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Mr W Coen
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Dear Mr Coen

COMMENTS ON: REVIEW OF THE CREDIT VALUATION ADJUSTMENT RISK FRAMEWORK

We thank you for the opportunity to provide comments on the above consultative document and fully support the objectives that will ensure consistency with the proposed revisions to the market risk framework under the Basel Committee's *Fundamental Review of the Trading Book* ("FRTB").

We are supportive of the proposal for the revision of the CVA regulatory framework in order to address the deficiencies of the current standard and alignment with bank's current as well as forward-looking CVA business and risk management internal processes and that the consultation paper ("CP") is trying to address a major flaw of the existing bank capital charge for volatility in the creditworthiness of banks derivative counterparties.

We have addressed the specific questions raised in Appendix 1 as well as specific provisions in Appendix 2.

1. Key observation points

1.1 Alignment with Accounting CVA

We consider Accounting CVA to be the most appropriate methodology to capitalise CVA risk for the reasons set out in this response, and so consider that accounting and regulatory CVA should be as closely aligned as possible to minimise the operational cost and burden associated with running parallel systems that would otherwise be required. Given the broad scope of CVA desks, internal models are essential to ensure that the capital charge is aligned to the economic risk, something a standardised approach cannot achieve whilst retaining a degree of simplification in the calculation.

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1.2 Recognition of applicable hedges

The proposals make a distinction between a CVA book and a trading book, and suggest separate capitalisation between the two books. It furthermore specifies that only transactions used for the purpose of mitigating CVA risk, and managed as such can be eligible and can include hedges against both counterparty credit spread and exposure components of CVA risk. Non-eligible CVA hedges are treated as trading book instruments and are capitalised via market risk rules.

Clarification is required whether internal market risk hedges executed for exposure components are eligible. We would like to indicate that it would be preferable for internal hedges to be eligible as this would support current practice where market risk hedges are entered into with each, separate, area of excellence, which then manages the whole bank's risks of that type.

1.3 Inclusion of Securities Financing Transactions (SFTs)

Current market practice is not to hedge CVA on well collateralised trades and SFT's due to the limitation of counterparty credit risk on such trades. Given the lack of a fair value CVA adjustment on these trades, the concept of holding a CVA capital charge to cover a risk that doesn't exist seems strange. While a conservative, 10 day, MPOR, makes some sense for the default estimation, applying a 10 day MPOR to the CVA calculation looks likely to force banks to hedge (and thus fair value) a risk many of them don't agree with. In many banks, this hedging would be seen as an addition to risk, rather than the mitigation of such.

We anticipate that the FRTB style calculation will be imposed as part of the flooring mechanism proposed in BCBS d306. These proposed calculations will be onerous to implement, notwithstanding potential inclusion of a high volume of SFT exposures for which no material exposure is expected. Alternatively, a punitive charge would apply to these exposures under the standardised approach which we would not support for the same reasons.

On this basis, we propose that the previous carve out based on immateriality be reinstated in the proposed text for immaterial SFT CVA.

1.4 Double Counting Equivalent Exposure Variability

The basic CVA capital charge is the sum of credit spread variability and equivalent exposure variability. The equivalent exposure variability is already taken into account in the calculation of EAD under SA-CCR which already includes a potential future exposure (PFE). The CVA is then calculated using the EAD inclusive of the PFE and then scaled up by 50% to reflect more CVA volatility from a component driven by the same underlying market risk factors. If the intention is to reflect that credit hedging shouldn't bring the CVA capital charge to zero, then the basic K_{unhedged} should be calibrated to less than the current CVA capital charge.

1.5 Internal models in the CVA framework

We strongly support the materiality based assessment of risk factors to eliminate unnecessary complexity. For example, the upcoming implementation of initial margin for un-cleared derivatives will eventually render CVA risk for

fully collateralised netting sets negligible, and the regulatory requirements should take account of this.

There has been considerable progress over recent years on accounting practices around CVA and some differences may exist between different institutions' approaches, they tend not to affect the most material exposures (i.e. long-dated un-collateralised trades with non-financial counterparties).

Furthermore, we believe strongly collateralised names should be considered differently with regard to the Minimum Margin Period of Risk (MPoR) calculation given the low risk associated with these counterparties. Collateralised names are subject to punitive MPoR rules under IMM where 1 illiquid trade can pollute the entire netting set, and we strongly support the proposal in the consultation paper for a fixed n+9 day MPoR for regulatory CVA. An overly conservative measure is not appropriate when the impact will be taken through the profit and loss account and may not incentivise appropriate behavior with regards to hedging.

