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EBF response to the Basel Committee on Banking Supervision's consultative document (d488) *Credit Valuation Adjustment risk: targeted final revisions*

A. Comments on the content of the consultative document (d488)

The EBF appreciates the amendments introduced by the BCBS document d488 on targeted revisions of the CVA risk framework. The alignment of relevant parts of the revised CVA risk framework with the minimum capital requirements for market risk (risk weights, index buckets, aggregation formula), is appreciated. Nevertheless, some issues should be considered:

a. Calibration between SA-CVA and BA-CVA

The introduction of the consultative document states "the Committee is [...] considering revising the calibration of the basic approach (BA-CVA) in order to have an appropriate relative calibration between the SA-CVA and the BA-CVA" (MAR50.14). Regulators view on the appropriate ratio between a more advanced SA-CVA and a less sophisticated BA-CVA is left unclarified. In our view, there should remain incentives for banks to develop and use the more risk sensitive approach. However, in its current form the BA-CVA leads to a strong increase in own funds requirements compared to the current Standardised Method which is not commensurate with risks. Therefore, the BA-CVA needs to be calibrated downwards as well.

b. Exemptions from the CVA risk charge under MAR50.5 (1)

The current proposal only excludes derivatives transacted directly with a central counterparty. However, the Committee now proposes also to exempt from the CVA risk framework certain client exposures. In particular it concerns the transactions that arise as a result of the clearing member acting as a financial intermediary (i.e. the clearing member completes an offsetting transaction with a CCP) between the client and the CCP.

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However, this exception seems to exclude such transactions only from the perspective of the client and not from the perspective of the clearing member. EBF strongly recommends to, more clearly if already intended, exempt such trades from both directions for the following reasons:

- Current EU regulation already excludes both directions: The EBA Q&A (2016-3009¹) mentions centrally cleared clients' trades to be exempted from both perspectives, clearing member and client.
- It makes most economic sense as the CVA risk charge is intended to capitalise for possible MtM losses if the credit worthiness of the counterparty deteriorates. However, the price of listed derivatives (CCP cleared derivatives) does not change if one of the clearing member's client's defaults, because the daily settlement prices are determined by the CCP. In an event of client default, the clearing member inherits the client's derivatives portfolio and will have the CCP as counterparty to the trade, without loss to its MtM.

c. Materiality of the CVA risk brought by SFT under MAR50.5 (2)

Institutions will appreciate more information on the CVA risk material threshold leading to an exclusion of some securities financing transactions (SFTs), as explained in the Introduction of the consultative document. As it stands, it seems that it will be left with National Competent Authorities (NCA), which may lead to differing requirements across jurisdictions.

More importantly, for institutions elected to calculate a CVA own funds requirements for its repo-like transactions, we believe that the capital charge should be limited to that of the counterparty credit spread risk (CCS) when using the SA-CVA. Indeed:

- CCS risk constitutes the bulk of the CVA risk while SFTs CVA is small compared to that of derivatives. Hence, other than CCS risk on the SFT perimeter is really of second order magnitude;
- Implementing the full SA-CVA for SFT exposures therefore represent a significant, usually disproportionately high amount of work. Limiting the SA-CVA on SFTs to CCS would greatly reduce the implementation operational burden and costs.

d. Index bucket: Request for clarification in MAR50.63(2)

A qualified index may not to be decomposed into index constituent sensitivities but instead be treated as a single sensitivity to the index assigned to a sector bucket (if over 75% of the index exposures belong to a single sector) or to a specific index bucket [MAR50.50]. This approach is consistent with that of the FRTB. However, MAR50.63 is in apparent contradiction with MAR50.50: Qualified indices may be mapped to the "qualified index bucket" (bucket no.8), presumably, consistently

¹ https://eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2016_3009

with MAR50.50, only when constituents do not predominantly belong (over 75%) to a single sector;

All instruments mapped to a sector bucket shall be decomposed.

For CCS, the treatment of qualified indices with over 75% of the constituents belonging to one sector is unclear when an institution chooses not to look-through. Consistently with MAR50.50, we believe that when an institution chooses not to decompose qualified indices, it should be authorized to do so within the CCS risk class, even when the index constituents predominantly (over 75%) belong to a single sector.

In what follows, we will consider that, the treatment applies to qualified indices within CCS is clarified as consistent with MAR50.50.

Proposal for a better recognition of index hedges:

We believe that the introduction of a new bucket for qualified indices in the counterparty credit spread risk of SA-CVA, with a cross-bucket correlation at 45% does not appropriately reflect how CVA desks manage CVA risks, and we strongly recommend to further address the shortcomings in the calibration of SA-CVA to better reflect CVA management market practices in the treatment of CDS index hedges. Overall, the EBF suggests revising the correlation parameter for bucket 8 as it is too conservative.

