

01 October 2015

Bank for International Settlements
Basel Committee on Banking Supervision

Dear Secretariat

BCBS: Consultative Document: Review of the Credit Valuation Adjustment Risk Framework

The Australian Bankers' Association (**ABA**) welcomes the opportunity to provide feedback on the Consultative Document: *Review of the Credit Valuation Adjustment (CVA) Risk Framework (CD)*.

With the active participation of its members, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

Key issues

1. Overview

The ABA supports the objective of providing better alignment between economic risks and the capital charge for CVA.

Key concerns regarding the current BCBS proposal are:

- a) Certain aspects of the proposed requirements for the Fundamental Review of the Trading Book (**FRTB-CVA**) are overly prescriptive and involve a significant computational burden.
- b) The proposed requirements for internal model method (**IMM**) pre-approval, will prevent certain banks from accessing the more advanced approaches because of local regulatory restrictions.
- c) The prescribed risk weights under the Basic Approach are overly conservative and will result in a significant increase in CVA capital.

The ABA advocates Option A (accounting-based CVA) for exposure estimation to enable the above objective, allowing banks to leverage their current audited IFRS-compliant accounting methodologies for regulatory CVA. However, the requirement to apply a risk-neutral approach with calibration to market-implied parameters wherever possible, may need to be reviewed in certain jurisdictions because of limitations in CDS market liquidity and coverage.



2. Exposure measurement

[Q5] Is Option A (accounting-based CVA) or Option B (IMM-based CVA) preferred for exposure calculation?

The ABA supports Option A (accounting-based exposure), on the basis that:

- It allows better alignment between economic risk and CVA capital, as noted in the CD; and
- It allows greater efficiency in CVA data, modelling, computation processes and controls by allowing banks to leverage existing audit-approved accounting CVA frameworks.

While acknowledging that a risk-neutral approach supports 'best practice' in CVA frameworks, the ABA wishes to highlight that the need for a risk-neutral approach and market-based volatility, and correlation factors will require a large and complex program of work for banks that may not meet these conditions within their current audit-approved accounting CVA models.

In particular, the requirement to apply risk-neutral estimates can be a significant limitation for some banks with material exposures to corporate counterparties that do not have liquid CDS in these geographies, such as Australia and Asia. In certain cases the available proxies may not provide a reasonable representation of these counterparties, resulting in excessive CVA volatility driven by unrelated factors.

In addition, the requirement stated in Annex 1, B.1. (f) 25. (page 16) to apply an algorithm that discriminates on at least three variables in order to estimate the credit spread curves of illiquid counterparties is overly prescriptive for banks operating outside of North America or Europe, where the depth and breadth of markets may not be compatible with this approach. It is noted, however, that paragraph 27 in Annex 1 does provide consideration for the use of historical PDs when no time series of peer credit spreads is observed as long as the resulting spread is still somehow related to credit markets. The ABA proposes that this exception should be extended to cases where there is limited time series available.

3. IMM approval

A requirement for IMM approval as an additional eligibility condition under the accounting-based CVA option poses an immediate restriction for banks in jurisdictions that do not currently permit the IMM approach, such as Australia.

[Q3] Should IMM approval be included as an additional eligibility requirement for the FRTB-CVA framework under Option A (i.e. accounting-based CVA method for generating scenarios of discounted exposure)?

The ABA recommends that IMM approval should not be a pre-requisite for the FRTB-CVA approach if Option A (accounting-based CVA) is selected, given that advanced modelling eligibility will be assessed through the specific qualitative and quantitative requirements for FRTB-CVA without having to rely on IMM approval as a signal of modelling capability.

These recommendations will enable banks that currently do not have the regulatory option to apply IMM to access the more risk-sensitive advanced FRTB-CVA approaches.

A requirement for IMM approval may:

- Create a more uneven playing field as certain jurisdictions such as Australia do not currently permit the IMM approach, and the ABA believes regulators in other jurisdictions have different appetite and resources to work with banks to provide IMM approval.
- Slow down implementation of more advanced CVA management frameworks for non-IMM banks considerably (e.g. IMM requires internal modelling of exposures at least one year prior to approval).



- Be an excessive additional requirement if the BCBS elects to apply the accounting-based CVA methodology, given that IMM accreditation is not directly used under this approach; and
- Pushing banks to implement the Basic CVA approach, which does not give appropriate recognition to market risk hedges, will likely cause banks to pass on the additional costs to customers and also potentially leave these risks unhedged.

IMM approval may be reasonable as a pre-requisite if Option B (IMM-based CVA) is selected.

4. Computational and data burden

The IMM exposure simulation process requires a significant computation capability. In addition, the requirement to compute sensitivities under the FRTB-CVA framework makes the process even more computationally intensive. It is proposed, therefore, that the standards be supportive of any steps to lessen the computation burden, for example, by accepting a reduced number of simulations and time steps required, as this will support banks' ability to apply the more advanced methods.

In addition, the requirement for data going back to 2005 for the IMA-CVA approach poses a considerable challenge for banks, given that Basel II-compliant data processes were typically developed to be effective from 2007/2008 onwards. The ABA proposes that a data history beginning from 2008 onwards will provide sufficient historical data coverage. This period will capture the GFC stressed period and ensure 10 years of historical data coverage by the anticipated start date of the new framework.

5. Basic CVA framework

The ABA's view is that the Basic CVA methodology is not sufficiently risk sensitive and does not favour convergence between accounting and regulatory CVA. This methodology does not give appropriate recognition to market risk hedges, and also increases capital requirements significantly.

