

April 27, 2015

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**Subject: Industry's views on the EBA Policy Recommendations to the European Commission on Credit Valuation Adjustment (CVA) risk in relation to the Basel framework**

Dear Mr. Enria,

The Basel Committee on Banking Supervision ("BCBS") has initiated a review of the prudential requirements on CVA risk and work is currently underway to evaluate the possibility of integrating the CVA capital charges into the revised market risk framework<sup>1</sup>. In light of these developments, we find that EBA's Report on CVA<sup>2</sup> ("the Report") is a timely and welcome contribution to the global CVA debate, and hope that this regulatory effort leads to a globally consistent implementation of an up-to-date and well calibrated international standard. To assist in the achievement of this goal, the undersigned Associations and their members stand ready to engage and constructively contribute on all aspects of the new framework.

The outcome of the BCBS discussions on CVA will have an impact on the derivatives market and, in particular, the end-users of these products. It is against this backdrop that we are taking this opportunity to offer the industry's views on EBA's Policy Recommendation no. 15 of the Report, which sets out the EBA's vision for the amendments to the Basel CVA framework.

In general, the industry is very supportive of the approach taken by the EBA in Policy Recommendation no. 15. We agree that the CVA framework should be re-dimensioned, within market risk, for the regulatory CVA risk charge to better reflect institutions' internal practices. Notwithstanding certain points noted below that require further investigation and careful consideration, it is our view that taking such an approach would lead to a CVA capital framework that benefits from enhanced risk sensitivity and

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<sup>1</sup> BCBS, *Regulatory Consistency Assessment Programme (RCAP): Assessment of Basel III regulations – European Union*, December 2014, [www.bis.org/bcbs/publ/d300.pdf](http://www.bis.org/bcbs/publ/d300.pdf)

<sup>2</sup> EBA, *EBA Report On Credit Valuation Adjustment (CVA) under Article 456(2) of Regulation (EU) No 575/2013 (Capital Requirements Regulation—CRR) and EBA Review On the application of CVA charges to non-financial counterparties established in a third country under Article 382(5) of Regulation (EU) No 575/2013 (Capital Requirements Regulation—CRR)*, February 2015, [www.eba.europa.eu/documents/10180/950548/EBA+Report+on+CVA.pdf](http://www.eba.europa.eu/documents/10180/950548/EBA+Report+on+CVA.pdf)

reduced conflicts of incentives, both of which are concerns in the current rules that industry has previously highlighted.

The Associations would respectfully recommend that the international policymakers take on board the recommendations highlighted herewith. This will help ensure that the revised framework is sufficiently robust, corresponds to risk management market practice and provides the right incentives to manage CVA risk. In a regulatory landscape that is still very much evolving, it is imperative that changes do not impact financial stability or the real economy in a negative manner. While the impacts from changes can only really be calculated once the precise calibration of the new FRTB parameters to be applied to CVA is known, we have provided below some high-level industry suggestions on the more detailed proposals under Policy Recommendation no. 15.

***CVA should be moved to the market risk framework and treated as a fair value adjustment subject to prudent valuation requirements***

Industry strongly supports the intent of this recommendation and is looking forward to engaging with the BCBS in refining the way in which CVA is included into the revised market risk framework, i.e. the Fundamental Review of the Trading Book (FRTB). The FRTB constitutes an overhaul of the current market risk methodology with significant structural changes, new risk measures and concepts that are still being evaluated and tested. The integration of CVA into the market risk framework is welcomed by industry if performed carefully and diligently. This will require a reasonable timeline, decoupled from the tight constraints of the FRTB, and the oversight of CVA calibration specificities.

We recommend that the current dependencies between the IMM counterparty credit risk framework and the CVA framework will need to be reviewed as the latter is transitioned to the market risk framework.

