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Secretariat of the Basel Committee on Banking Supervision  
Bank for International Settlements  
CH-4002 Basel, Switzerland  
[baselcommittee@bis.org](mailto:baselcommittee@bis.org)

Dear Sir/Madam:

**Re: CBA<sup>1</sup> Comments on the Basel Committee's Consultative Document: *Application of own credit risk adjustments to derivatives***

Thank you for the opportunity to comment on the Basel Committee on Banking Supervision's (Basel Committee) document entitled: *Application of own credit risk adjustments to derivatives* (Consultative Document).

We understand the Basel Committee's overall objective and agree that banks should not be able to rely on common equity resulting from their increased riskiness to meet capital requirements. However, we do not believe that the methodology proposed in the Consultative Document is appropriate as it does not fairly neutralize the impact of changes in own credit risk on the fair value of derivatives.

Primarily and pursuant to paragraph 75 of *Basel III: A global framework for more resilient banks and banking systems* (Basel III Framework), 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.*" However, the application of paragraph 75 to derivatives is not straightforward since their valuations depend on a range of factors other than a bank's own creditworthiness (such as the counterparty's creditworthiness, interest rates and other market factors). The fair value pricing of an over-the-counter (OTC) derivative incorporates the creditworthiness of both parties entering into a contract using both a credit valuation adjustment (CVA) and a debt valuation adjustment (DVA) to the derivative. 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

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<sup>1</sup> The Canadian Bankers Association works on behalf of 53 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 267,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness.

such payments taking into account the default risk of that bank. CVAs measure such relative value for the other party's payment obligations.

Gains in DVAs 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). Therefore, the Basel Committee does not want a bank to rely on retained earnings arising from the bank becoming more risky, but which cannot likely be realized unless the bank defaults.

The Basel Committee is proposing that DVAs for OTC derivatives that increase common equity be fully deducted in the calculation of CET1. For your consideration, below is a summary of our key concerns with regards to this proposed approach.

## **Conservatism**

As noted by the Basel Committee<sup>2</sup>, the proposed approach fails to reflect the intent of paragraph 75 in the Basel III Framework 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. The proposed methodology not only requires banks to derecognize the aforementioned unrealized gains/losses, but also to derecognize DVA with no regard to whether or not the DVA in fact increased CET1. We believe that such treatment is not only conservative, but inconsistent with the methodology for other Basel III regulatory deductions. Such deductions are usually required only where amounts increase CET1 without (or with limited) value as a gone concern, as such amount should be derecognized in the calculation of CET1 (e.g. goodwill, intangible assets, deferred tax assets).

This is perhaps best illustrated through the use of indicative numbers. Suppose a bank's credit default swap (CDS) spreads are 100bps for an extended period of time, with a relatively constant expected DVA exposure. Further, assume that the bank's CDS spreads rise to 110bps. In that case, the intent would be to deduct the gain associated with the 10bps increase in spread. The proposal outlined in the Consultative Document, by contrast, would deduct the full 110bps value, thereby overstating the capital deduction by a factor of eleven. By contrast, if the bank's CDS spreads have increased to 1000bps due to strong market concerns about the viability of the bank, then the Basel Committee's objective and the proposed approach are very closely aligned (i.e. conservative by only approximately 10%).

The conclusion is that the Basel Committee's proposal is representative in extreme situations. However and in the course of standard business situations, the proposed approach dramatically overstates the capital deduction. While we understand the technical complexities involved in implementing the Basel Committee's objective in the context of derivatives, we respectfully submit that the conservative expediency proposed in the Consultation Document is far too excessive and results in both perverse incentives and unintended consequences, as articulated below.

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<sup>2</sup> Page 3 of the Consultative 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.*"

## DVAs at trade inception

At trade inception, a bank's own credit risk is captured in the pricing of the trade (i.e. riskier banks make higher payments for their derivative transactions) and does not result in an increase in the bank's common equity. A bank's common equity increases due to changes in its own creditworthiness only when the bank's creditworthiness deteriorates after trade inception (i.e. the bank benefits from the mismatch between the bank's riskiness and the credit premium charged on the transaction at execution, and therefore recognizes the fair value gain in the profit and loss statement (P&L)). This is analogous to a bank that issues debt. On day one, the coupons it must pay to investors offset with the risky valuation of the debt instrument to bring the net fair value roughly to zero and no capital deduction is required. Only subsequent deteriorations in the issuing bank's credit risk will create a P&L gain on the debt that requires a capital deduction. By extension, "*derecognizing*" the full DVA on OTC derivatives (as opposed to derecognizing only the change in the DVA due to changes in the bank's creditworthiness since inception) would result in a deduction from common equity for an amount that is not actually captured in common equity.

