HIGHER SCHOOL OF ECONOMICS
National Research University
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February 17, 2012

Basel Committee on Banking Supervision
Email: baselcommittee@bis.org

Dear Sirs,

Basel Committee on Banking Supervision Consultative Document
Application of Own Credit Risk Adjustments to Derivatives

On behalf of the National Research University Higher School of Economics (HSE), and particularly the International Laboratory of Decision Choice and Analysis and the Laboratory of the Banking Institute we would like to thank Basel Committee on Banking Supervision for the opportunity to deliver our opinion on the Consultation Document 'Application of Own Credit Risk Adjustments to Derivatives' [further on - *BCBS214*] published by the Basel Committee on Banking Supervision on December 21, 2011 at http://www.bis.org/publ/bcbs214.htm.

The comments are presented in three parts:
(a) 'General Comments' refer to the overall issues related to capital disclosure;
(b) 'Paragraph-wise Comments' correspond to the particular paragraphs that attracted our attention.

We hope our comments would be of use for deriving financial stability-oriented identification and regulation principles with respect to capital treatment for own credit risk adjustments.

In case of further questions, please, do not hesitate to get in touch through email (dhm-econ@hse.ru), telephone (+7.495.621.13.42, ext. 2006) or fax (+7.495.772.95.90, ext. 2101).

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General Comments

The document proposes to fully deduct from CET1 the increase of DVA as the difference arising from the fair value of derivative contracts and the value estimated at risk-free rate (e.g. "deduct the unrealised gains … when the *creditworthiness of the bank deteriorates*", cf. page 3).

Then the banker would come with the question what he is to do with DVA recognition when the *creditworthiness of the his bank improves*?

Current solution follows from the issue that "all DVAs for derivatives should be fully deducted in the calculation of CET1". It means that decrease in DVA is also to be deducted. But decrease in DVA is a loss for the bank's PL. Following the Basel Committee conservative approach to risk provisioning it would be expected that the loss is to be fully *recognised* leading to decrease of CET1.

Thus it is proposed to explicitly differentiate the cases of positive and negative DVA and to underline that the paper is about deduction (subject to comment 3 below) of *positive DVA* only.

We would also like to vote for the alternative approach (c) "Adjustment based on liquidation claim and balance sheet value" reviewed in Annex (pp 5-6) looks more reliable since it allows to estimate the real value of CET1. Still we keep conscious that it may be difficult to calculate it in some cases.

Paragraph-wise Comments

1. **Page 2, footnote 5 "*DVA = fair value (reflecting all counterparty credit risk) – hypothetical fair value ignoring own credit risk*"**

Propose to change "*value ignoring own credit risk*" for "value estimated at risk-free level" because ignoring own credit risk might be understood in two different ways: either ignoring all the underlying risk, or ignoring only the supplementary risk attributable to the bank over the risk-free (sovereign/country risk level). As on page 3 it is said that "The deduction of DVAs … requires deducting the spread premium over the risk free rate for derivative liabilities", it seems to be more consistent to mention risk-free level also at the DVA definition on page 2.

2. **Page 3 "<u>all DVAs</u> for derivatives should be fully deducted in the calculation of CET1"**

It is proposed to add "all *accounting* DVAs" instead of "all DVAs", not to mix them neither with initial DVAs, nor with regulatory ones.

3. **Page 3 "all DVAs for derivatives should be <u>fully deducted in the calculation of CET1</u>"**

It is proposed to say that "DVAs are not recognised" in the calculation of CET1, rather than "should be fully deducted". Suppose that the bank has operated through a period of time in a manner that nothing changes, only DVA decreased. Then before dealing with DVA a banker would have the same CET1 like in a previous period. If he would be obliged to *deduct DVA*, then he would arrive at the capital that is less than the previous period value. But the bank's liabilities did not deteriorate. Thus is was expected that DVA representing positive PL is firstly to be added to CET1 and only than deducted, i.e. *DVA is not recognised*.

Research Team

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