



Via Electronic Submission

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

Re: Revisions to the Credit Valuation Adjustment Risk Framework

Ladies and Gentlemen:

The Goldman Sachs Group, Inc. ("Goldman Sachs" or "we") appreciates the opportunity to comment on the consultative document from the Basel Committee on Banking Supervision ("Basel Committee") on revisions to the credit valuation adjustment ("CVA") framework.¹

Goldman Sachs is a leading global market-maker in securities and derivatives, and provider of other banking and markets services to institutional, governmental and retail clients. In our capacity as a derivatives market-maker, our clients and other market participants count on us to provide liquidity in derivative markets. We also provide financing through securities financing transactions ("SFTs"), including repurchase agreements ("repos"), reverse repos, securities borrowing transactions and securities lending transactions. We couple these capabilities with our deep expertise, knowledge and global footprint to serve our clients. Through our derivative activities, we help companies globally in a wide range of industries manage their exposures to changes in interest rates, foreign exchange rates, commodities prices, credit prices and equity prices. We also help pension funds and mutual funds, whose clients include individuals saving for their retirement, manage their exposures to those and other risks.

We support the Basel Committee's efforts in the consultative document to improve the overall risk sensitivity of the revised CVA framework for derivatives and SFTs. The changes, many of which are designed to align the revised CVA framework with the Fundamental Review of the Trading Book ("FRTB"), are important improvements, especially those relating to hedge recognition, which we understand to be one of the Basel Committee's goals. We also strongly support the Basel Committee's proposal to reduce or remove the 1.25x CVA multiplier (" m_{CVA} "). We believe, however, that the proposed changes should be expanded to better align the revised CVA framework with risk assessments, accounting standards and the broader regulatory capital rules.

We have participated in industry letters, including the comment letters from the International Swaps and Derivatives Association ("ISDA") and Securities Industry and Financial Markets Association ("SIFMA"), and support the views expressed therein. In this letter, we would like to

¹ Basel Committee, *Consultative document, Credit Valuation Adjustment Risk: Targeted Final Revisions* (Nov. 2019), available at <https://www.bis.org/bcbs/publ/d488.pdf>.

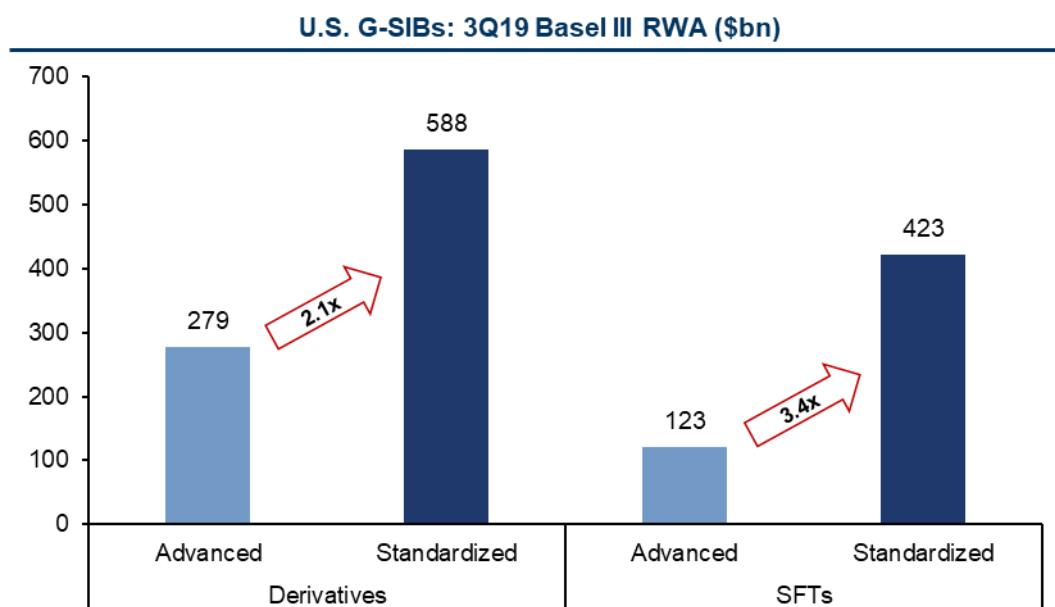
emphasize three key issues covered in those letters which we believe would significantly improve the CVA framework.