The requirements for the generation of market risk factor paths should be made less prescriptive, as the specification of calibration of simulation parameters (volatilities & correlations) to market-implied levels, and the inclusion of leptokurtosis in exposure modelling do not necessarily align with practical assumptions that are made to allow hedging and risk management of the economic CVA. For instance, with CVA covering a large numbers of trades of different maturities it is not always clear which are the appropriate market instruments to calibrate to, and CVA desks will often prefer to risk manage on the basis of longer run average volatility levels, removing unnecessary P&L noise and better reflecting the true cost of hedging. Likewise, the model risk that is introduced by calibrating highly complex models to full volatility surface information is generally undesirable, and will lead to increased potential for divergence between calculation approaches in different institutions.

The requirement to model the co-dependence of counterparty credit with exposure should not be a pre-requisite for internal model approval. There is no industry consensus around the calibration of such models, so requiring this would reduce the comparability of different firms' capital models. Wrong-way risk positions are limited by other governance processes and we would propose that firms identify the individual positions and capitalise the wrong-way risk via an explicit add-on.

1.6 Calibration of Basic CVA Approach

CVA should not only be calibrated to the largest international banks, but also to emerging markets (EM) and smaller banks. Larger banks are unlikely to use the Basic CVA approach as their primary CVA methodology, making their results less valid in a calibration exercise. It is likely that diversification benefits will be larger for the larger entities, implying that calibration including them will penalize smaller entities. In addition, larger international entities are likely to reflect higher relative levels of initial margin and higher relative levels of clearing. Both of these will drop their CVA charges relative to smaller and emerging market banks. Without the critical mass to make clearing and initial margining viable, a CVA charge calibrated including larger international banks in already developed markets will act as a roadblock to smaller, EM, markets and banks achieving this critical mass. In effect, an unnecessarily high CVA charge acts as a "barrier to entry", preventing smaller regions and entities from growing into competitive markets

1.7 Calibration of SA-CVA approach

Given that most smaller banks wouldn't have been able to respond to the first QIS on CVA, and are likely to be a few years away from being able to help with calibration of the SA-CVA approach, it must be considered that, just like the Basic CVA calibration point above, the calibration will be unavoidably skewed by the type of respondent able to involve themselves in the calibration process.

1.8 Proxy hedging with sovereigns

In many EM countries, the major risk relevant to non-local currency derivatives is that of the sovereign itself, which is also often the most sensible proxy credit. Where an entity (especially financials and SOE's) could be considered to be at the sovereign ceiling (in foreign currency terms), or is government backed, one should have another eligible level of proxy hedging for all approaches, being that of the sovereign itself. This should be somewhere near the 80% correlation number, consistent with that applied when a counterparty has a legal relation to another under the Basic CVA approach

1.9 Can a bank choose to split CVA portfolios between basic and FTRB methodologies based on internal estimation of relative sensitivities and materiality of risk?

Smaller banks may have different criteria and risk management policies for different CVA policies based on the materiality of the risk assessed under internal procedures and policies. This election will assist in driving portfolios with significant risk under more advanced methodologies and better reflect the economic risks associated therewith, than deeming the whole bank under a basic approach due to immaterial or less sensitive CVA portfolios.

2. Issues for further clarification

There were a number of issues that we are still unsure of and have listed them below:

- 1) Will the standardized approach be imposed in some form of regulatory capital floor should a bank obtain IMA-CVA approval (i.e. similar proposal as per the impending floor for market risk capitalization under FRTB)
- 2) Initial capitalization calculations of sample trades under the Basic Approach (BA-CVA) in the proposed standard seem highly punitive and largely attributable to a substantial increase in risk-weightings (adjusting for all other model inputs with reference to the current standardized formula)
- 3) For the Basic CVA α is used to adjust the EAD, the default is 1.4, is this specific to each bank and if so how is it determined?
- 4) For the Standardized approach is there a specific required shift size, for vega sensitivities?



3. Conclusion

We believe that further calibration post the current (and possible future) QIS is needed to establish prudent but appropriate risk-weightings.

Should you require any further information, please do not hesitate to contact us.

