Memorandum

To : **Dr Maxine Nelson, FSA**

Cc: ISDA and AFME Members

From: Peter Sime (ISDA)[1] and Christine Brentani (AFME)[2]

Date: 25 January 2012

Re: Key areas for clarification on CRD4 implementation relating to CCR.

This memo sets out the key areas outlined by members of the International Swaps and Derivatives Association ("ISDA") and the Association for Financial Markets in Europe ("AFME") during a four week consultation period during December 2011. It references CRD4[3], published July 20th 2011[4]. This note relates only to those changes to the calculation of Risk Weighted Assets ("RWA") relating to Counterparty Credit Risk ("CCR"). We also reference BCBS209, the Basel III FAQ, published in November 2011.

One over arching issue which concerns the industry is the Use Test. The Accounting Credit Value Adjustment ("CVA") addresses the need to fair value or mark the counterparty risk to market. In this context it is far from clear what the Regulatory CVA is seeking to achieve. Firms have invested significantly in their risk, CVA and stress-testing frameworks since 2008. These systems have been extensively calibrated and tested throughout the credit crisis and are used to manage the business and therefore satisfy the Use Test.

The new metrics introduced by CRD4 including stressed EPE, adjustments to periods of risk based on regulatory criteria which are not risk sensitive, and the use of VaR-of-Regulatory CVA ("RCVA") and Stressed-VaR-of-RCVA are in many cases additive and double or treble count the same risks. It is therefore difficult to envisage a framework in which these metrics would be used on a day to day basis to manage the business in order to pass the Use Test.

Furthermore, a construct in which the capital requirement is disconnected from the real risks which firms face will inevitably lead to misallocation of resources, disincentives to hedging and prudent risk management, and procyclicality.

Below are a further series of issues which our members would like to bring to your attention and where clarification is sought. In many cases, we are merely requesting confirmation of our current understanding in relation to the issues described. We would be grateful for your feedback on these issues at your earliest convenience.

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[1] The International Swaps and Derivatives Association
[2] The Association for Financial Markets in Europe
[3]The Capital Requirements Directive is partly a Directive and Partly a Regulation
[4]The draft compromise text proposed by the Danish Presidency on 9 January 2012

CRD4 - Article 375

1(a) single-name credit default swaps or other equivalent hedging instruments referencing the counterparty directly;

1(b) index credit default swaps, provided that the basis between any individual counterparty spread and the spreads of index credit default swap hedges is reflected in the Value-at-Risk.

1(cont) The requirement in point (b) that the basis between any individual counterparty spread and the spreads of index credit default swap hedges is reflected in the Value-at-Risk shall also apply to cases where a proxy is used for the spread of a counterparty.

For all counterparties for which a proxy is used, an institution shall use reasonable basis time series out of a representative group of similar names for which a spread is available.

If the basis between any individual counterparty spread and the spreads of index credit default swap hedges is not reflected to the satisfaction of the competent authority, then an institution shall reflect only 50% of the notional amount of index hedges in the Value-at-Risk.

The hedges referred to in point (b) may be used only for the purposes of the calculation of own funds requirements for CVA risk in accordance with Article 373.

BCBS209 – I Q1

All tranched or nth-to-default credit default swaps are not eligible. In particular, credit linked notes and first loss are also not eligible. Single name short bond positions may be eligible hedges if the basis risk is captured.

BCBS209 – II (c) Q23

Only hedges that are with external counterparties are eligible to reduce CVA. A hedge that is only with an internal desk cannot be used to reduce CVA.

BCBS209 – II (c) Q24

Any instrument of which the associated payment depends on cross-default (such as a related entity hedged with a reference entity CDS and CDS triggers) is not considered as an eligible hedge.

Issue 1 – Proxy Hedging

It is widespread industry practice to use proxy hedges to hedge the spread sensitivity of the Accounting CVA. For example, buying sovereign protection against a derivative exposure with a majority-state-owned enterprise .It is also possible to arrange single-name fully-funded credit-linked notes to provide offshore protection in the emerging markets. The collective statements of the FSA at the CREG meeting Dec 6th, the BCBS209 and Article 375 have left the industry feeling that the topic of eligible hedges critically needs clarification and that this must be an area of global regulatory coherence, since eligible hedging practices will dramatically affect the amount of cost transferred to the counterparties as banks navigate lower returns on equity. In particular, clarification is sought on eligibility of proxy hedging, any instrument referencing the single-name outside of a tranched or n'th-to-default arrangement.

Issue 2 – Credit Protection

On the topic of internal or external hedges, the industry reminds the FSA that when protection is bought internally or externally, trading book capital (Market Risk Rules) is ultimately held in the financial system against that short credit position. The industry needs to understand why it matters to the regulators where that capital requirement resides.

Issue 3 – CVA Variability Charge

The industry members would like confirmation on a technical note that, as with the downgrade-and-default charge within the Basel 2 framework, the CVA-variability charge associated with affiliate exposures will net out under group consolidated reporting.