Addressing these changes is particularly important to help reduce the likelihood of increased costs on end-users. As discussed further below, many end-users use derivative transactions to manage their business risks. Without further changes, the CVA capital framework may impact market liquidity and increase the costs of accessing these transactions. This may place undue burdens on end-users, particularly small- and medium-sized companies, mutual funds, and pension funds. To avoid such impacts, certain jurisdictions have already exempted these counterparties from CVA capital requirements, thus resulting in a fragmented global implementation. We believe our recommendations will help to mitigate the increased costs to end-users and improve the consistency of implementation of these standards globally. More broadly, we believe that these modifications would preserve safety and soundness and reduce systemic risk without introducing further constraints on market liquidity.

I. Remove the 1.25x mCVA multiplier

We support the Basel Committee's proposal to reduce or remove the 1.25x m_{CVA} multiplier and recommend removal. The Basel Committee notes that the multiplier is intended to address model risk within the standardized CVA framework. There is, however, already sufficient embedded conservatism within the framework, which obviates the need for a multiplier. Conservative elements of the framework include:

- **Removal of models:** Compared to the original Basel III CVA framework and the revised framework first proposed in 2015, the use of models has been significantly constrained. As shown in the chart below, Standardized frameworks throughout the Basel framework are less risk sensitive, typically resulting in significantly higher capital requirements than Advanced frameworks.²



² Source: Y-9C disclosures for the eight U.S. G-SIBs: Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street and Wells Fargo.

- **Calibration of MPoR:** The CVA framework has a 10 business day supervisory floor for the margin period of risk (“MPoR”). This MPoR calibration is more conservative than the industry’s current accounting practices; banks typically use a minimum MPoR of between zero and five days.
- **Calibration of risk weights and correlations:** Throughout the CVA framework, there are conservative risk weights and assumptions on correlations, as well as restrictions on recognizing benefits of diversification within a population of exposures.

Therefore, even without the $1.25 \times m_{CVA}$ multiplier, meaningful levels of conservatism would remain in the CVA framework.

II. Introduce more granular risk weights for financial counterparties

Balancing risk sensitivity, simplicity and standardization has always been a central aspect of the Basel capital framework. We are concerned that, without modification, the revised CVA framework would over-emphasize simplicity, most notably in the risk weight bucketing in the SA-CVA framework. Specifically, because only one category exists for financial counterparties in counterparty credit spread (“CCS”) risk,³ a vast and diverse set of counterparties is grouped together into one bucket. This includes prudentially regulated institutions such as commercial and certain investment banks; institutions with more narrowly defined missions such as pension funds and mutual funds, many of which are also regulated and have limits on leverage; unregulated institutions with no mandated limits on leverage such as hedge funds and private equity firms; and government-backed financials.⁴ Below are the risk weights applicable across this broad set of counterparties in the revised CVA framework:

Bucket	2: Financials
Investment Grade	5.00%
High Yield and Not Rated	12.00%

Differentiating among these multiple categories of financial institutions would more appropriately reflect the underlying risk characteristics of different types of financial institutions. Moreover, having multiple categories would also be consistent with other parts of the capital framework that distinguish the different types of financial counterparties. For example:

- The Basel III Standardized approach for credit risk⁵ and the Basel III Revisions apply lower risk weights to banks and prudentially regulated securities firms than other financials, which are treated as corporates;

³ CCS risk is the fundamental basis of the CVA framework, and is meant to capture the mark to market bilateral credit risk in derivative transactions.