We support the possibility to map a sectorial CDS index to the related sector bucket and treat the index sensitivity as a single-name sensitivity in that bucket when more than 75% of the constituents can be mapped to that bucket. In principle, this proposal goes into the right direction. Yet, CDS index hedges are fundamentally not applied at a sector level but at portfolio level to hedge the systematic credit spread risk of the CVA book: the larger and diversified the portfolio, the more efficient the systematic hedge as the idiosyncratic risks of individual names have largely diversified away at the global CVA book level. After many years of observation since the development of CVA risk and its associated hedges, it can be observed that index CDS hedges that cover the systematic credit spread risk are very efficient to mitigate the P&L volatility of a large diversified CVA book. The supporting intuition is that on the days when credit market move – and even more so when they widen – the instantaneous correlation across all names tend to rise, making CDS indices very efficient hedges. It is important to stress that credit spreads in the market are strongly correlated in practice, significantly more than realized default. Therefore, for a large diversified portfolio with thousands of names which is typical for a CVA book, it is quite easy to get the intuition that the systematic credit spread risk largely dominates (it should also be reminded that CVA is not about jump-to-default risk). For that reason, risk management practices include large amounts of hedges with cross-sectorial CDS indices, and a few hedges with sectorial CDS indices.

In that context, the proposed design for cross-sectorial CDS indices which includes an additional bucket with a 45% cross-bucket correlation in the aggregation

formula paragraph MAR50.53, yields results that are in contradiction with observations. A further shortcoming resulting from this proposal that raises concerns is the relief achieved on capital requirements by hedging strategies which is not predictable for practitioners in charge of the CVA risk management.

To illustrate, let's take a very simple example with a 100k€ credit sensitivity on an Investment Grade Corporate name in bucket #3. As the Corporate CDS market in Europe is not much developed, exposures on EU Corporates with non-traded or not sufficiently liquid CDS available are typically hedged with cross sectorial index hedges. Therefore, this example is particularly relevant for EU Corporates.

- When the exposure is unhedged, the capital required is 37.5k€ as the risk weight in bucket #3 is 3%.
- If the exposure is **fully hedged with a Single Name CDS** referencing the Corporate name, the capital required is 3.75k€, therefore, the **hedge efficiency is 90%**.
- Assuming the CVA multiplier defined in paragraph 50.41 is set to 1, and the disallowance factor defined in paragraph MAR50.53 is set to 0, this perfect hedge would lead to a **nil capital requirement** i.e. a 100% hedge efficiency.
- If the exposure is **fully hedged with a Cross Sectorial Index CDS** (such as iTraxx Main) assigned to bucket #8, the capital required is 33.6k€, therefore, the **hedge efficiency is 10%**. Compared to market evidence, this proposal does not yield sufficient hedging recognition.
- It should be highlighted that a CVA desk will not fully hedge the credit sensitivity of the exposure in practice. It will more likely hedge 70-80% of the credit sensitivity, therefore, the hedge efficiency would be even lower.
- Assuming the CVA multiplier is set to 1, this hedging strategy would lead to a 26.9k€ capital requirement.
- To further neutralize the capital impact, a CVA desk may consider buying twice the size of the exposure in the cross sectorial CDS index as the risk weight in bucket #3 for IG names is 3%, and the risk weight in bucket #8 for IG credit indices is 1.5%. It would result in a 200k€ sensitivity for the index. However, the capital requirement would instead increase to 39.5k€. Nevertheless, this strategy would not be appropriate as it would not only lead to higher costs but also to additional capital requirements for market risk as the position would be over-hedged in credit sensitivities.

To achieve an appropriate level of systematic index hedge recognition of 70% for large diversified portfolios as per market evidence, we would recommend considering an alternative option: extend the proposal on sectorial index to cross sectorial index, whereby a cross sectorial CDS index could be mapped to the related sector bucket of the exposure. The Kb formula should then include an additional term for cross sectorial index hedge with a higher disallowance factor of 0.09. Under this proposal, the capital required would be 11.2k€.

