Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

February 25, 2020

RE: Credit Valuation Adjustment risk: targeted final revisions, November 2019

Dear Members of the Basel Committee,

Credit Suisse AG ('CS') appreciates the opportunity to comment on the Committee's November 2019 Consultative Document detailing the targeted revisions to the credit valuation adjustment (CVA) risk framework (hereafter referred to as the 'Consultative Paper' or 'CP').[1] CS welcomes the Committee's proposals to amend the CVA risk framework in three broad areas: (i) Alignment with the market risk framework; (ii) Scope of the calculation, and MPOR revisions (iii) Recalibration of the SA-CVA multiplier.

In summary, we believe that these targeted revisions are significant and welcome improvements over the 2017 CVA risk framework proposal. However, we are concerned that the revisions still do not sufficiently address the industry consensus regarding the shortcomings of the framework. In particular the necessity for: (i) Further alignment to industry fair value accounting CVA principles and (ii) Improved risk sensitivity, especially with respect to the Counterparty Credit Spread bucket in SA-CVA.

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We thank the Basel Committee on Banking Supervision for its considerations of our comments. If you have any questions, please do not hesitate to contact the undersigned

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Director, CRO Regulatory Risk Management

[1] Basel Committee on Banking Supervision, "Consultative Document: Credit Valuation Adjustment risk: targeted final revisions. Available at: https://www.bis.org/bcbs/publ/d488.htm

Response to the Consultation

Our approach to quantify the impact of the proposed FRTB-CVA framework, as in the consultations, has been to make a number of assumptions regarding risks under BA CVA and SA CVA.

Using SA-CVA, as drafted in BCBS 424, our CVA RWA increases very materially compared to the current framework rules as per BCBS 189. Under BA CVA, the RWA of the equivalent portfolio increases materially compared to SA CVA.

The CP represents a significant improvement in the risk sensitivity of the SA-CVA. Below we assess the proposals made in the CP in turn and suggest further enhancements, which are required to improve the overall calibration to current regulatory CVA RWA and risk sensitivity of the framework.

1. Alignment to the Market Risk Framework

1.1 Aligning Risk weights

The CP incorporates a reduction of the risk weights for Counterparty and Reference Credit Risk, Interest Rate risk, Equity Risk, FX Risk, and Commodity Risk in order to better align with the finalised market risk standard. Credit Suisse welcomes the proposals on the re-calibration and the consistency of design between FRTB SA and the CVA framework. Areas where Credit Suisse believes that this could be further refined (as per ISDA/GARP BCBS Consultation paper of February 2020) will be discussed in section 3 below.

1.2 Introducing Index buckets

CS take note of the revisions that affect the recognition of hedges, namely the introduction of an additional bucket for indices in the counterparty credit spread, equity and credit reference risk classes, as well as the associated cross-bucket correlations. Historically, the existing CVA framework did not adequately deal with index hedges, leading to an overly conservative credit capital requirement that was not proportionate with the actual risks that were incurred by banks; CS appreciate Basel's efforts to remediate this. However, we believe further amendments are required to ensure that index hedges of CVA exposure are sufficiently recognised. The deviation from the Market Risk framework in this instance, is we believe, justified, as the CVA portfolio contains a diverse number of credit underlying's and counterparty credits, most of which are not directly hedge-able. Banks must use indices to hedge the CVA volatility driven by these names. Therefore, in the CCS bucket, index should be correlated higher than in the market risk framework. We believe that, at a minimum, the index hedge benefit should be comparable to that of BA-CVA to ensure consistency across the framework. CS therefore recommend that Basel provide a comparable index hedging benefit in SA-CVA that is seen in BA-CVA by revising the cross-bucket correlations for counterparty credit spread delta risk from 45% to 75% (as evidenced in the ISDA/GARP BCBS consultation paper of February 2020).

1.3 Revising the aggregation formula

CS is supportive of the proposed amendments to the formula for aggregating capital requirements across buckets in the CVA risk framework, and recognise that it better aligns with the market risk framework.

