using the following methods:

- a) If, with respect to any netting set of derivatives, such bank is able to calculate the increase to its common equity from the derivatives in such netting set from post-inception DVA (i.e. DVA caused by such bank's credit spread movements after inception), net of post-inception CVA (i.e. CVA caused by counterparty credit spread movements after inception), such bank shall deduct any net positive post-inception DVA from such netting set when calculating its CET1.*
- b) If, with respect to any netting set, such bank is unable to identify changes in credit spreads since inception, but is able to calculate DVA using current bank credit spreads for the derivatives in such netting set, and to net it against CVA calculated using current counterparty credit spreads for such derivatives, such bank shall deduct any net positive DVA since inception from such netting set when calculating its CET1.*
- c) If, with respect to any derivative, such bank is unable to accurately calculate DVA net of CVA or such derivative is otherwise not already taken into account under a preceding method, such bank shall calculate the DVA arising from such derivatives, without netting and based on current credit spreads, and shall deduct such gross DVA when calculating its CET1.*

In completing such calculation, the following rules shall apply:

⁴ "Post-inception net DVA" means DVA that is calculated based on a bank's changes in credit spreads after derivative inception and which is netted against changes in its counterparty's CVA since inception.

- *Under methods a) and b), if such calculation results in net positive CVA, no addition or deduction shall be made in respect of such netting set when calculating CET1.*
- *Under method a), if a bank has not recorded credit spreads at inception but is able to estimate such credit spreads in a consistent and reasonable manner based on actual credit spreads around the time a derivative was completed, the bank's supervisor may agree that method a) applies to the derivatives in such netting set.*
- *While many banks calculate DVA (and CVA) by comparing the present value of cash flows under the derivative at such bank's (or at the counterparty's) credit spread vs a risk-free rate, if a bank uses another method to calculate DVA or CVA when determining its common equity, such bank shall, when applying the above rules, calculate its DVA/CVA for the CET 1 deduction using the method applied to determine its common equity.*

National supervisors will review the calculation of a bank's para. 75 DVA deduction to ensure it results, at a minimum, in the deduction of all material increases to common equity arising from DVA and that, to the maximum extent practicable, that the methodology used to calculate such deduction is consistent with the bank's DVA methodology. National supervisors will share the manner in which they interpret and enforce these rules to help ensure international consistency across similarly situated banks.

Such a graduated approach will provide appropriate incentives for banks to invest in the ability to more accurately measure and calculate DVA - and will ensure that banks have an opportunity to only deduct, when calculating CET1, the DVA that increased its common equity.

We suggest that the above proposal will provide fair and flexible rules that can be implemented by the start of 2013 and allow banks to transition to their preferred level of sophistication over time. While BMO does not currently expect to be able to use method a) (as we have not captured inception credit spread information and do not have the systems in place), and while method b) will require us to make additional calculations and may not be available for all derivatives, we nevertheless consider that such a graduated approach will provide the right incentives.

Thank you for considering our comments. We would be pleased to discuss this with you at your convenience.

Sincerely yours,



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