POSITION PAPER

WSBI--ESBG response to the BCBS consultation "on the application of own credit risk adjustments to derivatives"

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The World Savings Banks Institute (WSBI) and the European Savings Banks Group (ESBG) welcome the opportunity to provide a response to the Basel Committee on Banking Supervision's (BCBS) consultative document "on the application of own credit risk adjustments to derivatives" in context of the new Basel III rules.

Paragraph 75 of the Basel III rules text requires Banks to *"[d]erecognise in the calculation of Common Equity Tier 1, all unrealised 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."* .This rule seeks to ensure that an increase in the own credit risk of a bank does not lead to a reduction in the value of its liabilities, and thereby an increase in its common equity through a fictional increase in its earnings.

General Remarks:

- In general, WSBI-ESBG agrees with the idea that unrealised gains and losses resulting from changes in the fair value of their own credit risk are not taken into account for the purposes of calculating Common Equity Tier 1 of financial institutions.

- WSBI-ESBG is in favour of a tougher regulation for OTC derivatives and to channel every OTC trade through CCPs. Nevertheless, WSBI-ESBG does not support the obligation for every financial institution to apply the new risk weighting systems in such a short timeframe. They will cause huge additional costs for small and medium size financial institutions who will find it difficult to meet the expense. This will probably entail the exclusion of many financial institutions, finally leading to a greater concentration on the markets.

- WSBI-ESBG is of the opinion that the idea of establishing a timeframe for reporting does not just respond to an intention of applying a proper accounting adjustment to the system but, on the contrary, it is part of a broader plan to generalise the use of advanced pricing models to the whole financial system. WSBI-ESBG considers that it is not in this type of document where this IRB extension should be addressed.

- WSBI-ESBG wants to express its opposition to the extension of this kind of system for the whole banking sector as it would eventually mean to exclude some small and medium size financial institutions that cannot afford the implementation of these systems.

- Therefore, WSBI-ESBG considers that an alternative to small and medium size financial institutions that cannot afford the implementation of these techniques should be provided. WSBI-ESBG propose that due to the difficulties and high added cost that the implementation of the new pricing system would entail for small and medium size financial institutions, a sort of exemption for these banks which do not entail significant systemic risk should be applied.

Specific comments:

- **Concerning the calculation of the Full Deduction of DVA (consultative paper p. 3):**

In the part of the consultation entitled "**Proposed approach: Full deduction of DVA**" the Basel Committee proposes, as an appropriate solution for this problem, a full deduction of DVA in the calculation of CET1 for financial institutions at each reporting date. "*The deduction of DVAs is to occur at each reporting date, and requires deducting the spread premium over the risk free rate for derivative liabilities. In effect, this would require banks to ponder their derivatives for CET1 purposes as if they (but not their counterparties) were risk free, and deduct the unrealised gains both at inception of the derivative and afterwards, when the creditworthiness of the bank deteriorates".*

DVA is defined in the same document as "*the difference between the value of the derivative assuming the bank is default-risk free and the value reflecting default risk of the bank".*

In order to provide a correct estimation of DVA some **complex modelling methodologies** are required. As BIS must be aware, not all the financial institutions currently have these methodologies and not all of them can afford it. Thus, the obligation of reporting this DVA deduction for the capital calculation will entail the underhand intention of obliging banks to adapt their operatives to the most advanced system. Due to the high costs of the implementation of these techniques, some small and medium size institutions will be *de facto* excluded from the derivatives market.

Therefore, WSBI-ESBG considers that an alternative to small and medium size financial institutions that cannot afford the implementation of these techniques should be provided.

- **Concerning the reporting timeframe obligation for the deduction of DVA:**

The solution proposed by the Basel Committee lies in establishing the obligation of reporting the deduction of DVA according to a timeframe of reporting dates. Financial institutions would have to provide, at each reporting date, the calculation of the deduction of DVA; which implies deducting the spread premium over the risk free rate for derivative liabilities. This means that banks have to value their derivatives portfolios as if they were risk free, and deduct the unrealised gains both at inception of the derivative and afterwards, when the creditworthiness of the bank deteriorates.