2. Further adjustments to the CVA framework

2.1 Exemptions in the scope of the CVA framework

CS welcomes the alignment of scope with the current Basel 3 ruleset with respect to client cleared transactions and secured financing transactions, as this certainly does reduce the operational burden. Furthermore, CS agrees with the ISDA/GARP BCBS consultation paper of February 2020, that client cleared transactions and SFTs should be exempted from the CVA charge entirely. In the case of centrally cleared portfolios the only scenario in which a loss occurs would be where the client cleared transaction defaults. This loss is already captured through the CCR charge. With respect to SFTs, we are also aligned with the ISDA/GARP BCBS consultation paper of February 2020, where the argument is made that the valuation of the SFT is driven by the underlying collateral and not the counterparty credit curve, and so banks would not recognise loses from the deterioration of the counterparty credit prior to default. As such there is no CVA equivalent for SFTs and these should be excluded from the CVA charge.

2.2 Recalibration of the CVA multiplier

The proposed revised text to set the multiplier mCVA at [1 to 1.25], subject to supervisory approval is an improvement from the previous ruleset. Credit Suisse feels that the empirical evidence of conservatism of SA-CVA in the QIS justifies the removal of the mCVA multiplier.

CS understands the Committee's need to maintain an appropriate relative calibration between the SA-CVA and BA-CVA via means of a general scalar applying to the overall BA-CVA capital requirement. Credit Suisse however recommend that Basel ensure that the application of this scalar does not lead to a capital charge that is more than 50% higher than the SA-CVA. Other shortcomings of the BA-CVA could be in part remediated by point 4.2 below.

3. Improved risk sensitivity

3.1 Further granularity in rating and sector of the counterparty credit spread bucket

CS does not believe that the granularity across sector or credit quality is sufficient to fully describe and capture the risk inherent in the counterparty credit spread bucket. This bucket does not contain risk that is readily tradeable, as in the Market risk framework, and is often an expression of corporate lending and capital markets activity and part of a broader relationship. These derivative positions are therefore more of a buy and hold proposition, albeit hedged where possible with CDS and market risk hedges. As such, it has some parallels to the Counterparty Credit Risk framework, which admits a much richer description of exposure categories, LGDs and PDs (or ratings).
The risk weights in the financials bucket, in particular, lack rating and sectoral granularity and do not differentiate between the large varieties of end users (a higher rated IG pension fund vs a lower rated IG hedge fund, for example)

CS Recommendation: Increase granularity across the sector dimension, particularly for the financial sector bucket, and across the rating dimension, for all sector buckets.

4. Further alignment to Accounting CVA principles

4.1 Use of Accounting LGD in sensitivity derivation

With reference to MAR 50.32 section 4, CS believes a wider specification of when the ELGD can differ from the one used to calculate the risk neutral PD from credit spreads is required.

It is relatively common for specific end users, such as pension funds and SMEs, to grant structural seniority to derivative hedge providers. In many cases, these end users do not have senior unsecured bonds readily available in the market to observe and demonstrate seniority of exposure over. This structural seniority, however, would show up in the LGD and rating applied to the exposure for capitalization under the counterparty credit risk framework (CRE 51).

CS Recommendation: Amend the language in MAR 50.32 section 4 to allow inference of seniority from a wider set of instruments (such as loans) and the seniority assessment made as part of the counterparty credit risk framework, provided it has not been already accounted for in the derivation of the market implied PD.

4.2 MPOR

CS welcomes the proposed amendment to the supervisory MPOR floor of 4+N business days for SFTs and cleared transactions as specified in CRE 54.12. However, we believe the MPOR floor should be revisited for the wider set of OTC derivative transactions.

In particular, CS's observed and audited experience of exit prices for our counterparties operating in these markets does not incorporate valuation adjustments of the size that would imply a supervisory floor of 10 days, or 9+N days. CS has long observed that interbank markets, for example, do not execute at prices that contain closeout risk considerations. We also believe that 9+N is too broad to capture the much improved collateralization practices of particular segments of the derivative market, and ultimately does not incentivize convergence to improved practices. CS believes that there should be an alignment between accounting and regulatory frameworks with respect to MPoR, especially given the extended scope in regulatory vs accounting CVA. Here an unaligned MPoR would increase P&L volatility when, per QIS results, the risks would need to be hedged. As the framework stands, CS would have to take on additional market risk, introducing P&L volatility and would therefore increase potential P&L losses as a result of the implications of the revisions to the framework.

CS Recommendation: Revisit the 9+N supervisory floor for particular netting sets, where collateralization practices are strong (daily or same day, collateral posting in cash, covered by portfolio reconciliation agreements or covered by regulatory IM).