Issue 4 – Back testing of the VaR of Regulatory CVA

The industry asserts that existing back testing of market risk and counterparty risk models is sufficient, and no additional back testing is required of the VaR of Regulatory CVA, since the associated Profit and Loss does not arise from the capitalisation of real risks faced by the firm.

CRD4 – Article 279

2. For transactions subject to daily re-margining and mark-to-market valuation, the margin period of risk used for the purpose of modeling the exposure value with margin agreements shall not be less than:

(a) 5 business days for netting sets consisting only of repurchase transactions, securities or commodities lending or borrowing transactions and margin lending transactions;

(b) 10 business days for all other netting sets.

Points (a) & (b) shall be subject to the following exceptions:

(i) for all netting sets where the number of trades exceeds 5,000 at any point during a quarter, the margin period of risk for the following quarter shall not be less than 20 business days. This exception shall not apply to institutions' trade exposures;

(ii) for netting sets containing one or more trades involving either illiquid collateral, or an OTC derivative that cannot be easily replaced, the margin period of risk shall not be less than 20 business days.

Issue 6 – Margin-Eligible Trades Under a Netting Set

It is possible to have a margined netting set where products are in-scope of the netting provisions, but are explicitly carved out of margin calls (for either legal, jurisdictional, or at-client-request reasons). The wording of Article refers to the number of trades under a netting-set. It should refer to the number of margin-eligible trades under a netting-set.

Issue 7 – Defaulted Exposures

Could the FSA clarify the treatment of defaulted exposures in terms of CVA-variability charge, and incurred CVA?

Issue 8 – Jump-to-Default Component of CCR

At the FSA CREG meeting of Dec 6th, the FSA used a slide showing the modification of the jump-to-default component of the CCR charge as the maximum of Stressed EPE or EPE. The industry understands from the original Basel text and CRD4 that it is the maximum of the entire portfolio of netting-set RWAs arising from EPE or that arising from Stressed EPE, but not the maximum of the underlying exposure measure. Please would you be able to clarify this?

CRD4 - Article 286

To evaluate the effectiveness of its stress calibration for EEPE, an institution shall create several benchmark portfolios that are vulnerable to the main risk factors to which the institution is exposed. The exposure to these benchmark portfolios shall be calculated using (a) a stress methodology, based on current market values and model parameters calibrated to stressed market conditions, and (b) the exposure generated during the stress period, but applying the method set out in this Section (end of stress period market value, volatilities, and correlations from the 3-year stress period).

Issue 9 – Comparison of Stressed to Unstressed Portfolios

It is not clear what this comparison is meant to achieve and how the information is to be used post comparison. Processes will need to be developed to enable presentation of the results as part of Management Information, especially if there is an impact on regulatory capital. The industry would be grateful for more detail on how this comparison is to be used to enable the internal and external processes to be formulated.

Issue 10 – Secured Funding Transaction CVA

At the CREG, the FSA indicated that they will perform an exercise over the next year to assess the materiality of Secured Funding Transaction (“SFT”) CVA and will engage with firms on whether and how to incorporate SFT’s into the CVA charge. The industry needs to know whether SFTs will be included in the near future as firms’ have to build and test the infrastructure in readiness for end August 2012. The industry’s view is that applying a CVA charge for SFTs is out of line with the accounting standard of not in general applying a fair value adjustment for counterparty risk in the valuation of SFTs.

Issue 11 – CAD2 Specific Risk VaR Model Approvals

The FSA confirmed that any changes to firms’ CAD2 approved Specific Risk VaR models made to accommodate the CVA VaR (e.g. use of proxies, longer maturities), would be reviewed and approved by the FSA’s Market Risk team and not the FSA’s Counterparty Risk team. Please can the FSA outline the approval process and timing of any Market Risk approval? For example, by when will the CAD2 Market Risk team require applications, will materiality thresholds for pre or post notification apply, and what will the Market Risk team’s information requirements be?

Issue 12 – Frequency of Computation on CVA VaR Capital Charges

The FSA indicated that their required frequency for computation of CVA VaR capital charges was at a minimum monthly, in line with regulatory capital reporting. Firms’ should also be able to run the CVA VaR model on an ad-hoc basis. Please can the FSA confirm that the industry’s understanding is correct?

Issue 13 – Parallel Run Deadlines

The FSA’s cross firm letter on the application and approval process for CRD 4 indicates that firms are expected to submit Parallel run capital calculations results covering a period of not shorter than 3 months by August 31st 2012. The industry believes that given the amount of infrastructure development required for a number of Basel 3 elements, this timeline is highly challenging. The FSA indicated at the CREG that the 3 month parallel run period did not need to be completed by August 31st 2012 but must be complete by

end 2012. Please can the FSA confirm that this later deadline applies, and confirm what if anything is expected by August 31st 2012?