Update to the ISDA and Industry Response to Basel Committee on Banking Supervision Paper 214 Application of Own Credit Risk Adjustments to Derivatives

Removal of CVA gains arising from own credit spread deterioration at the netting set level.

Introduction

The industry together with ISDA[1] ("the Industry") greatly appreciated the opportunity to consult with BCBS' Risk Measurement Group ("RMG") on the topic of "Prudential treatment of the impact of own credit spreads on the valuation of OTC derivatives" in the meeting in Canary Wharf on May 29 2012. Following the presentations and subsequent feedback obtained from RMG, the Industry is pleased to confirm that we are united behind a single proposal which we believe is prudent, simple to understand, and simple to implement.

Paragraph 75 of the Basel III[2] proposals requires banks to "[d]erecognise in the calculation of Common Equity Tier 1 ("CET 1), all unrealized gains and losses that have resulted from changes in the fair value of liabilities that are due to changes in the bank's own credit risk". BIS Paper 214 (The Paper") proposes the full deduction of all DVA, as opposed to that resulting solely from changes in the bank's own credit risk, due to the complexity of calculating the former.

This paper sets out a relatively straightforward method of calculating unrealized gains and losses arising from changes in a bank's own credit risk. The proposal is easy to understand and to implement and provides a way of complying with paragraph 75 of Basel III.

As noted in our initial written response dated February 22 2012 and in our discussions on June 29 2012, we would like to reiterate that:

- The Industry understands and appreciates the difficulty which financial regulators have in allowing regulated firms ("Firms") to record in Common Equity Tier I ("CET 1") gains arising solely from deteriorations in their credit rating and/or idiosyncratic widening of their own credit spreads;
- The Industry disagrees with the Basel proposal to deduct the entire balance of CVA liability[3] from CET1 because this would deduct amounts that did not increase common equity. The wording of paragraph 75 of the Basel proposals[4] requires Firms to derecognize gains and losses arising from *changes* in a Firm's credit worthiness. As currently drafted however, The Paper deducts inception date CVA liability priced in new OTC derivative transactions despite the fact that there are no related unrealized gains emanating from own credit spread on trade date[5];
- Uncollateralized OTC derivative liabilities represent a valid and diversified alternate funding source which are actively managed by Firms along with their other liabilities. Accordingly

[1] The International Swaps and Derivatives Association

[2] Basel III: A global regulatory framework for more resilient banks and banking systems. December 2010, revised June 2011

[3] We use the terms CVA asset and CVA liability to emphasize that these terms have an intrinsic connection because they are the two components of a single bilateral credit valuation adjustment, which takes into account the bilateral nature of counterparty credit risk. The term DVA (Debit Valuation Adjustment) is sometimes used by Firm's to describe CVA liability, but other Firm's use the term DVA (Debt Valuation Adjustment) to describe the effect of own credit on debt held at fair value (e.g., structured notes).

[5] This is recognized on Page 3 of the Consultation Document which states: "The Basel Committee recognizes that this option is generally more conservative than paragraph 75, as it generally leads to a CET1 deduction at trade inception equal to the credit risk premium of the bank, rather than the change in value of derivative contracts occuring [sic] as a result of changes in the reporting bank's own credit risk."

uncollateralized derivative liabilities should be treated consistently with other forms of funding from a regulatory capital standpoint. Unequal capital treatment relative to funding raised in the form of issued debt will lead to distorted incentives and an unnecessary increase in transaction costs for OTC derivative liabilities (and a corresponding negative impact on liquidity);

- There is diversity in the manner in which banks around the world calculate and manage the impact of their own credit spreads on the valuation of OTC derivative portfolios due to differences in business models, accounting regimes and risk management philosophies. This diversity is evident in the calculation of both CVA liability and Funding Valuation Adjustments[6] (FVA) for certain firms. Regardless of the source of diversity, a successful proposal should only seek to deduct amounts which pertain to actual increases in common equity resulting from deteriorations in idiosyncratic widening of a Firm's own credit spreads. A highly prescriptive and mechanical rule that does not respect the current diversity of practice will not result in the deduction of the correct amount[7].

Industry's Prudential Recommendation

The Industry proposal is to remove from CET1 the contributions to common equity from all netting sets whose bilateral credit valuation adjustments (i.e., the net sum of CVA asset, CVA liability and FVA) are positive numbers (gains) at any reporting date. For a bank that measures CVA using credit spreads, as both asset and liability flows are compared to a risk free rate, a deduction to CET1 would only be required for symmetric and equal asset and liability exposures to the extent own credit is wider than that of the counterparty credit in the netting set.

There are multiple benefits to this approach as it is:

- prudent as banks will not be able to increase their CET1 due to idiosyncratic widening of credit spreads;
- both simple to understand and implement – e.g. does not require the tracking of trade inception spread information;
- compared to the consultation document, the disincentive for banks to enter into derivatives due to a gross CVA liability deduction is mitigated[8];
- on a system-wide basis for derivatives between banks, it does not cause a double deduction against capital (as would be the case with the consultation document as both banks would deduct their liability CVA);
- can be applied consistently across the Industry, but follows the methodology used by the bank to calculate CVA asset, CVA liability and FVA in its financial statements;
- a reasonable estimate of the replacement cost for the netting set (or any transaction therein) should the counterparty wish to terminate or should the counterparty fail;
- respects the symmetry between the fair value assets and liabilities;
- mitigates CET1 volatility during a crisis because of the symmetrical treatment of assets and liabilities[9].

[6] FVA pertains to discounting assumptions for the funding of uncollateralized OTC derivatives cashflows.

[7] This is consistent with Basel III which stipulates that only unrealized gains/losses "due to changes in the bank's own credit risk" should be derecognized – and its policy goal is to remove unrealized increases in common equity arising from a bank becoming riskier.

[8] While it may result in a deduction for trade inception CVA that has already been priced into the trade (and should not, strictly speaking, be deducted), such amounts will be partly mitigated by the netting set calculation and should be acceptable;

[9] For example, if both counterparty and own credit spreads widen during a crisis the volatility of CET1 is reduced by allowing netting as per this proposal relative to the current Basel proposal.