***CVA should constitute a desk as defined in the Fundamental Review of the Trading Book and remain a standalone risk-charge in the market risk framework***

The industry is still contending with the transition to the new market for OTC and Cleared derivatives, and due consideration should be made by providing flexibility to further transition the structure of desks and business models over time. It is worth noting that Basel 3/CRD4/CRR heralded unprecedented changes in the measurement and infrastructure supporting CVA risk. The consequences of such business model shifts are likely to lead to further divergences in approaches unless sufficient time is allowed for these adjustments.

As this transition takes place, the industry would recommend that the CVA framework provides banks the flexibility to develop a fully integrated solution for capturing market and CVA risks that can be used for regulatory purposes, subject to supervisory scrutiny and approval. This would provide the opportunity for benefits and efficiencies in the methodology that can be passed-on to clients and help the real economy.

***CVA advanced and standardised methods should be adjusted to reflect outcome of Fundamental Review of the Trading Book, in particular the sum of the VaR and the stressed VaR should be removed***

Industry is fully supportive of removing the sum of the VaR and stressed VaR which we believe double counts the risk and is a source of unnecessary conservatism.

Applying certain FRTB concepts to the CVA framework, such as the expected shortfall measure, is arguably desirable to maintain consistency in the capital framework. At this stage it is not clear that all FRTB proposals are appropriate in the context of a CVA capital measure (for example the use of FRTB liquidity horizons), and there would be practical challenges to implementing the FRTB concepts in a revised CVA framework if those were applied without consideration to the idiosyncrasies of CVA. We also note that a number of critical decisions which could have a material effect on the CVA framework are still to be finalized including the Trading Book/Banking Book boundary and the Non-Modellable Risk Factors (NMRFs).

Therefore, the industry would encourage the BCBS to conduct a series of industry meetings and quantitative impact studies (QISs) on the impact and implications of proposed methodology changes. This is particularly important given the different regulatory regimes that have been implemented across the globe to address the shortcomings of the current CVA framework. Careful impact analysis is also required for the standardized CVA approach - given its current over-conservatism, as indicated by the EBA data collection exercise (section 5.2.1 of the EBA CVA Report), and the increasing significance of such approaches within the capital framework.

***Market risk hedges of CVA (interest rate, FX hedges...) should be recognised as eligible hedges***

This recommendation is fundamental from a risk management perspective and the industry is strongly supportive. We would only draw your attention on the need to provide sufficient time to test and implement the changes, since these are not trivial.

***Subject to definition of specific conditions (e.g. capture of basis risk), proxy hedging should be allowed***

Industry is supportive of this recommendation. We would strongly recommend early engagement with the industry on the criteria for permitting incorporation of such hedges, which should be guided by a better understanding of the differences in market structures across jurisdictions. For example, due to its market structure and the lack of liquidity in the CDS Market, the CVA framework might allow the use of reasonable proxies as well as the use of implied Probabilities of Default (PDs) from available bonds for capturing all available market information. The recognition of proxy hedges is paramount for banks so that they can make risk reducing derivative products available at a reasonable cost.

***Subject to conditions, advanced institutions should be allowed to use their internal CVA pricing models (without reference to the regulatory formula) for the purposes of computing the own funds requirement for CVA risks***

The industry supports a greater alignment of the regulatory capital requirements with the internal risk management practices. As discussed previously, we believe that the BCBS needs to carefully consider the

technical feasibility of the proposed rule changes in consultation with industry and that the regulatory CVA should be aligned with the accounting CVA to better reflect firms' practices.

*The CVA framework should be re-dimensioned for the regulatory CVA risk charge to better reflect institutions' internal practices.*

As discussed, industry supports in principle the convergence of the regulatory capital frameworks with internal practices and encourages the BCBS to retain the incentives that drive firms' internal model development.

We would like to reiterate our strong in-principle support for the proposals presented by the EBA under Policy Recommendation no. 15. We urge the EBA, and its Board members, to support the proposals in the relevant discussions at the Basel Committee. We would welcome the opportunity to comment further on some of the other recommendations that the EBA has put forward, but felt the immediate priority is to focus on the international standard and next steps at the BCBS level.

Yours sincerely,



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