WSBI-ESBG is of the opinion that the idea of establishing a timeframe for reporting does not just respond to the intention of applying a proper accounting adjustment to the system but contrary to that it is part of a broader plan to generalise the use of advanced pricing models to the whole financial system. WSBI-ESBG considers that addressing the extension of advanced pricing models is not suitable in this type of document. In the case of the Basel Committee wanting to generalise the use of this risk weighting system, it should have been addressed in an "ad hoc" document or consultative document.

In any case, WSBI-ESBG wants to express its opposition to the extension of this kind of system for the whole banking sector as it would eventually mean to exclude some small and medium size financial institutions which cannot afford the implementation of these systems. This would finally lead to a competition concentration and it would even contribute to the collapse of some small and medium size financial institutions or to their formal irrelevance.

Nevertheless, in case this DVA deduction reporting obligation is finally adopted, WSBI-ESBG would like to ask for a transition period so that all institutions who may be suffering from budget restraints would have time to implement the new methodologies.

- **Concerning the complexity of the new approach proposed:**

In case the approach proposed by the Basel Committee is eventually adopted, financial institutions will periodically need to calculate the deduction of the spread premium over the risk free rate. In order to obtain this calculation they will have to create a DVA/CVA internal function). Therefore, even though it is not explicitly expressed, financial institutions will be implicitly obliged to adopt this pricing system.

WSBI-ESBG considers that the former will add further complexity to the management systems given that it would entail very high additional costs and would affect simultaneously several areas and functions of financial institutions such as Regulatory capital management, Accounting adjustment, Pricing for credit risk, Active counterparty risk management, and Hedging P&L volatility.

In fact, the calculation of the DVA undertakes to maintain two different values for the same product type (one reflecting the risk of the counterparty default and other assuming the bank is default-risk free). This would eventually entail to maintain two different pricing systems. This would obviously mean an extra cost for financial institutions.

- **Concerning the difference between treatment of trades under ISDA and CSA system agreement and the treatment without resorting to them:**

Finally, WSBI-ESBG would like to refer to another of the conclusions we can draw from this consultative document. Under the approach suggested, those financial institutions which operate in derivatives will need to start trading through agreement systems such as ISDA and CSA contract frameworks due to the obligation of calculating their capital by applying the deduction of the DVA. WSBI-ESBG considers that under this approach it will be extremely difficult to operate in derivatives without resorting to these systems, and financial institutions which do not operate under these agreements will be excluded. Thus, even though it is not explicitly expressed, financial institutions will be implicitly obliged to work within these types of agreement frameworks. WSBI-ESBG believes that in case the proposal keeps in its current formulation, this obligation should be explicitly referred to in the regulation.

About WSBI-WSBI-ESBG(World Savings Banks Institute – European Savings Banks Group)

WSBI-WSBI-ESBG– The Global Voice of Savings and Retail Banking

WSBI (World Savings Banks Institute) is one of the largest international banking associations and the only global representative of savings and retail banking. Founded in 1924, it represents savings and retail banks and associations thereof in 90 countries of the world (Asia-Pacific, the Americas, Africa and Europe – via WSBI/ESBG, the European Savings Banks Group). WSBI works closely with international financial institutions and donor agencies and facilitates the provision of access to financial sectors worldwide – be it in developing or developed regions. At the start of 2009, assets of member banks amounted to almost € 9,000 billion, non-bank loans to € 4,300 billion and non-bank deposits to 4,600 billion. Together the member banks conducted operations through 160,000 outlets.

WSBI-ESBG(European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of over € 6.000 billion, non-bank deposits of € 3.100 billion and non-bank loans of € 3.300 billion (all figures on 1 January 2009). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

WSBI and WSBI-ESBG members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. WSBI and WSBI-ESBGmember banks have reinvested responsibly in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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