

# CRR 3 - Credit Valuation Adjustment (CVA) Risk

## May 2022

### Introduction

In July 2020, the BCBS published targeted revisions to the Credit Valuation Adjustment (CVA) framework, bringing final changes to the initial revised framework published in 2017, as part of the Basel III agreement. CVA refers to a measure of market risk incurred in the context of transactions or contracts involving counterparties (such as sovereign banks, other financial institutions, non-financial companies, etc.). In other words, as banks enter into derivatives contracts, they face the risk of incurring losses due to changes in the market value of those transactions and the deterioration of the creditworthiness of their counterparties.

Capital requirements for CVA risk are meant to require banks to hold aside capital to account for these losses. While the 2020 revisions attempted to solve some of the identified issues with the current CVA framework, further calibration is necessary to ensure that end-users, who typically use derivatives to hedge risk, are still able to access them at a reasonable cost. Particularly in the context of the recovery from the COVID-19 pandemic, it is crucial for banks to continue to support the real economy through the provision of these services and to not be constrained from doing so by an undue increase in the capital held against CVA risk. It is also important that the CVA framework is implemented in a coherent manner, and due consideration should be given to aligning the implementation timeline with the interlinked market risk standards.

### CVA: A Brief Primer

Banks that undertake derivatives are subject to the risk of incurring mark-to-market losses because of the deterioration in the creditworthiness of their counterparties. This potential source of loss, due primarily to changes in counterparty credit spreads, but also other market risk factors, is known as CVA risk. CVA is thus viewed as the “price” of counterparty credit risk (CCR).

In December 2017, the BCBS published an initial revision of the CVA framework[1](#_bookmark47) to better capture CVA risk and provide better recognition of CVA hedges. Further revisions were introduced on July 8th 2020[2](#_bookmark48) when the BCBS released its final rule for the CVA framework to ensure, amongst other provisions, further alignment between the market risk and CVA rules, as well as address calibration issues within the framework.

This finalized standard is a significant development that is expected to have material implications for the industry, as it replaces the current CVA standardized approach and removes the ability to use internal models.

The main changes introduced by the BCBS in this framework include a re-calibrated standardized approach (SA-CVA) and basic approach (BA-CVA), adjustments in some of the previously-determined risk weights (RWs) in both these approaches, an adjustment to the scope of transactions that are subject to CVA-linked capital requirements, as well as the introduction of “index buckets”, whereby banks can calculate their capital requirements by referring to certain set credit or equity indices, instead of relying on the credit-worthiness of the underlying counterparty. Finally, the BCBS has recommended setting the mCVA multiplier, meant to

1 <https://www.bis.org/bcbs/publ/d424.pdf>

2 <https://www.bis.org/bcbs/publ/d507.htm>

account for model risk, to 1 – to address calibration issues in the framework. This also takes into account the fact that there is no advanced approach available for the calculation of the CVA capital requirements.

**The main changes introduced in the final revision of the BCBS CVA framework**:

* a reduction of the SA-CVA multiplier (mCVA) to 1 from 1.25, originally intended to account for model risk.
* the introduction of a scalar to BA-CVA of 0.65 to ensure an appropriate relative calibration to SA-CVA.
* the recognition of hedges is improved through the introduction of index buckets, allowing banks to calculate their capital requirements by referring to certain set credit or equity indices, instead of relying on the creditworthiness of the underlying counterparty.
* a revision to the aggregation formula used to calculate the capital requirements and revisions to a number of risk weights downwards to align the requirement closer to the finalised market risk framework.
* a reduction in the gap between regulatory and accounting CVA through the revision of the floor to margin period of risk (MPOR[3](#_bookmark49)) as it relates to client cleared transactions (CCTs); and
* the exemption of SFTs with immaterial CVA risk from CVA capital requirements.

These latest revisions have allowed for greater sensitivity in the determination of the CVA risk linked to specific exposures and are positive. Nonetheless, further changes to the framework are necessary to ensure that the rules are commensurate with the underlying risk.

**Implementation timeline for CVA**

The Commission’s CRR3 proposals include a mechanism, by way of a delegated act under Article 461a which aims to adjust the timing and calibration of the FRTB market risk standard based on third country implementation.

There is a significant read-across between the FRTB and CVA risk frameworks and interlinkages stemming from the fact that the risk weights in CVA are largely based upon the market risk standard – meaning the market risk revisions will be reflected in the CVA risk framework.

The flexibility provided in the delegated act under Article 461a, offering a potential 2-year delay to the start date of FRTB is a critical tool in light of the uncertainty resulting from the lack of visibility on timing, content and impact of the locally adopted FRTB rules in other major jurisdictions. Besides, beyond the mechanism to adjust the calibration set in the delegated act, some additional aspects could also be considered, including ensuring the concurrent implementation of both CVA and FRTB framework given the significant read-across between the two standards.

