Comment on Review of the Credit Valuation Adjustment Risk Framework
issued by the Basel Committee on Banking Supervision

October 1, 2015

Mr. William Coen
Secretary General
Basel Committee on Banking Supervision
Centralbahnplatz 2, Basel
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Dear Mr. Coen,

Following the publication on July 1, 2015 of the Basel Committee on Banking Supervision’s consultative document on Review of the Credit Valuation Adjustment Risk Framework, the undersigned associations would like to draw your attention to some extremely important issues for our members.

General comments
The proposed new framework for CVA risk capital charge is based on a basic assumption that deep and liquid CDS market is available throughout the world and all banks hedge their CVA risk in the market. Hence, the alignment with FRTB framework is highly focused.

However, it is being ignored that such assumption is not appropriate for many commercial banks, especially in Asia, because they hold CCR exposures and CVA risks until the maturity as like in the banking book. In addition, CDS market tends to be immature or illiquid for their main counterparties such as mid-size corporates and SMEs.

After recognizing differences in business models and market environments, it should be noted that an appropriate accounting CVA calculation methodology and an effective approach to manage the CVA risk are different among banks.

For the banks that see risks associated with derivative transactions as like in banking
book, it is appropriate to recognize an accounting CVA by using historical PD derived from internal assessment of the counterparty rating. In such case, P&L risk is less volatile than the case where CVA is calculated based on market-implied PD which is currently assumed in the proposed framework.

Taking into account above points, it is not appropriate to apply the current one-size-fits-all FRTB-oriented CVA risk framework to all banks.

The associations suggest that the BCBS should construct CVA risk capital framework adequately recognizing difference in business models, market environments and accounting practices to appropriately capture the actual economic risk at each bank.

**The Basic Approach**

Through current QIS, the associations have recognized the proposed Basic Approach has fatal flaws and result in excessive capital requirements against underlying economic risks.

In the consultative document “Strengthening the resilience of the banking sector” published by the BCBS in December 2009, it is stated that during the recent market crisis, roughly two-thirds of counterparty credit risk (CCR) losses were due to CVA losses and about one-third were due to actual defaults. From this observation, the ratio between credit risk and CVA risk in RWA should be around 1:2.

However, the associations are aware that the Basic Approach causes significant increase in CVA risk capital charge that makes the ratio much higher than 1:2.

The significant increase in capital charge will result in the increase of allocated cost to corporate customers (i.e. end-users of OTC derivatives) who need transactions to hedge underlying risks associated with their real business.

The number of banks offering the OTC derivatives to meet real demand of corporate customers may be reduced due to punitive capital requirement, which lead to increase the volatility of derivative market and weaken the stability of financial system.

The punitive CVA risk capital charge is caused primary due to the revised risk weight
matrix which is too conservative compared to the current Standardized Approach. There is no economic justification to support the significant increase in the level of the risk weights as current risk weights under the Standardized Approach are already calibrated based on the data during the recent stress period. The risk weight matrix needs to be recalibrated to have the CVA capital charge aligned with underlying economic risk. When calibrating risk weights, an appropriate liquidity horizon should be applied to each bucket rather than applying unique 1 year liquidity horizon since it is not realistic to assume that the shock observed during the recent stress period will last for 1 year.

In addition to the risk weight matrix, the computation formula which simply multiplies the maturity to determine capital charge should be reconsidered. Under SA-CCR, EAD for long-term interest rate derivatives become much higher than the current CEM as there is not cap on the maturity when calculating the add-on.

The doubled effect of proportional treatment of maturity leads to unrealistically conservative risk weighed asset for long-term uncollateralized derivatives such as project finance.

Overall, the Basic Approach has fundamental and material issues.

The associations strongly propose that the Basic Approach should be carefully reviewed. Otherwise, unintended consequence on real economy will be caused.

**The FRTB-CVA**

Eligibility criteria for the FRTB-CVA require CVA calculation using market-implied PD and the CVA desk which manages CVA risk as a usual activity. However, these requirements are not appropriate for banks subject to illiquid CDS market such as Asia. If CVA is calculated based on market-implied PD, the volatility will be too high due to the lack of liquidity of CDS market. In addition, the CVA desk will not effectively work in such market condition.

The requirements should be more flexible to better align with actual CVA risk of each bank employed different business models or in different jurisdiction.
For example, banks calculating accounting CVA by using historical PD to be consistent with their management policy should be allowed to calculate regulatory CVA with historical PD rather than market-implied PD. In this case, the establishment of CVA desk should not be a requirement because hedging CVA with historical PD is not practically effective.

**Finalization of the rule**

As described above, current proposal has fundamental issues that need to be addressed. In particular, the Basic Approach will have material negative impact on real economy if the BCBS make no further revisions.

The associations suggest the BCBS issue a second Consultative Paper and comprehensive assessment of the framework thorough an additional QIS.

**Implementation schedule**

Implementation schedule should be carefully determined considering other regulations such as SA-CCR, FRTB and margin requirement for non-centrally cleared derivatives. Sufficient time is necessary for all banks to meet regulatory requirements with their system infrastructure and operations.

The associations suggest that the implementation of the new CVA risk framework should be after September 2020 when the margin requirement for non-centrally cleared derivatives is planned to be fully implemented.

Yours sincerely,

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