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Basel Committee on Banking
Supervision

Review of the Credit Valuation Adjustment (CVA) risk framework

Internal models

We would suggest that a framework that provides for and incentivizes the development of a risk-sensitive approach, is more desirable than a more simplistic (less risk-sensitive) framework where risks may not be fully captured and understood, further that this is important from both the perspective of the an individual banks risk management and in terms of how banks report and capitalize their risks.

The use of internal models for capital requirements supports the alignment of regulatory risk capital and what banks view as the real economic risk. We don't think that divergence in regulatory risk measures and the measure of real economic risk is at all desirable. This is also important for the end-users of derivatives given that CVA plays a significant role in the pricing of products and is especially significant for end-users that are not able / required to post collateral, e.g. corporates and sovereigns.

We appreciate that comparability of the internal approaches maybe of concern, however, the requirement to also produce numbers run on the standardized approach should provide a means for comparability and differences in outputs can inform on the development of the models. Further comfort should be provided by the rigorous P&L attribution and back-testing that applies to the internal models. This, one could argue, is the ultimate test of any model and will ensure that banks can only use such models where they can accurately manage the risk.

Materiality thresholds

FRTB CVA framework relies on extensive calculation of sensitivities. Unless risk materiality considerations are taken into account, most of the computation resources would likely be spent on parts of portfolio that generate little or no CVA risk.

We suggest that materiality based exemptions are allowed from the CVA scope for portfolios that due to their characteristics give rise to minimal CVA risk. We suggest the following are considered under this category:

- Portfolios subject to BCBS-IOSCO rules on margin requirements for non-cleared derivatives
- Client cleared listed and OTC derivatives
- SFTs and other forms of collateralised borrowing.

Along with materiality based exceptions we also suggest that simpler approaches could be applied to immaterial portfolios, e.g. through the application of an add-on. Allowing for simpler approaches to be applied to immaterial portfolios, while the FRTB framework is applied to material portfolios, would also help mitigate a scenario whereby a small and immaterial parts of a portfolio would prevent the use of e.g. FRTB models on the larger and material parts of the portfolio.

Overlap between credit risk and CVA risk changes

The capital requirement for credit risk captures two risks according to the internal ratings based (IRB) approach; default risk and migration risk. The migration risk charge is intended to capture any losses from changes in the mark-to-market value due to a potential down-grade of the obligors rating¹. However, the risk of losses from changes in the mark-to-market value due to a potential down-grade of the obligors rating is also covered by the Basel Committee's proposed CVA risk framework. Thus, the migration risk is double counted.

Any measure of CVA risk should avoid counting risks that are already captured elsewhere in the capital framework, or vice versa.

There are (at least) two solutions to the issue; either the migration risk is ignored in the credit risk charge or in the CVA risk charge. Technically, the migration risk charge is ignored by setting the effective maturity to 1 year in the IRB formula or by calibrating the CVA risk weights so that the migration risk is filtered out.

The risk weights proposed by the Basel Committee for the SA-CVA and BA-CVA approaches have been, we assume, calibrated to some observed volatility in credit spreads. Rating down-grades causes normally the credit spread to increase. However, there are a few other causes for the observed changes in the credit spreads, such as changes in the risk premium.

In order to avoid double counting the migration risk it is important that the Basel Committee determines the risk weights for CVA risk based on an adjusted history of credit spreads that ignores spread changes that could be attributed to rating migration. Since such an adjustment is not trivial, we propose that the Basel Committee keeps its proposed risk weights for CVA risk and instead state that the effective maturity in the IRB formula is set to 1 year for instruments that are subject

¹ An Explanatory Note on the Basel II IRB Risk Weight Functions, July 2005.

to a CVA risk charge. Currently this is only a possibility for institutions that use IMM and have an internal model for the specific risk of debt instrument, and can demonstrate that this internal model contains effects of rating migrations (CRR Article 162(2)(i)). We argue that the migration risk in the IRB formula should be ignored regardless of whether the CVA risk is determined with the IMA-CVA, SA-CVA or BA-CVA approach.

Finally, we would like to stress that the impact of this overlap is significant. According to EBA's data collection exercise it could range from 5-40% of the default risk.

Basic Approach

The new framework is overly penalizing with the proposed calibration. It is likely that the RWAs will be more than double that of the current S-CVA. In our view these levels dramatically overstate the actual risk. Looking forward, given the estimated size of the capital requirement on the BA vs. other approaches (i.e. several fold larger) then it is not really a credible alternative approach.

We suggest the following changes could be made:

- A more granular bucketing of counterparties and corresponding risk weights, so that the risk weights better reflect the real credit worthiness of counterparties. This additional granularity should reflect the diversity of external/internal ratings and sectors,
- To re-visits the actual risk weights themselves, so that they are not overly conservative,
- To remove the 1 year time horizon and use the same liquidity horizons as in the FRTB-CVA framework,
- We would suggest a maturity cap (e.g. 5 years) be applied to long dated derivatives. Without a cap the CVA capital change on long dated derivatives could be extremely punitive (several fold larger than under the current CEM) and would draw into question the value of such derivatives.

CVA model performance

We agree that capturing NMRF's through the mcva multiplier is a reasonable approach. However, we believe that the size of the multiplier needs to be backed with empirical evidence. In our view it seems somewhat conservative.

We strongly support that the multiplier is determined in a calibration process based on empirical data and expect that the industry actively engages in such a process.

It is our firm opinion that solid back-testing performance is incentivised through the mtb multiplier. However, we do believe that a floor of 3 is too conservative and would potentially create disincentives for many banks from pursuing the IMA approach. Instead we suggest that the dependence to back-test performance is retained, but that the multiplier is kept between 1 and 1.33 (in-line with what is prescribed in FRTB).



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)?

In principle, we would suggest that only illiquid or disputed trades should impact MPOR. If a netting set contains a few illiquid products or if for example there is one disputed trade in a netting set then in our view it is not reasonable to increase the MPOR for the whole netting set (i.e. all trades)

We also would like to mention that a consistent treatment of this issue in IMM CCR and CVA risk is advisable.

Note that penalising the whole netting sets by increasing the MPOR for all trades, if only one or few trades are illiquid, may have adverse economic effect by making such products even less liquid. Banks will be discouraged from trading such products, given the high marginal capital cost. This does not necessarily refer to exotic "speculative" products, but for products that provide valuable economic hedges and where banks act as market makers (e.g. inflation products).

Recommendation: Assign illiquid trades to a specific netting set with increased MPOR, where no netting is allowed between this "hypothetical" netting set and the rest of the trades.

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

Alternative 1 (9+N to be the floor). It is more risk-sensitive, in that it takes into account that the re-margining period (N) could be bigger than 1 day, a feature which can be accurately modelled in exposure calculators.

Q3. 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)?

No, we do not see that this is needed. The systems for accounting-based CVA may be separate from IMM systems and thus IMM approval may have little relevance to the accounting based CVA system. The list of criteria in paragraph 19 seems sufficient, to add any additional required controls that are applied in the accounting CVA.

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?

Synergy exists in terms of the basic data inputs, e.g. same trade set, netting sets/agreements, collateral information, market data. We currently see limited

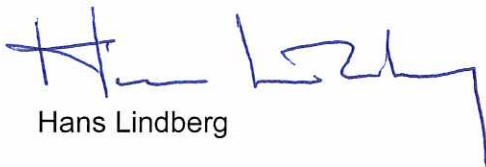


synergy in terms of the process and methodology, due differing requirements in the accounting and IMM CVA.

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

We think that both options can be maintained: accounting with a number of constraints and IMM.

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