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By email: baselcommittee@bis.org

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Sirs

Review of the Credit Valuation Adjustment (CVA) risk framework – Consultative Document

We refer to the BCBS Consultative Document on the review of the Credit Valuation Adjustment (“CVA”) risk framework. After consulting members of the Hong Kong Association of Banks (HKAB), we set out below the key concerns on the Consultative Document and our response to the specific questions raised in Annex 1 of the Consultative Document (See Appendix 1).

We support the Committee’s decision to increase the risk sensitivity of the CVA framework by strengthening the link between the capital calculation and the economic dynamic CVA risk. A key component of the increased risk sensitivity of the framework is represented by the alignment of the framework to industry risk management and hedging practices through increased scope of eligible hedges. Although the dynamics of CVA risk are complex, we believe that the revised framework strikes an appropriate balance on simplicity, risk sensitivity and comparability without the need for the introduction of capital floors.

Notwithstanding the many welcome developments, we would like to emphasize and elevate within this response a number of issues that go beyond the remit of this Consultative Document, but are important and should be addressed appropriately prior to

the finalization of the framework, especially, the framework should take into account structural measures relating to clearing and potential adverse impact on non-financial users.

Internal Model approach in CVA and in the Basel framework

The Consultative Document indicates that the BCBS is considering the removal of the modelled approach from the final framework. We strongly urge the BCBS to reconsider the role that internal models play in improving risk management standards across the industry. The incentives to monitor, manage and model risks in a proactive fashion should not only be retained by the final CVA framework but also by other Basel policies close to finalization.

Treatment of Corporate exposures in the CVA framework

We encourage the BCBS to give due consideration to the structure of Asian corporates in the development of the final CVA framework. While the introduction of margining requirements and the advent of central clearing will reduce the scope of a CVA capital charge, we recommend BCBS to attend to the relatively modest contribution to systemic risk by small Asian corporates. In the absence of a CVA exemption, these corporates will find it more expensive to hedge their risk exposures or may look for potentially less-expensive alternative hedging with the non-regulated sector.

Specific concerns on Internal Model Approach IMA-CVA modelling

Capital multiplier: We see the inclusion of the *a-priori* 1.5 model-risk multiplier in the capital calculation as unnecessary. Any capital multiplier should only be set on the basis of performance assessment of the CVA capital model and should be applied at the discretion of supervisory authorities.

P&L Attribution and backtesting of Expected Shortfall ES-CVA: P&L attribution is already complex in the context of the Fundamental Review of the Trading Book (FRTB) market risk framework and we believe it would set an unrealistic burden of proof on any modelled approach for the CVA exposure metric. Further, we believe that the modelling constraints and the backtesting requirements set out in the Consultative Document

already provide sufficient safeguards against model risk. We recommend the BCBS to drop the requirement related to the P&L attribution test stated in Paragraph 76 in Annex 1.

Timelines for the finalization of the new CVA framework

We suggest BCBS to consider an extension of the timelines for the finalization of the new CVA framework to allow for appropriate testing, impact analysis and recalibration. We believe that this will not only promote evidence-based policy making but will also reduce the burden of implementation in a time of significant regulatory change.

We hope you find our comments useful. For any questions, please do not hesitate to contact Ms Emily Ngan of the Secretariat at (852) 2526 6080.

Yours faithfully



Henry Chan
Secretary

Enc.

c.c. Ms Karen Kemp, Executive Director (Banking Policy),
Hong Kong Monetary Authority

Appendix 1:

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)?*

Members of the HKAB follow a rigorous set of internal risk management rules and principles for the monitoring, measurement and management of risk exposures. Generally, these internal requirements extend beyond the minimum standards set out in supervisory manuals.

With respect to MPoR, the size of a netting set, the liquidity of transactions and recent disputes feature in holistic risk assessment. However, step-changes to MPoR estimates of a netting set resulting from minor changes to the risk characteristics of one or a handful of transactions can very often lead to a misrepresentation of the true risk of a portfolio.

In some instances (where the trade population is agreed), there can be disagreement over the basis of valuation. Each party could reach the same pricing conclusion as the other, were they to use the other party's basis. While there are a number of remedies (exchanging the larger of the in dispute margin amounts, agreeing to exchange an average, excluding specific transactions and so on), there can be cases where one party deems this a dispute and the other does not. Practical guidance on these matters would be valuable to ensure uniformity. The integration of stay language and margin requirements for non-centrally cleared derivatives will heighten the importance of regulatory clarity in this area.

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

The revised CVA framework specifies two alternative approaches for the supervisory floor applicable to the calculation of MPoR. In our view, a MPoR floor set at 9+N business days (Alternative 1), where N is the re-margining period specified in the margin agreement, would not only ensure simplicity of implementation but would also be coherent with recent BCBS-developed reforms (Working Group on Margining Requirements (WGMR) – “Margin requirements for non-centrally cleared derivatives” as an example). Most importantly such an approach would match the BCBS's stated policy objective to better align capital estimates and the economics of CVA risk.

The Alternative 2 proposal (based on paragraph 41(i)–(iii) of Annex 4 of the Basel framework), as currently drafted, reduces the role of the market risk factors in driving the exposure metric and we would see this as counterproductive in the context of the policy objectives.

Q3. *Should IMM approval be included as an additional eligibility requirement for the FRTB-CVA framework under Option A (i.e. accounting-based CVA method for generating scenarios of discounted exposure)?*

To address the variability of the application of accounting standards relevant to CVA the new framework is suggested to, where possible, leverage the foundation of the IMM. These requirements will not only ensure comparability of capital charges across jurisdictions but will also provide assurance to regulatory authorities in the supervision of the capital models. To achieve this objective, we believe that IMM approval should be a prerequisite to the use of the proposed IMA-CVA approaches, though it might be more robust for approval to be given on the entire approach as the counterparty risk computation is arguably a subset of the CVA computation rather than the other way round.

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?*

For the vast majority of derivative transactions, some large banks employ the same data, processes and similar methodologies for the computation of accounting CVA risk exposures. This provides significant alignment and efficiency between the calculations used for pricing and risk capital purposes. Further this enables us to perform the assessment of the risks associated with derivative transactions more efficiently.

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

In principle, we favour greater alignment between accounting and regulatory CVA. In our view an accounting based IMA-CVA would promote convergence between capital requirements and actual P&L volatility experienced as a result of exposure to CVA risk. Further, as per our response to Q3 above, the computation of accounting-based CVA exposures should be complemented, where possible, by existing IMM requirements.

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

The CVA framework outlines two options for the incorporation of liquidity horizons for credit spreads of within the framework: the first is based on the FRTB liquidity horizons and the second that allows the use of a single 60-day liquidity horizon. We see the single 60-day liquidity horizon for liquid counterparties and the systematic components of credit spreads of illiquid counterparties as a superfluous simplification. To advocate risk sensitivity and holistic consistency of the capital framework, we support the alignment

with the FRTB framework (Option 1), though we believe that more granular liquidity horizons would be beneficial even in the FRTB.

An area of the FRTB-CVA framework that would instead benefit simplification is the bucketing structure of the SA-CVA. This change will reduce the complexity of the framework and better place the SA approach as a middle-ground modelling solution between the Basic and the IMA options.