There is a risk of implementing a CVA framework which is overly conservative without a strong commitment from local regulators to allow for the more risk-sensitive FRTB-CVA (under BCBS requirements). An overly conservative and risk-insensitive measure would impact the competitiveness of Australian financial institutions, their profitability and ability to service Australian corporates effectively. The capital impact is likely to have severe adverse impacts on the business viability, market pricing and competitiveness of derivative activities for banks that do not have the option to, or are unable to, apply more advanced approaches.

6. Indicative capital impacts

SA-CVA: Estimates of regulatory capital under the SA Standardised CVA approach indicate a significant increase in capital, which is mainly driven by the additional capital charges from market risk factors.

Basic Approach CVA: Preliminary estimates of regulatory capital under the Basic CVA approach also indicate a very significant increase in capital, in the order of 3-6 times the current standardised method capital, as a result of the considerably higher risk weights proposed under the new approach.



Responses to specific questions

BCBS Questions	ABA Response
Q1. To what extent do large netting sets, potentially illiquid transactions within a netting set, and recent disputes affect the internal assessment of the margin period of risk (MPoR)?	The number of counterparty trades may not necessarily be a good indicator of increased collateral close-out times or increased MPoR although it could indicate concentration risks with certain counterparties. It is highly likely that counterparties with large netting sets will contain a large number of similar vanilla transactions (that make up a majority of the overall portfolio) which generally does not increase margining risk. These counterparties are very likely to be other large inter-dealer bank counterparties which have access to their own sophisticated valuation systems. Given the volume of new transactions (which could be either new trades, novations or unwinds) that happen regularly, the size of the netting set is not taken into account in the internal assessment of the MPoR. In addition, banks are already regularly tearing up trades bilaterally or via trade compression exercises. At that point when an ISDA is legally closed-out, illiquid transactions would also be closed-out accordingly. Even if the counterparty disputes the valuation, the counterparty can only dispute the valuation as of the designated termination date. As such, the margin period of risk should not be a function of potential disputes or liquidity of the trades. It should only be a function of the time taken to close-out trades. The ABA believes that the current 10-day minimum is a conservative estimate, where actual margin close-outs in periods of stress/illiquidity such as the GFC have typically been shorter.
Q2. Is Alternative 1 or Alternative 2 preferred with regard to the calculation of the MPoR?	Alternative 1 is preferred since it is likely to be closer to market practice for accounting CVA. Alternative 1 is still likely to be more conservative than what many in the market use for the MPoR for collateralised counterparties in their accounting CVA. The ABA does not believe that large netting sets or recent disputes are good indicators of increased MPoR; for illiquid/structured transactions, an increase in MPoR may be applied if required by internal assessment (refer to Q1). It is noted that Alternative 2 would allow banks to use the same simulations for both IMM counterparty credit regulatory capital and regulatory CVA, while Alternative 1 would require different simulations for



BCBS Questions	ABA Response
	accounting and regulatory CVA, which would come at the cost of additional computational demand.
Q3. Should IMM approval be included as an additional eligibility requirement for the FRTB-CVA framework under Option A (accounting-based CVA) for generating scenarios of discounted exposure?	No - requiring IMM approval under Option A poses an immediate restriction for banks in jurisdictions such as Australia where the IMM methodology is not yet permitted by their regulators. The FRTB-CVA and accounting based CVA requirements are adequately described under paragraph 19 and IMM approval should not be an additional requirement under Option A. Under FRTB-CVA, there would be better alignment between economic risks and capital charge for CVA that would incentivise banks to implement a sound CVA risk management framework. Eligibility for advanced modelling should be separately assessed through the specified qualitative and quantitative regulatory requirements specified for the IMA-CVA without having to rely on IMM approval as a signal of modelling capability.
Q4. To what extent is there synergy between the calculation of accounting CVA and the EAD calculation for IMM with respect to processes, data and methodology?	This does not apply to Australian banks since the IMM approach has not been implemented in Australia. However, the underlying counterparty and trade information required will be applicable for both accounting CVA and IMM calculations. There will also be overlap of some processes and methodology. As noted for Q2, banks may have to apply separate runs to compute accounting CVA and regulatory CVA depending on the treatment of the MPoR.
Q5. Is Option A (accounting-based CVA) or Option B (IMM-based CVA) preferred for exposure calculation?	Option A is preferred. • This option would allow non-IMM or less sophisticated banks to develop their CVA management capabilities and hedge CVA exposure sensitivities (assuming IMM accreditation by the supervisory authority is not required under Option A). This would then better align with hedging economic risks and the capital charge for CVA. • Many banks currently have different systems for calculating capital and accounting CVA. Allowing the use of accounting-based CVA exposure calculations for regulatory capital would remove the need for separate systems and also reduce system-related operational risks. • Option A would give banks a consistent approach in accounting for both their CVA, as well as recognition of hedging, thus promoting sound CVA risk management.



Strong banks – strong Australia

BCBS Questions	ABA Response
	As noted by BCBS, the only advantage of Option B is to decrease supervisory effort for banks where IMM has already been approved. However, ABA notes that the requirement for risk-neutral estimates within the accounting CVA framework is not feasible in certain markets because of insufficient liquidity in CDS. This added requirement also poses a significant additional burden for banks whose current IFRS-compliant, audit-approved accounting frameworks do not meet the risk-neutral requirements. The use of risk-neutral estimates may also increase the likelihood of failing regulatory back-testing requirements if the same underlying model is being employed for IMM counterparty credit capital calculations.
Q6. Is Option 1 or Option 2 preferred for simulation time horizons?	Option 1 is preferred, for consistency with the FRTB framework and conservativeness.

Thank you for taking the ABA's comments into consideration. If you would like to discuss any part of this submission please contact me on the number below.

Yours faithfully

Aidan O'Shaughnessy
Policy Director, Industry Policy
02 8298 0408
aidan.oshaughnessy@bankers.asn.au