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Basel Committee on Banking Supervision
Centralbahnplatz 2
Basel, Switzerland

Dear Sir/Madam:

Re: CBA response on BCBS Consultative Document: Review of the Credit Valuation Adjustment (CVA) risk framework

The Canadian Bankers Association¹ (CBA) welcomes the opportunity to provide comments on the BCBS's consultative document: Review of the Credit Valuation Adjustment (CVA) risk framework. The CBA supports the BCBS's motivation for improving the CVA capital charge through incorporating market risks into the calculation, and aligning with institutions' accounting-based CVA calculation.

We set out our comments on this consultative document below. The CBA's responses to the specific questions contained in the consultative document are included in the appendix.

Capturing all CVA risks and better recognition of CVA hedges

The CBA strongly supports the initiative to incorporate the effect of market variables on exposure profiles in the CVA capital charge. Market risk hedging of CVA is a primary concern for an institution actively managing its CVA, and the recognition both of the market risk and the consequent hedging instruments is a welcome modification to the CVA framework.

The CBA underscores the concerns raised by ISDA that sensitivities for some collateralized counterparties can be extremely computationally expensive, but have only immaterial effect on the CVA capital charge. In particular, interbank trading will eventually incorporate initial margins, as per BCBS/IOSCO regulations on non-centrally cleared derivatives. Here, collateral requirements will result in a near-zero CVA, similar to that of central counterparties, which are excluded from current and proposed CVA capital charges. The CBA would propose that institutions at least be permitted to calculate immaterial sensitivities on a reduced frequency, to avoid the expense of daily computation. In a similar vein, institutions should be provided with flexibility to avoid unnecessary computational burden, for example, by calculating sensitivities to less material risk factors in the same class with a single simultaneous shock.

¹ The Canadian Bankers Association works on behalf of 60 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 280,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness. www.cba.ca.

On the other hand, for certain portfolios and instruments, some institutions are unable to calculate CVA sensitivities. Particular examples include portfolios managed by subsidiaries that do not actively manage CVA, and exotic instruments that are too complicated to accurately calculate CVA sensitivities. The CBA understands that fallback approaches will be acceptable in such cases, but encourages an explicit acknowledgement in the framework, with similar restrictions as in the existing IMM framework.

Alignment with industry practices for accounting purposes

The CBA strongly supports the proposal to align the CVA capital charge with institutions' accounting CVA. This relates the capital charge more directly with internal CVA management and removes the need for the parallel regulatory computation used in the current advanced CVA capital charge.

There is a growing trend to directly account for other valuation adjustments (most notably FVA), as well as to actively manage them using sensitivities, consistent with CVA. While we are aware that valuation adjustments other than CVA were not considered for this version of the proposal, we encourage the BCBS to consider expanding the CVA capital charge to include FVA and other valuation adjustments in future versions of this framework.

The CBA suggests that the BCBS provide greater clarity on the treatment of hedges for non-CVA-related valuation adjustments, either in a revised consultative document, or through an amendment to the FRTB proposal. In particular, the market exposure arising from these hedging instruments will be most problematic, as they will appear as uncovered risk.

It is important that regulatory standards are developed with some flexibility and future intent to align with industry practice around management of valuation adjustments, so that a single framework can continue to be used for both regulatory and accounting purposes. As such, we recommend that the scope of derivatives trades included in the CVA charge be restricted to those to which fair value accounting is applied.

Securities financing transactions do not normally have a CVA charge calculated; the CBA believes such risk is immaterial due to the highly-collateralized and short-dated nature of the transactions. Thus, we would request that their inclusion in the CVA capital charge be reconsidered.

Alignment with proposed revisions to the market risk framework

The CBA strongly supports the addition of market risks to the CVA framework. Both the IMA-CVA and SA-CVA approaches are a significant improvement over current approaches, as they are better aligned with the management of CVA.

We encourage alignment between the CVA computation and the general FRTB framework, allowing CVA to be viewed and managed consistent with other market risks in the firm. In particular, we encourage as much harmonization as possible to avoid requiring two distinct, but very similar, risk models to be built for the regulatory calculations.