Implementing a methodology which derecognizes DVA inclusive of the DVA at trade inception may prevent lower-rated counterparties from accessing derivatives markets. For example, a bank with a lower credit rating would pay a higher derivative premium to its counterparty, and simultaneously take a capital deduction for the full DVA included at inception. This 'double counting' of risk could lead to a concentration of all derivative trades into a handful of highly-rated participants, and as such increase systemic risk in the financial system.

## DVAs within a counterparty trade set

Since DVAs and CVAs are offset in the fair value adjustment for credit risk, where DVA is less than or equal to CVA in set of transactions with the counterparty, CET1 does not increase due to such DVA. As a result, there is no amount to derecognize. In other words, DVA should only be deducted when, on a counterparty basis, an excess DVA has increased retained earnings. This is because CET1 is only increased (and can only be derecognized) when the net balance for the counterparty is a DVA balance.

This argument is supported by the fact that if a bank and its counterparty terminate swaps early, the price to settle those contracts should account for CVA and DVA, and where DVA is offset by CVA, the bank effectively monetizes DVA by offsetting it. For example, if the credit spreads of two counterparties were to widen since the inception of a trade, their CVAs and DVAs would both increase, with only the net balance being economically considered at early termination.

Furthermore, if netting by counterparties is not allowed given that only DVAs resulting from changes in a bank's creditworthiness since inception need to be derecognized, banks would be motivated to early terminate positions with large offsetting DVA and CVA increases, for no other reason than to bolster their regulatory capital. For instance, if credit spreads for two equally risky

counterparties widen by an equal amount and the CVA/DVA offset is not allowed, then there will be a DVA capital deduction for both banks. To avoid this, they could agree to terminate existing contracts and subsequently enter into new ones, thus eliminating their respective capital deductions. This self-help would of course unnecessarily increase operational risk while doing nothing to improve the actual capital resilience of either firm.

## Alternative approaches

While we acknowledge the risk in introducing a sophisticated solution, we believe that the Basel Committee's attempt to simplify calculations should not result in a treatment that is contrary to economic reality and unnecessarily punitive to banks with material derivative positions. There are two effects which we think it important for any approach to capture:

- capturing the net effect between CVA and DVA. If a bank's credit spreads have increased, causing a gain in the DVA, while the counterparty's have also increased, causing a loss in the CVA, the capital deduction should be based on the net of those two effects; and
- making reference to some comparative spread against which to compare the bank's current spreads. As discussed above, the proposal is to essentially assume that the bank's historical spreads were zero, which is excessively punitive and distortive since it penalises banks which are performing well relative to banks which are not.

Below we present proposals which address both of these points. Proposal 1 represents an advanced approach. Proposals 2A and 2B are simpler standardized fallback approaches.

1. Provided a bank is able to calculate its post-inception net DVA by netting-set, then only the amount its CET1 has increased due to such post-inception net DVA ought to be deducted. Therefore and as an alternative option, we believe that the Basel Committee should allow able banks (either based on rules set by the Basel Committee or by individual national regulators) to develop and implement a methodology that accomplishes the intention of paragraph 75 of the Basel III Framework. This can readily be achieved by requiring banks to derecognize only DVAs that do in fact increase CET1, and by creating a rule requiring a bank to derecognize DVA resulting only from post-inception changes in the bank's creditworthiness where the DVA is higher than CVA in a netting-set. For any bank choosing not to implement this advanced approach, the Basel Committee should allow the fallback standardized approaches discussed below.

This method requires a bank to determine the change in DVA and CVA for each transaction due only to the change in CDS spreads for both the counterparty and itself. One method that could be employed is to calculate the marginal expected exposure for each trade based on today's market inputs and then determine the impact in the change in CDS spreads between the inception date and today on both CVA and DVA. In the case where the change in DVA is greater than the change in CVA, the net impact on CET1 would be equal to the difference in the change in DVA and the change in CVA. If the change in DVA is less than the change in CVA, the impact on CET1 would be zero since the DVA change is not contributing to an increase in CET1. The proposed methodology is similar to the second alternative approach (*Derecognition of DVA*)

*changes due to the bank's own creditworthiness*) described in the Consultative Document, although it provides a specific solution for trade level allocation and includes CVA changes since inception as an offset to DVA changes since inception.

In order to complete the calculation, an institution would need to develop capabilities to: (a) store both counterparty and own bank spreads historically to cover all days on which existing trades have been executed; and (b) calculate a meaningful trade level exposure allocation, which, according to the proposed approach, is based on the marginal impact of each trade on the rest of the portfolio.

Further and as an alternative approach when considering the treatment of DVA, the net bilateral position in CVA arising from the relative difference in counterparty quality (represented by credit rating) could be assessed for:

- bilateral positions where the bank has a net DVA balance, apply the full deduction; and
- bilateral positions where the bank has a net CVA balance, do not apply a deduction.