Should the Committee choose to maintain the proposal based on an additional index bucket, a very high cross bucket correlation would be needed to achieve an acceptable hedge efficiency. To illustrate, a 90% correlation would lead to a capital requirement of 22k€ i.e. a 40% hedge efficiency. Assuming the CVA multiplier is set to 1, the capital required would be reduced to 17.8k€ (still above the 11.2k€ needed to achieve a suitable hedge efficiency).

e. Multiplier m_{CVA} under MAR50.41

The m_{CVA} multiplier should be set at 1 since:

- the industry believes that level of model risk in the calculation of CVA sensitivities is not higher than in calculation of sensitivities of market value of trading book instruments
- SA-CVA conservativeness is already achieved through:
 - The removal of an internal model approach: standardised approaches are by nature more conservative;
 - The conservative calibration of risk weights [MAR50.56-MAR50.77];
 - A hedging disallowance, 'R' [MAR50.35].
- The Basel estimates have shown that CVA risk is subject to a significant uplift in capital requirement. Even under the foreseen alignment with the final FRTB text and a multiplier set to one, are own funds requirements significantly increased.

B. Additional topics that should be addressed in the final version of the CVA risk framework

a. Deviation between the regulatory CVA and the accounting CVA

The EBF believes that capitalizing a hypothetical regulatory CVA distinct from the true accounting CVA distorts the essential link between economic risk and capital requirement. We think that the prudent valuation is a more suitable framework to impose high quality standards on accounting CVA than the CVA risk charge. In that respect, we note that CVA remains the only market risk in the Basel framework where the accounting measure is not used as an input for the capital requirement calculation.

The main sources of divergence between accounting CVA and regulatory CVA can be classified in 2 categories:

i. Parameters

1. Loss Given Default (LGD)

The EBF acknowledges that there is a broad-based adoption of market-implied parameters in accounting CVA including PDs, recovery rates and diffusion parameters. The Basel Committee logically imposes a regulatory CVA based on market-implied parameters. We note that some flexibility is granted to use different LGDs in specific cases where "the bank can demonstrate that the seniority of the derivative exposure differs from the seniority of senior unsecured bonds" (BCBS d424)².

We advocate that banks should be able to use different LGDs for certain types of exposures, e.g. because they are secured (such as covered bonds, funds or project finance vehicles) or because their nature does not permit the reliance on the credit

² <https://www.bis.org/bcbs/publ/d424.htm>

market (see for instance the uncertainty around political intervention in the context of sovereign exposures), subject to being able to demonstrate that the use of such parameters are properly governed and validated within the credit institution.

2. Margin Period of Risks (MPoR)

The final Basel standard imposes a regulatory CVA based on “9+N business days” margin period of risk (MPoR) where N is the remargining period (except for SFTs and centrally cleared clients’ trades [MAR 50.5]). The prescribed MPoR is overly conservative, not commensurate with the risk truly incurred and not consistent with accounting CVA practices. Different banks may use different MPoR assumptions. However, the vast majority are using 5 or fewer business days. Hence, while in principle true P&L variability should be capitalised, i.e. the accounting CVA variability, as a second-best option we advocate that the prescribed supervisory MPoR is set to no more than 5 business days for derivative transactions.

3. Wrong way risk

Wrong way risk is required to be reflected in the CVA calculation for prudential purposes, irrespective of whether the accounting CVA reflects it or not. Consideration of wrong way risk should be required only if it is reflected in the accounting measure.

b. Proxy hedges with Sovereign CDS

In some specific cases, proxy hedges are strongly penalized. This is typically the case for:

- Financial institutions strongly tied to their sovereign;
- Emerging country corporates strongly linked to their sovereign.

When duly justified to supervisors, the recognition of proxy single name hedges should be allowed where the CDS reference name and the counterparty are not in the same bucket while they however share the same underlying economic risk.

To illustrate, let’s take a very simple example with a 100k€ credit sensitivity on an investment grade financial institution backed by a Sovereign in bucket #2 (for example Group *Caisse des Dépôts* “CDC” or Group *Agence Française de Développement* “AFD” in France; Bank of China or China Construction Bank in China).

- When the exposure is unhedged, the capital required is 62.5k€ as the risk weight in bucket #2 is 5%;
- If the exposure is **fully hedged with a Single Name CDS referencing the Sovereign** name backing the financial institution, the capital required is 61.5k€, therefore, the **hedge efficiency is almost nil**;
- Assuming the CVA multiplier is set to 1, this hedging strategy would lead to a 49k€ capital requirement.

To achieve an appropriate level of hedge recognition, we propose that when a financial institution or a corporate is strongly linked to its Sovereign and is hedged with the related Sovereign CDS single name, the hedge could be mapped to the related sector bucket of the exposure and treated as a single name sensitivity in that bucket (a similar treatment is provided in [MAR50.50]).

c. Sensitivity of the CVA framework on financial counterparties exposures

We are concerned by the limited risk sensitivity of the revised CVA framework on financial counterparties. Financial counterparties are captured in a single credit bucket consistently with the FRTB approach. Yet, the financial counterparties in the counterparty credit spread component are very different from the issuers of instruments in the trading book. Financial names in the CVA book usually include several thousand names which are also very diversified (e.g. insurance companies, asset managers, pension funds and mutual funds which are pivotal to the real economy).