As such, we suggest that the diversification parameter w used in the expected shortfall calculation be set consistently with the corresponding parameter ρ in FRTB (which has yet to be specified by the BCBS). Similarly, in our response to question 6 below, we prefer that horizons for credit curves used in the IMA-CVA capital charge are consistent with the general FRTB treatment.

We believe that the IMA-CVA approach is the most relevant for risk capture for CVA. Furthermore, we feel that the FRTB framework itself is robust enough to determine the

appropriateness of this approach, particularly through the backtesting and P&L attribution requirements.

Basic Approach

Finally, we feel that the basic approach, as specified, may be too conservative. This is a concern as it is likely to be used as a fallback to FRTB-based approaches. The risk weights for BA-CVA are calculated based on a fixed one-year time horizon, in contrast to the shorter time horizons for credit spread risk under the SA-CVA. We would suggest BA-CVA risk weights be amended to reflect the same time horizons as the SA-CVA risk.

We would be pleased to discuss these comments with you further at your convenience.

Sincerely,

A handwritten signature in black ink, appearing to read "Dave Hamel". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

cc: Brad Shinn, OSFI
Patrick Tobin, OSFI

APPENDIX – CBA Responses to Specific Questions

Q1. 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)?

In general, the MPoR used in accounting CVA is not adjusted in the exceptional circumstances described here. In particular, there are very few counterparties affected by the netting set size and frequent disputes.

Pricing and reserves on illiquid transactions are normally managed independently from the CVA estimation.

As CVA is a pricing measure, it is difficult to overlay conservative regulatory assumptions and keep a consistent view of market price. Accounting-based CVA is based on expected MPoR and it is difficult or punitive to impact an entire netting set based on a single transaction or recent disputes to the current MPoR values.

For example:

- Large netting sets and potentially illiquid transactions are not valid arguments to increase the MPoR for the CVA of a counterparty. In the event of default, amounts are claimed in bankruptcy proceedings and those have nothing to do with the number of trades in the portfolio.
- The real issue occurs for derivatives on an illiquid underlying. Those run the risk of seeing the claimed value be challenged in court in the event of a default. However, we believe this is more of a pricing issue than an MPoR issue.
- Since CVA is a long term expected risk, the MPoR should be closer to a long term average of liquidation period, and should not be impacted by temporary (or operational) issues arising from collateral disputes.
- Typically, legal opinions on enforceability of netting agreements are not required for recognition in the CVA calculation if a reasonable expectation of enforceability exists.

Q2. Is Alternative 1 or Alternative 2 preferred with regard to the calculation of MPoR?

Alternative 1 is preferred. Using a 9+N day MPoR is closer to current accounting CVA standards than the more conservative IMM floors. Deviation from market practice for accounting CVA will lead to a bifurcation of the sensitivity calculation into regulatory and accounting versions, which is not desirable.

Q3. 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. The accounting-based CVA method is separate from the CCR credit risk IMM capital charge method and a distinction should be made. The CVA model approval should be treated like any other derivative pricing model and corresponding approval for market risk. The accounting CVA system is already subject to controls due to accounting requirements.

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?

Generally, the accounting CVA and IMM/PFE systems are distinct, run by different teams within each institution, and use different assumptions in calibrating the risk factor evolution models.

Data sources will generally overlap, but are often managed by different groups as well. The trade population, legal agreements and CSAs, and market data usually come from the same source.

Methodologically, the models are often similar, but technologically, the accounting system will have to be optimized to calculate trade-time incremental exposures and sensitivities.

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

The accounting-based CVA is preferred for the exposure calculation. In particular, it is an improvement on the existing framework, as it would more closely link the capital held to institutions' view of the volatility of the adjustment. Additionally, as hedges will be captured in the new metrics, it is important that the sensitivities used in the regulatory calculation are consistent with the sensitivities used to build the hedging portfolio.

As noted above, it is important that regulations evolve with developments in xVA, as a static, prescriptive CVA sensitivity method may in future require a parallel calculation for regulatory purposes.

Q6. Is Option 1 or Option 2 preferred for simulation time horizons?

Option 1 is preferred. To harmonize the modelling, wherever possible, the CVA framework and the general FRTB rules should be consistent.