The method could be applied by counterparty or by netting set. Each counterparty or netting set would fall into one of these two cases:

1. Where the CVA is greater than the DVA - no CET1 deduction (e.g. CVA=5MM, DVA=3MM, CET1 deduction is zero).
2. Where the CVA is smaller than the DVA - CET1 deduction is abs (CVA-DVA) (e.g. CVA=5MM, DVA=7MM, CET1 deduction is 2).

One sums up the CET1 deductions across all counterparty/netting sets to get the final deduction number.

This method would ensure that no additional complexity is introduced since banks keep track of their CVA/DVA position as part of their financial reporting.

2. Regarding the comparative spread, there are two points of view which one can take. The first point of view is to take an accounting point-in-time view of comparing to a basket of high-quality reference banks credit spreads. Alternately, one can compare to an indicative historical spread specific for the bank. We discuss these in turn:
  - A. The first approach is to use market based spreads to define a regulatory DVA. The concern outlined in the Annex in the Consultation document is regarding spread deterioration of the bank leading to an increased DVA that would not be reflective of the claim the counterparty will make if the bank fails. We believe this could be addressed through the concept of a market based conservative estimate of DVA, which would provide a natural offset to the CVA charge that should better reflect the liquidation value of a derivatives portfolio. This perspective is based on close-out costs as opposed to historical inception DVA, as we feel this gets closer to the economic issue. This could be accomplished by determining a conservative estimate of an industry average bank spread to effectively define a regulatory DVA<sup>3</sup>. We believe this offers a reasonable

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<sup>3</sup> This could, for example, be based on a basket of internationally active banks that have an active credit default swap market on their names. Based on a basket of 20 such banks, at the time of this submission the average spread of the top 5 banks was approximately 115bps, and the spreads across these 20 names varied from 100-250bps with an overall average of 180bps. We would further propose that the banks actual spread acts as a floor to their DVA determination, so this proposal would have not impact for banks that have a spread lower than this average.

estimate of the close-out value of a derivative portfolio, since this represents a lower bound estimate of DVA, and in turn the CVA a counterparty would need to incur in re-assigning the portfolio to another institution.

- B. In the event that the preceding 2A proposal is not acceptable, the Basel Committee could consider amending its second rejected proposal (*Derecognition of DVA changes due to the bank's own creditworthiness*). Rather than attempt a trade-level allocation, the DVA deduction could be determined as the difference between the current DVA and a historical DVA, both determined at the portfolio level and using current market prices (interest rates, exchange rates, etc.) and positions. The historical DVA would be determined using the bank's spreads from the past. The historical spreads could be taken conservatively as the lowest spreads experienced over the past X years where X is conservatively estimated as the typical age of the bank's derivatives portfolio, with some regulatory floor. The intent is to assign a conservatively estimated effective historical spread at the portfolio level and not at the trade level. For instance, X could be fixed as the weighted average life of the trades, with the weighting fixed at the CEM EAD value. This could be floored at one year to make it consistent with the time frame applied to other regulatory measures.

An analogous process could also be implemented for the counterparties' historical spreads to account for the spread-based change in CVA. The two impacts could then be netted, to implement the netting CVA/DVA effect discussed above.

Either approach 2A or 2B, would have the following advantages:

- it would not penalize banks whose credit spreads have been experiencing a secular improvement;
- it would be relatively easy to implement and is intuitive and simple to explain;
- it would provide appropriately moderate numbers in the normal situation while approaching the full DVA deduction in the case of a bank whose spreads have increased excessively;
- it would only be dependent on exposures as established on the valuation date. This is appropriate since the intended language is only meant to capture P&L associated with changes in the bank's credit spreads, not with changes in the bank's expected exposure profile (as discussed in the first paragraph of alternative approach (b) in the Annex to the Consultation Document);
- it provides flexibility for regulators to inject conservatism in the choice of comparative spreads to compensate for any residual uncertainties regarding the effective comparative CDS spread to use; and
- it is a generalization of the proposed approach insofar as the Basel Committee's proposal represents the limiting case of this proposal where comparative spreads are set to zero.

We believe that the application of the abovementioned alternative proposals results in a fairer outcome and will still meet the objective of ensuring that a deterioration in own credit risk does not result in a CET1 increase.

Finally and as a general comment, we perceive the Consultative Document as yet another example of the deviation of Basel rules from accounting standards. We encourage the Basel

Committee to closely monitor this issue with aim to minimizing the increasing difference between accounting practices and the calculation of regulatory capital. We believe that the proposals contained in this submission would aim to achieve the same.

We thank you for taking our comments into consideration and would be pleased to discuss these issues further at your convenience.

Sincerely,

A handwritten signature in black ink, appearing to be "J. E. Smith", written in a cursive style.