ISDA Safe, Efficient Markets

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Capital for Counterparty Credit Risk

Dear Raquel

The industry appreciates the considerable work that the Risk Management and Modelling Group ('RMMG') has undertaken on the Basel counterparty credit risk framework, and commends it for the degree of consultation that has characterised its recent program. In the spirit of this cooperative approach, we would like to take the opportunity to provide the RMMG with some comments regarding various aspects of the Basel counterparty credit risk framework. Discussions with our member firms have highlighted the issues below as they have initiated efforts to plan and build the systems needed to implement the new rules.

Our comments are grouped under six headings, and relate both to the bilateral capital charges and to the proposed capital framework for exposures to central counterparties.

1. The basis of the calibration of the advanced CVA charge
2. The definition of maturity in the CVA charge
3. The use of derivatives-specific recoveries in the CVA charge
4. The inclusion of CVA hedges into the IRC
5. The capital treatment from the clearing member's perspective of client-cleared trades
6. The regulatory definition of maturity and exposure at default for exchange traded derivatives

We understand that the broader issue of the treatment of market risk hedges to the CVA, and of credit spread hedges beyond single name and index CDS (such as securitisation tranches or nth-to-default notes) has been referred to the Trading Book Group ('TBG'), and so we refer the RMMG to our comments to the TBG on these issues[1].

[1] See our note to the TBG titled *CVA Risk and Capital*, dated May 2011.

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1. The basis of the calibration of the advanced CVA charge

In our analysis of the capital charges for CVA, we have noted that the incentive for using the advanced approach to CVA capital can be small (or even negative). Given the importance of this charge, we suggest that the RMMG publishes a summary of the results of the QIS used for calibrating the advanced and standardized CVA charges.

2. The definition of maturity in the CVA charge

The original definition of 'maturity' for OTC derivatives netting sets (sometimes known as *M*) in Basel II given in paragraph 38, Annex IV, involves a division. Since the denominator in this definition can be arbitrarily small, this can give rise to *M*s which are very long (or even infinite). This does not cause an issue in the Basel II rules as *M* is capped at five years. However the Basel III framework does not everywhere retain this cap. We therefore ask the RMMG to clarify that *M* can be capped at the longest contractual maturity in the netting set.

3. The use of derivatives specific recoveries in the CVA charge

The definition of CVA in paragraph 98 of BCBS 189 as revised uses LGD_{MKT} in two senses: one to calibrate the CVA charge to the CDS market, and another to refer to the risk of the specific netting set. There may be situations where the netting set recovery differs from that inferred from the CDS market, for instance where the netting set is subordinated, or where benefit can be gained from a security package. Therefore we ask the BCBS to replace the first instance of LGD_{MKT} in the definition of CVA in paragraph 98 by LGD_{NS} (for netting set), and to carry these changes through into the subsequent definition of Regulatory CS01. (Note that this LGD_{NS} may differ both from LGD_{MKT} and from the LGD used for the same obligator in the IRB.)

4. The inclusion of CVA hedges into the IRC

BCBS 189 envisages that qualifying CVA hedges, such as single name CDS, will go into the CVA VAR (plus stressed CVA VAR) calculation for evaluating the net credit spread risk created by CVA and its hedges. However, these hedges also hedge the default risk of the netting set, even though they do not typically qualify for hedging treatment under the counterparty credit risk framework. Therefore we request that banks are permitted to include them in their IRC calculations. Similarly to the treatment of equity positions, we would expect that firms would need to include these positions consistently.

Treatment of internal hedges

In contrast to the treatment of counterparty credit risk, BCBS 189 does not explicitly limit hedging benefits to transactions with third parties. We support the absence of such limitation, and seek to clarify this understanding. CVA desks are typically managed in a distinct fashion from other trading desks and frequently transact at arms' length with other trading desks within their firm.

5. The capital treatment from the clearing member's perspective of client-cleared trades

We previously communicated several concerns with the RMMG relating to the proposed capital treatment from the clearing member's perspective of client cleared trades. Briefly, these related to:

- The treatment of default fund exposures;

- The lack of justification for the '2% of EAD' clearing member to CCP charge where the clearing member can pass the consequences of CCP non-performance back to the client; and
- The case for a shorter margin period of risk on the client-to-clearing member leg of client cleared trades reflecting shorter close out periods (in the context of client clearing agreements which reflect many CCPs' tightly defined close out procedures).

We understand that the RMMG may be considering modifications to their proposals relating to the first two elements here. The third is however of great importance, especially given the decision to impose the CVA capital charge on the client-to-clearing member leg (or on the guarantee of the client-to-CCP leg in the FCM model). We believe that the significant efforts being undertaken by CCPs to establish robust procedures in this area will improve the speed and reliability of close-outs relative to a bilateral process and therefore we would again urge the RMMG to consider the use of a shorter margin period of risk in this context.

6. The regulatory definition of maturity and exposure at default for exchange traded derivatives

The current proposal for exposures to central counterparties requires firms to extend their capital calculation to exchange traded derivatives too. Given that this is a new requirement, we suggest that the RMMG may wish to provide guidance as to how to calculate *M* and *EAD* for such instruments.

We appreciate the opportunity to provide these comments. Should you require further information, please do not hesitate to contact the undersigned.

Kind regards,

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