

Response from CVA Services GmbH

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CVA Services GmbH
Bettinastraße 30
60325 Frankfurt am Main
Germany

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

20 September 2015

Re: Basel Committee on Banking Supervision Consultative document on “Review of the Credit Valuation Adjustment (CVA) risk framework - consultative document”

Dear Sir/Madam,

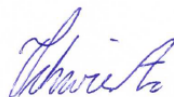
CVA Services GmbH would like to thank the Basel Committee on Banking Supervision for the opportunity to comment on the Consultative document on The Review of the Credit Valuation Adjustment (CVA) risk framework. Please find attached our response to the consultation.

We would be happy to discuss with you, in further detail, any further comments you may have. Please do not hesitate to contact Thomas Schwiertz on +49 69 974 611 43.

Yours sincerely,



CVA Services GmbH
Stefan Zur
Managing Director



CVA Services GmbH
Thomas A. Schwiertz
Head of Financial Engineering

CVA Services GmbH Response to the Basel Committee on Banking Supervision Consultative Document on The Review of the Credit Valuation Adjustment (CVA) risk framework

INTRODUCTION

We are pleased to respond to the BIS consultation on “The Review of the Credit Valuation Adjustment (CVA) risk framework”.

CVA Services GmbH is a leading consultancy firm in Germany in the field of financial risk management. Our consultancy expertise is centered on market, credit, liquidity and operational risk management and extends from accounting to IT service implementations within the risk control and trading departments of financial firms. Providing managed services for CVA and exposure calculations based on Basel III SA-CCR and IFRS13 our company is in the process of relocating from Berlin to Frankfurt am Main. Besides, we are extending our activities to the French market. Most of our clients incur considerable costs for implementing and following new regulations or requests to respond to consultations such as QIS. Those costs are part of what we refer to as RVA (regulatory value adjustments).

Please find below our comments on the key principles as well as the specific questions set out in the paper. We welcome proposals and questions.

The CVA framework is deeply connected to the FRTB and new exposure methods i.e. SA-CCR. Overall, it represents an improvement over the existing non-modelled approaches for calculating exposure at default (EAD) of derivatives in the new SA-CCR framework as it better reflects differences between margined and non-margined transactions and takes better account of hedging and netting benefits. With this Review of the Credit Valuation Adjustment (CVA) risk framework a clear picture becomes visible and enables our clients to prepare internal processes and IT landscape for regulatory reporting and risk management.

Comments on individual consultation 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 rules for defining a margin period of risk should depend on and should be in line with the potential liquidation period of these illiquid transactions. For some instruments, e.g. swaptions, the definition of a liquidation period in stressed market condition seems to be very difficult. In addition, the liquidation period for instruments which cannot be cleared via by a CCP at a certain point in time cannot be estimated since a CCP's Default Management Process and its liquidation period via e.g. a mandatory auction cannot really give a reliable answer. Usually replacement costs for these OTC derivatives (which defaulted) can be estimated and should be part of the internal assessment. If a counterparty defaults and cannot fulfill its contractual payments on the derivative the replacement cost and the period required to buy the same transactions may form an adequate measure for the margin period of risk. There is no need to distinguish transactions used for hedging or steering purposes.

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

We recommend “Alternative 1”.

Besides the avoidance of the confusion regarding paragraph 41 (i)-(iii) of Annex 4 “Alternative 1” provides a clear statement that the daily exchange of margin is better than the exchange in longer intervals. There is still a lack of consideration of intraday margin calls, but in practice this is only a type of market convention for CCPs. For CCPs a CVA charge is zero, if Base CVA or SA-CVA is in place. For IMM it depends on the credit portfolio model used by the bank.

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)?

In general we support and recommend strongly to use Option A, i.e. the accounting-based CVA method – please refer to our answer to Q5. The dependency on any eligibility requirement should be given to the local watchdog, since financial markets and business models can be very different. We support the accounting-based Option, since it would eliminate any maladjustment and economic imbalances between banks, other financial and non-financial institutions. In addition, the accounting-

based CVA method should generally provide a better alignment between the economic risks and the capital charge for CVA and reduce the incentive banks currently have to leave some of their risks unhedged.

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?

We believe that there are considerable synergies in using similar methodologies for accounting CVA and EAD calculation for IMM, particularly when it comes to calculating CVA sensitivities, P+L attribution on transaction level which represent calculation-intensive exercises. This is due to the use of similar underlying methodologies based on sophisticated (American) Monte Carlo simulations for path-dependent instrument types. However, due to the expression of economic risks we believe that accounting based methods are more suitable to define material limits and calculate sophisticated risk measures in order to make decisions based on efficient calculations and adequate approximations.

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

We have a clear opinion to support Option A. Please refer to our responses to Q3 and Q4 for the explanation.

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

In Option 1 the units of the time horizon seem to be more logical than in Option 2 since PDs are typically expressed for one year. In addition, the link to the FRTB seems to be more appropriate and forms a closed mathematical concept in its triple convergence of FRTB, SA-CCR and CVA.

Option 2 seems to be more appropriate regarding market conditions and liquidity, i.e., bid/ask spreads of CDS. CVA Services GmbH has no clear opinion or recommendation on Q6.

To give a proper recommendation the market data for the calibration of the credit risk portfolio model and economic capital calculations used by the respective financial institution has to be taken into consideration. In other words a model less dependent on market data analogue to BA-CVA or a model using more market data and less stale and interpolated data analogue to SA-CVA should be used. Regarding stress tests and its connection to the Expected Shortfall and Initial Margin calculation a time horizon and its appropriate stress value can be defined by using truncated Lévy flights. See book ISBN: 978-3-95850-864-4 for details. E.g. the stress scenarios defined within ECB's stress tests of banks in October 2014 were set rather randomly and without detailed analysis.

Financial institutions' stress tests are often defined by historical scenarios e.g. 09/11.

Such stress scenarios and the liquidation periods as well as periods of market turmoil, which should define the simulation time horizons are not always captured properly.