### Designing an effective and proportionate CVA Framework for the European Union

In September 2021, the European Banking Authority’s (EBA) published a report[4](#_bookmark50) showing that the revised Basel CVA framework for European banks will result to an increase of +2.2% in minimum required capital (MRC) for CVA under a full implementation of Basel standards scenario. The EBA shows the impact of CVA risk only through the change in MRC, rather than the increase in RWAs, which is the metric required to assess

3 The MPOR is defined as the time period from the most recent exchange of collateral covering a netting set of transactions with a potentially defaulting counterparty, until the transactions are closed out and the resulting market risk is re-hedged.

[4https://www.eba.europa.eu/sites/default/documents/files/document\_library/Publications/Reports/2021/1020673/EBA%20Report%20on%20B](https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2021/1020673/EBA%20Report%20on%20Basel%20III%20Monitoring%20%28data%20as%20of%2031%20December%202020%29.pdf)

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how much additional capital would be required to maintain current capital ratios. The MRC does not fully take into account supervisory capital buffers and guidance, as well as banks’ own management buffers and as such, we believe the EBA’s analysis materially understates the impact of the revisions to the CVA framework.

Even when the enhancements of the final Basel CVA standards are considered (e.g. the removal of the capital multiplier) plus the maintenance of existing exemptions in CRR, there is still a significant impact in the amount of capital banks would need to allocate for CVA risk. This is due to calibration issues in the CVA framework, such as the lack of granularity of risk weights related to exposures to financial sector entities which still need to be addressed, exacerbating the impact of losing the ability to use advanced CVA in the updated framework.

CVA risk represents a significant driver of risk-weighted assets (RWAs) for derivatives and capital market activities, and deficiencies in the framework have an impact on banks’ ability to provide key financing, liquidity and hedging services and products to end-users. As a result, it is very important that the design and calibration issues be addressed appropriately to ensure that capital requirements are in line with real economic risk incurred by banks.

Increases in capital requirements can have a knock-on effect and any requirements that constrain the use of derivatives may affect the ability of end users e.g. pension funds, mutual funds, and commercial end users to hedge their funding, currency, commercial and day-to-day exposures, which would in turn weaken their balance sheets and make them less attractive as investment prospects.

In terms of more specific recommendations, the industry supports further targeted revisions to the CVA framework on the following points:

* 1. Improve the calibration and granularity of risk weights (RWs) particularly for financial counterparties.
	2. Improve the recognition of CVA Index hedges.
	3. Misalignment between regulatory and accounting CVA

These changes would also need to be addressed at the BCBS level, to ensure incorporation into the final CVA standard that should result to consistent transposition of the CVA framework at national levels. We provide more details on these points below:

### Improve the Calibration and granularity of risk weights (RWs) particularly for financial counterparties

*Regulated Financial Risk Weights*

In the revised CVA framework, the risk weights allocated to exposures to financial sector entities are the same, regardless of the type of financial sector entity (i.e. all financial institutions are allocated to the same “bucket”). This means that a wide set of counterparty types all pivotal to the real economy including pension funds, insurance providers, covered bonds[5](#_bookmark51) and buy-side end-users are captured in the same bucket without any means to account for their specific risk profile.

The European Commission and co-legislators should improve the granularity of the counterparty credit spread (“CCS”) risk weights. At a minimum, recognize the differentiation in CVA risk profiles between financial counterparties.

A simple solution would be divide the current bucket for financial sector entities into two buckets (i.e., regulated and unregulated financials) for both the investment grade and non-investment grade categories:

*Investment grade*

5 Counterparties within bond issuance structure buying market risk hedges *pari passu* with covered bond debt.

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| --- | --- | --- | --- |
| Bucket Number | Credit quality | Sector | Risk weight (percentagepoints) |
| 4 | Credit quality step 1 to3 | Financial sector entities includign credit institutions incorporated or established by a central government, a regional government or a local authority and promotional lenders | 5,0% |

|  |  |  |  |
| --- | --- | --- | --- |
| Bucket Number | Credit quality | Sector | Risk weight(percentage points) |
| 4a | Credit quality step 1 to3 | Regulated financial sector entities includign credit institutions incorporated or established by a central government, a regional government or a local authority and promotionallenders | 3,0% |
| 4b | Credit quality step 1 to3 | Unregulated financial sector entities | 5,0% |

*Non-investment grade*

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| --- | --- | --- | --- |
| Bucket Number | Credit quality | Sector | Risk weight (percentagepoints) |
| 13 | Credit quality step 4 to6 | Financial sector entities includign credit institutions incorporated or established by a central government, a regional government or a local authority and promotional lenders | 12,0% |

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| --- | --- | --- | --- |
| Bucket Number | Credit quality | Sector | Risk weight (percentagepoints) |
| 13a | Credit quality step 4 to6 | Regulated financial sector entities includign credit institutions incorporated or established by a central government, a regional government or a local authority and promotionallenders | 8,5% |
| 13b | Credit quality step 4 to6 | Unregulated financial sector entities | 12,0% |

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This would significantly enhance risk sensitivity in the CVA framework by improving the mapping of exposures to industry sectors based on the underlying risk.