⁴ In general, and as discussed below, we believe government-backed financials should be treated as sovereigns for all purposes in the revised CVA framework. Our suggestions in this section assume that they continue to be treated as financials, as proposed in the Consultative Document.

⁵ Basel Committee, *Basel III: A global regulatory framework for more resilient banks and banking systems* (Jun. 2011), available at <https://www.bis.org/publ/bcbs189.pdf>.

- The Basel III internal ratings-based approach (“IRB”) and the Basel III Revisions IRB similarly distinguish banks and prudentially regulated securities firms from other financials, which are treated as corporates; and
- Under Basel III and the Basel III Revisions, the minimum SFT haircuts do not apply to financials that qualify as “core market participants,” including, among others, banks, prudentially regulated securities firms, and other financial companies eligible for a 20% risk weight under the standardized approach for credit risk.

In our view, differentiating risk weights for financials, consistent with the aspects of the capital framework referred to above, would improve coherence within the overall capital framework without introducing undue complexity or impairing standardization. Furthermore, because the CCS bucket is specific to CVA, this change would not result in an inconsistency with FRTB.

We recommend the Basel Committee create three risk weight categories for financials as summarized in the table below:⁶

Bucket	2a: Regulated financial institutions	2b: Pension funds and mutual funds	2c: Other financial institutions
Investment Grade	3.00%	2.50%	5.00%
High Yield and Not Rated	8.50%	6.00%	12.00%

III. Improve hedge recognition

One of the Basel Committee’s primary objectives in proposing to revise the CVA framework in 2015 was to better recognize CVA hedges. While the proposed revisions are a step forward in this area, we remain concerned that the revised CVA framework still lacks sufficient hedge recognition, most notably for index proxy hedges and single name proxy hedges across buckets. For example, there are situations in which the CVA framework may recognize as little as 9% of the hedge as a valid risk mitigant,⁷ as compared to nearly full recognition from an accounting CVA and risk perspective. This result could affect banks’ decision-making and activity, particularly because banks typically hedge their holdings and exposures on either a portfolio or risk-specific basis, as opposed to an instrument-by-instrument basis. This could also result in reduced liquidity or higher prices for market participants to enter into derivatives with banks, and perversely increase systemic risk.

Revising the CVA framework to further improve hedge recognition would align regulatory CVA with accounting CVA and risk management. More importantly, it would also align the CVA

⁶ These risk weights are derived by way of comparison to other counterparty buckets in the revised CVA framework: 2a is calibrated to the most punitive of all corporate counterparty buckets, 2b is calibrated to 50% of the current financials bucket, and 2c is calibrated to the current financials bucket.

⁷ For example, consider a bank with \$2,000 of CVA exposure to a pension fund. Due to insufficient availability of single-name credit hedges, in order to mitigate CCS risk, the bank would enter into a proxy CDS index hedge of \$2,000. The pension fund is in the financials bucket and therefore receives a 5% risk weight, resulting in a standalone SA-CVA capital requirement of \$100. The index is in the index bucket and therefore receives only a 1.5% risk weight. After adjusting for cross-bucket correlation of 45% and aggregating the capital across buckets, the hedged portfolio capital requirement is approximately \$91. That is, the proxy index hedge has only reduced SA-CVA capital requirements by 9% (i.e., 9 cents on the dollar).

framework with elements of the broader Basel capital framework, including the market risk and threshold deductions for holdings in financial institutions frameworks, both of which recognize hedges as risk-mitigating tools and provide appropriate incentives for banks to employ risk-reducing hedges.

