

17 February 2012

Basel Committee on Banking Supervision  
Bank for International Settlements  
Centralbahnplatz 2  
CH-4002 Basel  
Switzerland

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Dear Sirs

### **Application of own credit risk adjustment to derivatives**

We welcome the opportunity to respond on the BCBS Paper on Application of Own Credit Risk Adjustments to Derivatives.

### **Key Concerns**

We would urge the Committee to delay concluding on a particular methodology for the following reasons:

- The proposal is more punitive than for bonds as the full amount is deducted rather than just the impact of changes in spreads since inception. Broadly, the proposal is asking banks to deduct an asset from capital that, at inception, has never been recognised in the capital base. The Committee accepts this, but its view is that isolating the change in valuation due to credit spreads changing is impractical. We do not agree with this assertion and we believe it is possible to devise a methodology that is sufficiently objective and conservative.
- We believe that the way the industry prices funding costs and benefits into valuations and the interaction with DVA is still evolving. We therefore argue that regulators should delay imposing rules for the capital treatment of DVA until a consensus has emerged as this may lead to the penalisation of approaches that price funding more conservatively and manage funding commitments better.
- There is inconsistency across the industry in the calculation of DVA and the capital impacts of the proposed changes will reflect these inconsistencies. We believe that the implementation of the proposed changes could act as a disincentive to banks to improve their overall valuation framework for the management of counterparty and funding risk on uncollateralised derivatives.
- We believe the current proposal leads to distorted incentives. A bank trading an uncollateralised derivative with a positive funding benefit would suffer an immediate capital reduction whereas if the bank changed the terms to make it worse from a funding perspective (e.g. agreed to a one way CSA or a downgrade contingent CSA) they would avoid the proposed reduction in capital. Given that uncollateralised derivatives are predominantly traded with corporates, this would penalise hedging activity in the real economy.

### **Proposed alternative solution**

We believe that the capital treatment should reflect the overall management of counterparty and funding risk on uncollateralised derivatives and this should be considered in a joined up framework.

A derivative should be valued as the risk neutral expected cash-flows discounted at an appropriate funding cost. The application of a higher funding cost than Libor within this valuation will result in

valuation adjustment in comparison to a valuation produced by discounting at Libor flat. We term this the "funding valuation adjustment" (FVA) which applies to both assets and liabilities.

DVA<sup>1</sup> applies only to derivative liabilities and is calculated in an identical manner to FVA. If a bank used a cost of funding based on the bank's issued debt prices then the inclusion of a separate DVA would be a double count (as it would already be incorporated into FVA).

Illustratively, if a bank's credit spread increases then typically the cost of funds will also increase impacting both assets and liabilities (i.e. DVA). Thus, the increase in DVA will be offset by the FVA arising from the derivative assets.

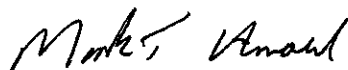
Therefore, we propose that, if a bank were to price its funding and calculate its DVA in this way, any DVA capital deduction should be the net of FVA. This would, therefore, only arise where the funding benefit from the derivative liabilities exceeds the funding cost from the derivative assets.

An illustrative worked example has been included as an appendix to this letter.

We would welcome the opportunity to discuss this proposal further with the Basel Committee.

Yours faithfully

P.P.



Chris Kyle  
Chief Financial Officer – Markets and International Banking

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<sup>1</sup>This is because both FVA and DVA are modelling the impact of the bank's (market implied) probability of default; if this is higher this both reduces the fair value of the bank's liabilities, and, equivalently, increases the bank's cost of funding through these liabilities.

## Appendix – illustrative worked example

As an illustration of how this would work, consider the following example. For illustrative purposes we have assumed counterparties are risk-free to avoid complexity, however, this would be equally pertinent to all counterparties.

Assume a bank has two identical but offsetting derivative positions:

- Derivative A with a risk free counterparty. This trade has an expected payoff of +1000 and the probability of the exposure becoming negative is negligible.
- Derivative B with a second risk free counterparty. This trade is the mirror image of the first trade and therefore has an expected payoff of -1000 and the probability of the exposure becoming positive in the future is negligible.

We assume a bank takes an FVA based on its funding/credit spread of 100 bps.

The bank therefore has:

- An FVA of -10 on derivative A.
- An FVA of +10 on derivative B. This component of FVA is, therefore, identical to DVA as it represents the gain arising from the fact that the bank is not risk-free, i.e. it has a credit spread.

The net FVA is zero so with our proposal there would be no capital deduction, even though the FVA can be decomposed into a DVA of +10 and a funding adjustment independent of DVA of -10.

Now, if the bank were to be liquidated, both derivatives are identical and therefore should be unwound at the same value (i.e. the cashflow from derivative A should be sufficient to repay the liability to the counterparty on derivative B). Similarly, as we move forward in time and the bank does not default, the cashflows on the two derivatives should match exactly. There is therefore no reason to believe that the accounting valuation is overstating the ability of the bank to pay off its liabilities, and hence no need for a capital deduction.