A distinction should be made between various types of financial counterparty within the CCS financial bucket (no.2). In the same way as sovereigns and local government are attributed distinct risk weight within bucket 1, we see fit to purpose to distinguish four types of financial counterparties within buckets 2:

- Financial counterparties which should be assigned lower risk weights than the existing bucket 2 risk weights:
 - Prudentially regulated financials (banks, insurance companies, ...);
 - Regulated funds (Pension funds, UCITS, regulated mutual funds, ...);
 - Covered bonds (i.e. counterparties transacting derivatives whose purpose is to hedge the market risk of covered bonds and which are pari passu with corresponding covered bonds debt) where risk weights aligned with the ones for covered bonds bucket in FRTB framework (MAR 21.53) would be more representative of underlying CVA risk.
- Other financial counterparties which would be assigned the existing risk weights applicable to bucket 2 counterparties (respectively 5% and 12% for IG and HY financial counterparties [MAR50.65]).

This distinction should be made as well with regard to the applicable risk weights within the BA-CVA (MAR50.16).

d. Sensitivity of the CVA framework on creditworthiness of counterparties

The EBF is also concerned by the limited risk sensitivity of the revised CVA framework to the creditworthiness of counterparties. The current Basel III standardized CVA approach (finalized in 2011) has a much more granular approach to defining the risk weights for counterparty credit spreads with 7 credit quality steps (AAA, AA, A, BBB, BB, B, CCC) than the CVA revised framework that accounts only for 2 credit quality steps (IG and HY/NR). Such a reduced granularity in credit quality steps results in increasing significantly the risk weights compared to the current standardised approach as well as decreasing the risk sensitivity of the CVA

framework, and is an issue that contributes to the significant uplift in CVA capital requirements, which has a potentially heavy impact on the end-user. Therefore, the EBF proposes to introduce more granularity not only with respect to financial counterparties as advocated for in point c. of this section, but also to introduce more granularity with regard to non-financial counterparties.

e. Exposures to clearing member

We fully support the Basel proposal to exclude exposures to clearing members for centrally cleared transactions when the conditions for a CCR risk weighting at 2% or 4% are fulfilled.

f. Sensitivities definition

The BCBS text is rather prescriptive in the way such sensitivities must be computed (bumping approach). Besides an explicit reference to bumping approach in paragraph MAR50.47, it is indirectly suggested by the sentence *"A bank's relevant supervisor may increase the aggregate capital requirement multiplier if it determines that the bank's CVA model risk warrants it (eg if the level of model risk for the calculation of CVA sensitivities is too high compared to market risk sensitivities...)".* As opposed to market risk, bumping approach within CVA context is deemed as unpractical due to the huge number of scenarios and time horizons. It is crucial that some flexibility be granted to banks to adopt any other approach (e.g. the Likelihood Ratio Method or the Adjoint Algorithmic Differentiation) they are currently using to manage CVA risk.

g. Vega risk factors

The BCBS text states that *"The sensitivities to the FX volatilities are measured by simultaneously shifting all volatilities for a given exchange rate between the bank's reporting currency and another currency by 1% relative to their current values and dividing the resulting change in the aggregate CVA (or the value of CVA hedges) by 0.01. For transactions that reference an exchange rate between a pair of non-reporting currencies, the volatilities of the FX spot rates between the bank's reporting currency and each of the referenced non-reporting currencies must be measured."*

We deem this definition of vega risk factors not in line with market standard and with other reforms (e.g. FRTB SBA or SIMM). Vega risk factors should be the volatilities of all exchange rates, no decomposition with respect to the domestic currency is required.

h. Exemption of intra-group transactions from CVA risk

In relation to intra-group transactions which are exempted under CRR, it is important to note that the BCBS rules are designed and calibrated to apply at a consolidated level. On a consolidated basis, intragroup transactions are not considered. On a solo basis, exposures between intra-group entities established in the EU or equivalent jurisdictions should continue to be exempted from CVA risk. More generally intra-group exposures between a parent entity and a consolidated sub-entity should be exempted. In addition, intra-group exposures subject to strong collateral agreements should be excluded from the scope of CVA risk on the basis that the identification of default is immediate and the resulting market risk can be re-hedged simultaneously with the default

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