In our view, the following recommendations would significantly improve hedge recognition in the revised CVA framework:

1. Treat government-backed financials as sovereign exposures

As mentioned above (see footnote 4), we believe that government-backed financials should be considered sovereign institutions for all purposes in the revised CVA framework. This change, which would make the treatment of government-backed financials consistent with the treatment for government-backed non-financials, is important for a number of reasons, but is particularly necessary in order to improve hedge recognition. Banks often hedge exposures to government-backed financial counterparties with sovereign CDS as a prudent risk-management practice. This practice promotes safety and soundness because CVA risk to government-backed financials is closely correlated with changes in sovereign credit spreads. The revised CVA framework does not appropriately reflect this standard risk-reducing practice, primarily due to low cross-bucket correlations and high risk weights for government-backed financials compared to sovereigns. Aligning the risk weights and bucket classification for government-backed financials with sovereigns would be more consistent with the underlying risk for these counterparties, and would significantly improve recognition of risk-prudent hedges between the two counterparty types, providing further incentives for banks to enter into prudent risk-mitigating hedges.

2. Map counterparties with explicit guarantees to the same bucket as their guarantor

Similarly, the classification of entities should take into consideration whether a guarantee exists and transfers the risk to the guarantee provider. For example, if a government-backed financial is explicitly guaranteed by its sovereign, we believe that it should not only be included in the sovereign bucket, but it should also receive the same risk weights and correlation as its guarantor, reflecting the presence of the guarantee. In addition to improving risk sensitivity, allowing banks to map exposures to the guarantor would also improve consistency with the broader capital framework where guarantees are recognized, including FRTB, Standardized credit risk and the Large Exposures framework.⁸

3. Improve index hedge recognition

We support further aligning the CVA framework with the revised market risk framework finalized in January 2019, including by introducing index buckets and revising the aggregation formula in the CVA framework. In addition, the Basel Committee should make further changes to improve the capital relief from index hedges. One way this could be achieved is by increasing the cross-bucket correlation between indices and other sectors for the index CCS risk bucket from 45% to 70%. A higher cross-bucket correlation would more accurately recognize the risk-mitigating benefits of index hedges and appropriately provide further incentives for banks to use index hedges to manage their CVA risk.⁹

⁸ Basel Committee, *Large Exposures* (Dec. 2019), available at https://www.bis.org/basel_framework/standard/LEX.htm?type=all.

⁹ Basis risk between single names and proxy hedges is actively risk managed by banks and also reflected in the correlation factors applied to index hedges within the revised CVA framework.

We think this recommendation would be most impactful for hedging risks associated with small- and medium-sized companies, where banks use proxy hedges because direct, single-name hedges are not available. As a result of this practice, there is not enough market data available to observe correlations for these entities. Using financials as a proxy, we show in the table below that CDS spreads for U.S. and E.U. G-SIBs have exhibited high degrees of correlation with various indices through the cycle. We would expect this effect to be even greater during stress periods, when market movements broadly become more correlated, and we would expect the result to be similar for other entities as well.

	Correlation: CVA Capital	Average Correlation: 2004-2020
E.U. G-SIBs vs. iTraxx	45%	75%
U.S. G-SIBs vs. CDX IG 5y	45%	63%
E.U. G-SIBs vs. iTraxx FinSen	45%	86%

IV. Conclusion

We appreciate the Basel Committee's efforts in re-opening the revised CVA framework and your consideration of our comments on the consultative document. As with all areas of the capital framework, the CVA framework could have material adverse consequences if improperly calibrated.

While the consultative document notes that CVA “constitutes less than 2% of banks’ overall capital requirements on average...” and therefore “any increase in CVA capital requirements is unlikely to result in a significant change in banks’ overall capital requirements on average,”¹⁰ this proportion is small largely due to the exemption for end-users in Europe. Furthermore, the capital requirements for CVA account for a significant portion of banks’ RWA attributable to capital markets activities.¹¹ Therefore, while changes to the CVA framework may have a modest effect on overall capital requirements, they will have a material impact on capital attributed to capital markets activities. These changes will affect economic costs, potentially reduce market liquidity and increase costs to end-users. We believe our recommendations would help mitigate these adverse effects.