Yours faithfully



Gary Haylett
General Manager – Prudential



Appendix 1

To what extent do large netting sets; potentially illiquid transactions inside a netting set; and recent disputes affect the internal assessment of the margin period of risk (MPoR)?
○ Neither accounting CVA or Counterparty Credit Risk Management use large netting sets, illiquid transactions or collateral disputes in consideration of the margin period of risk. These measures are only used in Regulatory capital calculations. As in the case of accounting CVA, when putting something through P&L and potentially hedging it, it is important that the measure is representative of the real economic risk and not just conservative for the sake of being conservative. ○ Under a default or near default scenario, the MPoR will likely increase materially above the contractual threshold. ○ Clarification is required on whether the question is in relation to a bank's own assessment of MPoR in its own control framework or also in relation to the regulatory MPoR requirements? ○ Large netting sets and potentially illiquid transactions don't affect MPOR for the whole netting set. Enough disputes could if they can't be tracked to individual trades.
Is Alternative 1 or Alternative 2 preferred with regard to the calculation of MPoR?
Alternative 1 is highly preferable over Alternative 2 with regard to the calculation of MPoR. The IMM extension of MPoR rules are excessive. The idea that one small illiquid transaction could potentially pollute a netting set with thousands of other trades extending the MPoR for all is conservative in the extreme, and for the same reasons as described earlier creates a mismatch with the true economic risk
Should IMM approval be included as an additional eligibility requirement for the FRTB-CVA framework under Option A (ie accounting-based CVA method for generating scenarios of discounted exposure)?
○ IMM approval should not be included as an additional eligibility requirement for the FRTB-CVA framework under Option A ○ The benefit of imposing such a requirement does not create a material benefit above the already stated requirements and governance framework that will be



imposed for deriving accounting-based CVA exposure scenarios to a suitable regulatory standard

- Additionally, the generation of such scenarios may fall under completely different systems and processes internally which would create additional operational risk considerations – again for no material risk management benefit
- Accounting based CVA should be validated in the current existing accounting framework. Regulatory requirements should provide guidance on “Prudent Value Adjustment” or any required deviations from the adopted accounting based CVA.
- The accounting based CVA measurement is subject to accounting and audit requirements, which include model and input validation, and further approval is therefore not deemed necessary.
- Also, on the back of the changes brought about by SACCR, most banks won’t be able to justify the cost of applying for IMM approval, implying that only currently IMM approved banks would be able to apply either SACCR approach. This would, once again, create a barrier to entry for smaller banks and markets.

To what extent are there synergies between the calculation of accounting CVA and the EAD calculation for IMM with respect to processes, data and methodology?

- Currently the accounting CVA sits in a completely distinct architecture to the IMM EAD engine. Certain input data will come from the same sources such as netting flags, CSA information, trade and position details etc, but the exposure calculations are separate. Accounting CVA only covers a subset of the full counterparty population, and there are differences in modelling capabilities and configuration. The methodologies share several similarities, but there are important distinctions in the calibration of the simulation dynamics, the treatment of collateral and the modelling of counterparty rating transition.
- For some SA banks, there is no synergy as the bank has no current intention to be on the IMM regulatory standard
- Some SA banks deploy significant infrastructure to quantify accounting CVA under a risk-neutral or market calibrated basis
 - I.e. there is no re-use or expected intention to use current infrastructure to generate IMM EAD which would require new processes to obtain traditional credit input parameters
- Whilst conceptually aligned from a Monte-Carlo or stochastic simulation methodology perspective, the re-use of processes and data for deriving accounting

CVA and IMM EAD is very limited and not a basis for the simplified use of IMM EAD within the more advanced FRTB-CVA regulatory capitalization formulae

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

Accounting-based CVA (Option A)

- We believe the benefits of greater alignment to the accounting recognition of CVA and the associated economic capitalization as well as actual banking risk management framework far outweigh the alternative approach which, although simpler and easier to regulate, does not sufficiently align with the actual valuation (e.g. non risk-neutral) and hedging of CVA in the industry
- The imposition of an IMM requirement has far reaching implications for a bank that is significantly wider than CVA as a class of risk (i.e. the development of systems, processes and governance of CVA risk management will be subject to a wider standard and not aligned with how so banks intend to develop and enhance CVA risk management internally)
- This is the exposure measure that generates PNL and is therefore likely to be most closely aligned to financial reporting and hedging strategy.
- The capital requirement under this approach is then directly linked to the actual P&L volatility that banks will record.

Is Option 1 or Option 2 preferred for simulation time horizons?

- Currently we are of the view that Option 1 is the preferred simulation time horizon for CCR spread simulation time horizons as this brings it into line with the trading book FRTB and distinguishes between different counterparty credit ratings.