*Industry sector mapping of CVA exposure*

In addition to more granular risk weights, we recommend that the EU allow for more flexible mapping of CVA exposures to sector buckets. In the rules, there is already an allowance for firms to use appropriate proxies to determine the SA-CVA risk factor sensitivities. We recommend that the same criteria, which is set out in CRR Article 383a point (ii) of subparagraph 2, for mapping illiquid risk exposure to liquid credit spreads, can also be used to assign CVA risk exposure to a sector. This would allow for a closer alignment of the CVA capital framework and the risk management and accounting CVA framework, where the risk to financial sector entities can be marked to the credit spreads of other sectors. Examples cited in the rules include municipalities, project finance and funds. We believe this flexibility for mapping risk exposures to sector buckets could be applied more broadly if there is a credible economic justification that is demonstrated to a firm’s supervisor. For example, government-backed entities, (e.g. government-backed financials; state-backed pension funds) should be allocated to the sovereign bucket where they are backed by the sovereign or local authority.

### Improve the recognitions of CVA Index hedges

Credit-default-swaps (CDSs) are a type of insurance taken against the loss arising from the default of a counterparty. Banks can also use standard baskets of CDSs, called CDS indices (analogous to equity indices), which are more liquid than the over-the-counter CDSs and provide a useful tool to hedge systemic credit risk. These are especially useful for many small and mid-cap companies, as they do not have any direct “hedges” that would allow mitigation of counterparty credit risk– meaning that hedging has to occur at a more macro- level for the entire portfolio, using these indices as reference.

The July 2020 Basel revisions have introduced new ‘index buckets’ for these indices, namely for: (i) counterparty credit spread risk class; (ii) reference credit spread risk class; and (iii) equity risk class of the SA-CVA, in alignment with the Basel market risk framework (the Fundamental Review of the Trading Book).

The introduction of the counterparty credit spread index bucket is positive. The scope of eligible hedging instruments is limited to qualifying indices. However, the implied correlation between the CVA portfolio and the index bucket does not provide sufficient recognition to index hedges and does not reflect the observed historical correlation between the typical CVA portfolio and CDS index hedges.

This outcome does not incentivize prudent hedging practices and may lead to inadequate protection against the real economic CVA risk. Treating the entire CVA portfolio as an index and aligning its correlation with the index bucket to a level matching the calibration of SA-TB[6](#_bookmark52) is one approach to improve the hedge recognition.

### Misalignment between regulatory and accounting CVA

There are significant mismatches between the regulatory CVA per Basel standard, and the way those charges are treated from an accounting perspective, through IFRS rules. In order to ensure that CVA charge is not overstated, the CVA framework should be more closely aligned with market practices, specifically by introducing changes to the length of the Margin Period of Risk (MPoR[7](#_bookmark53)) – which accounts for lags in timing within which the nominal and market value of the contract can widen.

The current MpoR floor is based on outdated information about risk management and accounting practices. The market structure has changed substantially over the last ten years due to greater monitoring and active reduction of interbank risk exposure following the large financial institution defaults that took place during the global financial crisis.

The current proposals mean that the MPoR is set equal to a minimum of 9+N business days irrespective of master agreement documentation, jurisdiction legal differences, or type of counterparty. This approach does not reflect the legal terms negotiated between parties that dictate and reduce the MPoR. For example, the implementation of margin requirements under EMIR has reduced grace periods and imposed ‘same-day’ settlement for margin transfers. In contrast, the conventional regulatory MPoR has not changed to reflect these market developments.

Furthermore, since banks hedge their exposures based on economic CVA risk rather than regulatory CVA the impact of hedges is reduced in the regulatory CVA charge compared to how hedges would mitigate economic CVA losses and by adding flexibility to the expected loss given default[8](#_bookmark54) (ELGD) used for specific exposures.

**Recommendations on the design and calibration of CVA**

We would recommend that the following changes be considered:

* A recognition of the different risk profiles of different financial institutions through the introduction of distinct risk weights per type of financial institutions, instead of their allocation a single bucket.
* A better recognition of indices used to hedge CVA risk, particularly in terms of their usage linked to the hedging of systemic credit risk, rather than specific sectoral or counterparty risk.
* A greater alignment of regulatory and accounting CVA. Namely, through:

6 As it relates to the correlation between to Credit Default Swap (CDS) indices: Under the revised market risk approach, the calculation of the sensitivities-based method under the standardised approach for market risk sets the correlation between two sensitivities within the same index bucket at 80%.

7 See footnote 3 for a definition of MPOR.

8 9 Expected loss given default is the average loss anticipated for a specific exposure in the event of the counterparty to the contract defaulting, taking into account the exposure and the probability of default

* making adjustments to the period stipulated by the MPoR. This could be done by adjusting the MPoR floor from 9+N days to 4+N days, which would make it more aligned with accounting market practices; and
* the use of specific ELGD[9](#_bookmark55) for secured exposures (e.g. covered bonds, infrastructure or utilities specialized lending vehicles) or entities which by nature expose derivative counterparties to lower risks than bond holders (e.g. sovereigns).

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* 1. Information about AFME and its activities is available on the Association's website: [www.afme.eu.](http://www.afme.eu/)