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Reference NVB response to the Basel Consultative Document Review of the Credit Valuation Adjustment Risk Framework

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz2, CH-4002 Basel
Switzerland

Dear Sir/Madam,

Introduction

The Dutch Banking Association (Nederlandse Vereniging van Banken, NVB) appreciates the opportunity to comment on the Basel Committee on Banking Supervision's (BCBS) consultative document (CD) on the Review of the Credit Valuation Adjustment Risk Framework.

In the ISDA led industry response there is a focus on the proposed FRTB-CVA framework. As the Basic CVA approach shall be used for (larger) parts of several portfolios of the Dutch institutions, the Dutch response will focus on the Basic CVA approach.

In the first section we listed the most relevant issues that we identified related to the Basic CVA framework. In the second section we answered some of the questions that were stated in the BCBS consultative document.

Section 1

1. Huge capital increases when comparing the proposed Basic CVA framework with the current methods and the proposed FRTB CVA framework

We believe there is a justification for limited discrepancy of capital allocation when using the more advanced FRTB CVA framework compared to when using the Basic CVA framework. A cruder and simpler framework should be more conservative because of the additional unknown factors.

However, the gap should not be as wide as currently proposed. It would put the institutions that will report (parts of) their portfolios on the Basic CVA framework at a too big of a disadvantage. It is of great value that a wider group of institutions can operate in the derivatives and SFT markets, also the less sophisticated institutions. This is essential for safeguarding a strong market with sufficient amount of market participants where clients can benefit from.

Also the impact from the current CVA framework to the new proposed Basic CVA framework seems to be too large (Dutch banks reported capital increases from 300% to 500%) although this was not the intent of the BCBS proposals.

Therefore we kindly urge the BCBS to reduce both the gap between the current CVA frameworks and the new proposed Basic CVA framework as also the gap between the proposed FRTB CVA framework and the proposed Basic CVA framework. We trust that the QIS results provide evidence that these two gaps are very significant.

In order to perform a like for like capital allocation analysis both the Basic CVA framework as also the FRTB CVA frameworks should be calculated by taking into account no hedges, then the allocated capital differences should be limited.

2. SFT and derivatives for which no accounting CVA is calculated should yield to zero CVA capital

The intention of the regulator is to align accounting CVA with CVA capital. Therefore it makes sense to exclude transactions for which no CVA is recognised under the accounting standards. This includes Security Finance Transactions, which are short term, over-collateralised and liquidated as soon as margin requirements are not met, and transactions done under a strong CSA (i.e. ones that are bilateral, have a close to zero threshold, and daily margining). Under the default capital rules (counterparty credit risk) capital will still be allocated.

While we acknowledge the need for regulation to be prudent and conservative, this does not logically apply to the accounting rules that determine the accounting CVA. Giving the intention to align with accounting CVA, we believe the appropriate conservatism is best reflected in the market stress factors, and not in the CVA calculation itself.

3. Inclusion of collateral and guarantees

By default, the Capital for CVA calculation is based on senior unsecured exposure, but many derivatives transactions to clients are linked to lending transactions. In these cases additional credit protection in the form of physical collateral and guarantees could be available, either on client level or transaction level. As long as these covers are eligible under the Credit Risk Mitigation chapter (Articles 195-204), it makes sense to include these in the calculation of CVA capital for derivatives, also within the Basic CVA framework. The covers can be accounted for by multiplying the regulatory CVA with the ratio between the unsecured LGD and the collateralised LGD, when both are calculated through supervisory approved internal LGD models.

4. Lack of granularity

The crude cut between investment grade and non-investment grade introduces two undesired and unnecessary issues. There is a significant cliff effect once a counterparty deteriorates from investment

grade to non-investment grade, while the incremental risk can be marginal (one credit quality step). On the other hand a significant deterioration but still within the range of investment grade will not lead to additional capital. We believe a more granular scale with regards to the counterparty rating, like the one currently used in the Standardised Approach for CVA Capital, would address these issues.

5. Exposure variability

The framework is using $K = K_{\text{spread}} + K_{\text{EE}}$ whereby K_{EE} is there to capture for exposure variability. Applying a factor 0.5 to compensate for exposure variability seems to be a very crude measure for exposure variability.

6. Alignment exposure measure for Basic Approach with accounting

The basic approach uses EaD divided by alpha and scaled up by effective maturity. The EaD divided by alpha is the Effective Expected Positive Exposure (Effective EPE) as defined in Annex IV of Basel II. The “effective” is introduced as to also capitalise for roll-over trades. However for accounting CVA the Expected Exposure is used which is based on the current portfolio. To align CVA risk with CVA accounting we propose to use the Expected Positive Exposure as defined in Annex IV of Basel II scaled up by effective maturity, where effective maturity is again based on EPE i.o. Effective EPE. The resulting exposure measure (EPE times effective maturity EPE) is then reflective of the exposure used in accounting CVA.

7. Hedging based on CVA and DVA

The use of unilateral CVA has an impact on the hedges, which in many institutions are based on the bilateral CVA that is reported on. This means that DVA is also hedged. However, the split in the hedges cannot be made between a sensitivity part of CVA and of DVA. This would result in undesired effects when looking at the unhedged unilateral CVA position and the hedge sensitivity based on bilateral CVA. Therefore the complete hedge based on the bilateral CVA should be recognised without facing additional capital charges under the Market Risk framework.

8. Proxy hedges

The consultative paper is currently opaque on how proxy hedges have to be accounted for. In the consultative paper it is explicitly mentioned that the use of proxy hedges is eligible. However, for the Standardized and Internal Model Approach, there is nowhere mentioned what kind of proxy hedges are eligible, and how these should be incorporated in the capital calculation.

9. Vega hedges

There seems to be a misalignment between the vega risk weights and the cross-bucket correlations of credit spread between the Standardized Approach of the FRTB-TB and FRTB-CVA. Where most of the parameters between the Standardized Approach of the FRTB-TB and FRTB-CVA are the same, we see that for those two cases different parameters are proposed. For the risk weights of the vega, the FRTB-CVA does not have a cap and uses 55% times the liquidity horizon for all risk assets.

In the FRTB-TB, the risk weights are capped at 100% and for IR and reference credit spread, one has to multiply 0.32% with the liquidity horizon. For the cross-bucket correlations, the FRTB-TB is allowed to use half the values for the HY cross-bucket correlations compared to the correlations of the FRTB-CVA. We have used the parameters as given in the FRTB-CVA, but we would like to have some clarification on this.

Section 2

Q1 A1	<i>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)?</i> Given the supervisor's intention to align Capital for CVA with the accounting CVA, we believe large netting sets, illiquid transactions and disputes should affect the MPOR to the extent that these are reflected in the accounting framework, not as additional prudential constraints. Since these elements are currently not part of the accounting CVA, we believe they should not be part of the regulatory CVA calculation.
Q2 A2	<i>Is Alternative 1 or Alternative 2 preferred with regard to the calculation of MPoR?</i> Consistent with the rationale in Q1, alternative 1 is the preferred approach.
Q3 A3	<i>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)?</i> No answer
Q4 A4	<i>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?</i> There is overlap in market data and trade details but in less extent in pricing models because different systems are often used.
Q5 A5	<i>Is Option A (accounting-based CVA) or Option B (IMM-based CVA) preferred for exposure calculation?</i> Basel should allow for both options. For some banks the Credit Risk systems are more advanced and for other banks the accounting based systems are more advanced.
Q6 A6	<i>Is Option 1 or Option 2 preferred for simulation time horizons?</i> Theoretically we favour option 1. However as it is presented the FRTB liquidity horizons are too conservative.