Appendix 2

Ref	Paragraph	Comment
13	Regulatory CVA must be calculated as the expectation of future losses resulting from default of the counterparty under the assumption that the bank itself is default risk-free	Please refer to point 1.3 regarding the implications of excluding DVA
13	The term structure of market-implied PD must be estimated from credit spreads observed in the markets. For counterparties whose credit is not actively traded (i.e. illiquid counterparties), the market-implied PD must be estimated from proxy credit spreads estimated for these counterparties (see Section 1(f)).	In many EM countries, the major derivative counterparts tend to be highly correlated to their sovereigns in non-local currency terms. As such, their credit spreads, and their hedging are often treated on a "sovereign plus" basis.
19	The current and historical market data must be acquired independently of the line of business and be compliant with accounting	We propose that the wording be changed to indicate that current and historical market data must be independently verified or sourced as opposed to independently sourced. This is more supportive of the structures within smaller banks, which may not necessarily have an independent sourcing function, but separate validation and governance processes to provide similar levels of accuracy and validity.
20	For margined counterparties, collateral can be recognised and modelled along a path under the following conditions: • Collateral management requirements outlined in paragraph 51(i)–(ii) of Annex 4 of the Basel framework are satisfied. • All documentation used in	Recommendation would be that if accounting regulations don't force the fair value of CVA impairments with a non-zero MPOR, why would one hold Capital on an item that, therefore, can't cause any fair value volatility? In addition, often over 80% of derivative transactions live within daily margined, very low threshold netting sets. The

	collateralised transactions must be binding on all parties and legally enforceable in all relevant jurisdictions. Banks must have conducted sufficient legal review to verify this and have a well-founded legal basis to reach this conclusion, and undertake such further review as necessary to ensure continuing enforceability. • A bank's exposure models used for accounting CVA calculations must be able to accommodate a non-zero value for the margin period of risk (MPoR).	computational requirements to calculate sensitivities on these netting sets don't make sense given the low risk they present. In addition, where documentation might not have been tested (as is the case in many EM markets), the binary nature of the framework prejudices developing markets. The suggestion would be that where there is no legal impediment, but due to the lack of precedent it is hard to find a legal opinion, and in-between option might be found (allowing some limited level of netting).
24(f)	Credit spreads of illiquid counterparties	
	A bank should estimate the credit spread curves of illiquid counterparties from credit spreads observed in the markets of its liquid peers via an algorithm that discriminates on at least three variables: a measure of credit quality (e.g. rating), industry, and region.	• Within the South African context where the majority of the CVA risk relates to less liquid counterparties and/or thinly traded secondary credit market, this provision may be challenging and using a market observed parameter may overstate the risk.
	In certain cases, mapping an illiquid counterparty to a single liquid reference name can be allowed. A typical example would be mapping a municipality to its home country (i.e. setting the municipality credit spread equal to the sovereign credit spread plus a premium). A bank must justify every case of mapping to single names.	• In many EM countries, the major derivative counterparts tend to be highly correlated to their sovereigns in non-local currency terms. As such, their credit spreads, and their hedging are often treated on a "sovereign plus" basis. This is likely to fit into paragraph 26. However, it would make sense, then, for hedging thereof to allow a higher offset than reflected in the SA-CVA and Basic CVA framework for these examples.
	When no time series of credit spreads is observed in the markets of any of the counterparty's peers due to its	

	very nature (e.g. project finance, funds), a bank is allowed to use a more fundamental analysis of credit risk to proxy the spread of an illiquid counterparty. However, where historical PDs are used as part of this assessment, the resulting spread cannot be based on historical PD only – it must relate to credit markets	
31(h)	Multiplier	
	To compensate for a higher level of model risk in calculation of CVA and CVA sensitivities (in comparison to market value of trading book instruments and its sensitivities), the expected shortfall measure used in the FRTB is scaled up via a multiplier. $CVAm$	The revised CVA Capital framework specifies a model risk parameter for CVA, m_{cva} that multiplies the CVA capital figure and has a default value of 1.5. We do not support the approach to including model risk in the capital framework.
	Multiplier has a default value of [1.5]. However, the default value of the multiplier can be increased by the bank's supervisory authority if it determines that the bank's CVA model risk is higher than its peer's. In particular, the default value will be increased if the bank does not account for the dependence between exposure and counterparty credit quality in its CVA calculations $CVAm$	
46	Buckets, risk factors, sensitivities, risk weights and correlations	Where banks calculate buckets with more granularities will they be allowed to use more granular buckets to approximate the risk for the specified buckets under the proposed framework? Or would separate models be run with the exact match risk buckets.