If not recalibrated, other Basel III Revisions, including those to Standardized credit risk,¹² the Standardized Approach to Counterparty Credit Risk (“SA-CCR”)¹³ and FRTB,¹⁴ will also result in

¹⁰ Basel Committee, *Consultative document, Credit Valuation Adjustment Risk: Targeted Final Revisions* (Nov. 2019), available at <https://www.bis.org/bcbs/publ/d488.pdf>.

¹¹ CVA is consistent with the amount of capital held for other critical credit RWA components. For example, SFTs and securitizations both comprise approximately 2% of Advanced RWA for Global G-SIBs, while derivatives counterparty credit risk and equity both comprise less than 4% (Includes all global G-SIBs for which the required data is publicly available: Bank of America, Bank of New York Mellon, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, Groupe BPCE, Groupe Credit Agricole, ING Bank, JPMorgan Chase, Morgan Stanley, Santander, Societe Generale, Standard Chartered, State Street, UBS, UniCredit, Wells Fargo).

¹² Basel Committee, *Basel III: Finalizing post-crisis reforms* (Dec. 2017), available at <https://www.bis.org/bcbs/publ/d424.pdf>.

¹³ Basel Committee, *Standardised approach to counterparty credit risk* (Dec. 2019), available at https://www.bis.org/basel_framework/chapter/CRE/52.htm?inforce=20220101.

¹⁴ Basel Committee, *Minimum capital requirements for market risk* (Jan. 2019), available at <https://www.bis.org/bcbs/publ/d457.pdf>.

outsized adverse impacts to capital markets, which in many jurisdictions are exacerbated by stress testing regimes. For example:

- Overly conservative multipliers increase capital requirements without improving risk sensitivity (e.g., the alpha multiplier in SA-CCR)
- Significantly reduced hedging, diversification and risk mitigation recognition create mismatches between economic risk and capital requirements (e.g., the rho parameters in FRTB and the overly broad scope of the SFT minimum haircuts framework)
- Duplication across frameworks reduces regulatory coherence and disproportionately affects capital markets activities (e.g., derivatives exposures are capitalized several times through the revised CVA framework, SA-CCR, FRTB, the Global Systemically Important Bank ("G-SIB") surcharge and stress testing regimes)

If the cumulative effects of bank capital requirements are not properly considered and addressed, the combination of these varying frameworks and regimes could impede the most active market makers from providing cost-effective services to the capital markets.

Banks' allocation of capital to their businesses plays an important role in allowing capital markets to drive growth in the global economy. Improperly calibrated capital requirements could raise costs for banks to enter into derivatives transactions, and could cause banks to reduce or exit certain business lines altogether. The availability of derivatives transactions is important because derivatives are used by end-users to hedge external risks. For example, 26 out of the 28 non-banking companies in the Dow Jones Industrial Average ("DJIA") use derivatives to hedge foreign exchange rate risk and interest rate risk, including all consumer discretionary, technology and industrial firms in the Dow Jones Index.¹⁵ If it becomes more difficult for these and other companies to hedge their business risks in a cost-effective manner, costs for their customers may increase as well. We believe small- and medium-sized companies may be most adversely impacted because insufficient liquidity in single-name instruments referencing these companies limits banks' abilities to directly hedge their risks. Our recommendations would specifically mitigate adverse effects of improperly calibrated CVA capital requirements on these companies, as well as on pension funds and mutual funds.

We therefore believe it is critical that further changes to the revised CVA framework are considered. We thank you for your consideration, and would be pleased to discuss our comments and recommendations with you in more detail and to provide additional information that may be helpful.

Sincerely,



Sheara Fredman
Chief Accounting Officer

¹⁵ Financial Services Forum, Large Banks, Derivatives and the Economy (Jun. 2019), available at <https://www.fsforum.com/types/press/blog/large-banks-derivatives-economy/>. Underlying data sourced from firm-specific 10-K reports, available at <https://www.sec.gov/edgar/searchedgar/companysearch.html>.