

Comments

Review of the Credit Valuation Adjustment Risk Framework (BCBS 325)

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Berlin, 15-10-01

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On 1 July 2015, the Basel Committee on Banking Supervision published the consultative document "Review of the Credit Valuation Adjustment Risk Framework" (BCBS 325). We gladly take the opportunity to deliver our opinion.

I. General comments

We welcome the review of the Credit Valuation Adjustment Risk Framework. In this context it seems to be reasonable that the focus is on changes of exposures on the basis of daily market risk factor changes.

However, we believe that in several aspects the review does not live up to its objectives set out in the beginning.

The objectives of the review are to

- (i) ensure that all important drivers of credit valuation adjustment (CVA) risk and CVA hedges are covered in the Basel regulatory capital standard;
- (ii) align the capital standard with the fair value measurement of CVA employed under various accounting regimes; and
- (iii) ensure consistency with the proposed revisions to the market risk framework under the Basel Committee's Fundamental review of the trading book.

DVA, which is the single most important hedge for any CVA book, is treated in a manner that violates objectives (i) and (ii). We do indeed accept that DVA based on a bank's own credit spread must not be covered in the framework, since it would encompass a too high degree of idiosyncratic risk and would not be prudent. Therefore "prudential filters" could ensure that accounting DVA would not flow into capital calculations as is currently provided for e.g. in the European CRR¹. However, whereas valuing DVA using own credit spread in pricing makes sense for reasons of symmetry and while we acknowledge that under current IFRS the use of own credit spread is prescribed, we would like to encourage an alternative approach for the allowance of DVA in the CVA Risk Framework. Consider, for example, an exit from a derivative trade via a novation in the interbank market in a way that a third bank would assume the position vis-à-vis the counterparty. The exit value would then be calculated using the credit spread of a potential interbank novation partner. If DVA then did not encompass an element of own (idiosyncratic) credit spread, but instead represented interbank (systemic) market risk, neither the "prudential filter" for DVA should apply nor should DVA be excluded from the CVA Risk calculation. We feel that the regulation would profit from adopting a more accommodating approach in this regard.

Specifying that all transactions should be in scope "regardless of the accounting treatment" is not consistent to conditioning the treatment of securities financing transactions (SFT) on being "fair-valued by a bank for accounting purposes". Neither is it consistent to objective (ii) when looking at the treatment of derivatives for example under German National GAAP (HGB) where derivatives in the banking book are not valued at fair-value and hence do not contribute to any CVA profit and loss variability. Indeed, they could never contribute to any accounting loss (or accounting profit). Therefore, in our view, the "scope of application" needs to be much more differentiated.

In the Basic Approach as well as in the Standard Approach the risk weights are defined by sector and risk category (investment grade and non-investment grade). A rating based approach, as currently defined in

¹ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

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the CVA Risk Charge is not proposed. We believe that a rating based approach is not only sensible, but also crucial to enable a risk adjusted calculation in the CVA Risk Framework that shows the specific risks of banks' OTC-Derivative Portfolios. Following the definition of the consultation paper, for example, Spain and Germany will receive the same risk weight (2.5% in the Standard approach and 8.8% in the Basic approach), as both countries have an Investment Grade Rating. However, the volatility of the Spanish sovereign risk is significantly higher than the volatility of the German sovereign risk. We therefore propose a rating based risk weight by sector that reflects the different volatility of the respective rating classes.

The calculation set out in the Basic Approach requires the usage of the EAD and of the effective maturity calculated according to Annex IV of the Basel framework. The EAD is defined as the sum of the mark-to-market plus an "add-on" for potential future exposure. The effective maturity is defined as "notional weighted average of the maturities in the netting set". As most of the CVA risk generally stems from non-collateralized long dated interest rate derivatives (e.g. Swaps), the natural exposure development should be taken into account (i.e. the exposure builds up in the beginning of the trade's life time and declines towards the end). We believe that the average EAD of the netting set reflects the exposure much better than a constant EAD.

We believe that the exemptions that are defined in the current CVA Risk Charge were sensible at the time of issuance and remain sensible. As the economic situation in Europe has not changed significantly, the removal of all exemptions seems radical and early.

For transactions covered by a Credit Support Annex (CSA), the margin requirements for uncleared derivatives will increase over the next years, so that large CSA exposures won't exist or rather these portfolios will only have a very small CVA. However, the full calculation of the CVA and all the CVA sensitivities of these portfolios is very complex. We believe that in these cases it is necessary to propose easier approaches or materiality thresholds because the costs of resources are disproportionate to the calculated capital charge.

The current proposals would place clearly higher capital requirements for CVA-Risks. For example the current CVA-Framework assigns a risk weight of 0.7 % (with a rating of AAA). According to the proposals made in the consultation paper the risk weight would increase to 2.5 % in case of a similar rating, i.e. by a factor of 3.5. This extremely conservative calibration should be validated by the current impact study.