12th February, 2016

The European Banking Authority
One Canada Square (Floor 46), Canary Wharf
London E14 5AA - United Kingdom

Re: Industry Response to the EBA Consultative Paper on the Guidelines on the treatment of CVA risk under the Supervisory Review and Evaluation Process, published on 12 November 2015

Dear Mr. Enria,

The International Swaps and Derivatives Association (ISDA) and the Association for Financial Markets in Europe (AFME) welcome the opportunity to comment on the EBA Consultative Paper (CP) on the Guidelines on the treatment of CVA risk under the Supervisory Review and Evaluation Process (SREP), published on 12 November 2015.

The industry believes the right place to make changes to the CVA framework is at the Basel level. Both the EBA and the Basel Committee have recognized that the current Basel III CVA rules are flawed and outdated, and so they are rightly being revisited by the Basel Committee. Until this review is finalized, no changes to the current CVA framework should be made at the European level. The industry and their clients do not need an intermediate step, especially one based on the current flawed CVA framework as proposed by the CP, which would necessitate yet another change in market practices, before implementing the revised Basel CVA framework. Moreover, while we are generally supportive of Guidelines as a tool to promote consistent application of the CRR, we do not think that they should be used to undermine the CRR Level 1 policy, which is effectively what the proposed Guidelines would accomplish. For these reasons we strongly urge the EBA not to proceed with the proposed benchmark approach based on the current pillar 1 calculation, and consider reinforcing the existing SREP through guidance that focuses on assessment of actual CVA risk.

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The EBA should wait for finalisation of the CVA capital charge framework at the Basel level

There are fundamental issues with the current Basel III CVA Risk framework, including with its calibration, which have been widely acknowledged by Regulators and the industry. We support the current Basel CVA Risk review, provided that the internal model approach is retained. We believe that addressing the issues with the current framework and helping solve the jurisdictional inconsistencies at the Basel level is the best approach to ensure that CVA capital requirements are commensurate with the actual CVA risk faced.

We welcome the indication from the EBA Guidelines that the Basel III CVA VaR capital charge should be approximately half its current level. However, rather than using rudimentary methods to calibrate the level of capital in the interim period, we would strongly recommend that the EBA wait for the CVA capital charge to be fixed at Basel, assuming the internal model approach is retained, while reinforcing the existing SREP framework to ensure appropriate assessment of the actual CVA risk faced by firms, rather than using methodologies that are not fit for purpose.

Promoting a flawed CVA risk charge under Pillar II would reduce end-users hedging

When Basel III was transposed into European legislation via the CRD IV package the European legislator decided to exclude CVA capital charges on the counterparty risk arising from derivative transactions with "end-users", i.e. non-financial counterparties (NFC), sovereign and pension funds, which use derivatives to hedge against potential adverse moves in currencies, interest rates or other financial variables (cf. art. 382 §4 CRR). The European legislator believed end users of derivatives shouldn't have to incur higher costs to hedge risks because they were unable to collateralize their derivatives transactions due to significant infrastructure costs or lack of access to liquid assets. This was also recognized in the European Market Infrastructure Regulation (EMIR) that exempts corporates below a threshold from the clearing obligation for derivative contracts.

The industry welcomes the EBA criticisms of the current Basel CVA framework[1] and continues to believe that the mis-specification of CVA risk capital disproportionately increases the cost of derivatives for end users (corporates and sovereigns counterparties) and creates a disincentive for end users to use these instruments for hedging purposes. In this respect we acknowledge the EACT letter to the EBA dated 7 December 2015.

[1] EBA Report on CVA dated 25 February 2015, pages 30-31

The EBA should not use Guidelines to set Level 1 Policy

While guidelines are generally helpful in ensuring the common, uniform and consistent application of the CRR, in this specific case, we believe that the EBA's work goes beyond such objectives and equates instead to Level 1 policy making. This is because the proposed guidelines work against the spirit of the Level 1 decision to exempt CVA charges for transactions with counterparties that are subject to the central clearing exemption under EMIR, aiming at protecting the use of bespoke OTC derivative products by NFCs, sovereigns and pension funds hedging financial risks to their core business activities.

We think the legislator's intention to maintain these exemptions is clear as the CVA review clause under CRR Article 456(2) allows for changes to all aspects of the CVA rules except for the exemptions under Article 382(4). In impact terms, under all proposed permutations of x and y calibrations, it is likely that a large component of the Level 1 exemptions will be undermined by potential capital add-ons under the Pillar 2 framework. In this respect, we recognize the strong concerns expressed by the European Parliament in its Report on EU Financial Services Regulation dated 9 December 2015[2].

Lastly, guidelines should provide more guidance to supervisors on how to review risk management and measurement within banks. These draft guidelines focus on formulas for calculating hypothetical outcomes, where calibration of threshold remains unclear, and disconnected from the wider CVA risk management framework. In addition, local authorities already perform SREP assessment encompassing CVA, and the EBA recently published draft guidelines on ICAAP/ILAAP (currently under consultation) that will set higher standards on ICAAP/ILAAP and will ensure banks properly assess whether their risks are sufficiently capitalized. The proposed guidelines therefore fall short of their purpose as they end up providing a flawed benchmark, on which we expand below.

[2] Paragraph 17. "The European Parliament expresses concern that valid exemptions in the European Market Infrastructure Regulation (EMIR) for non-financial companies have been partly undone in the Capital Requirements Directive and Regulation with regard to the application of the Credit Valuation Adjustment (CVA) charge; calls on the Commission to better perform its role in ensuring consistency in policy approach and outcome across different legislative proposals."

Paragraph 49. "The European Parliament stresses the need to respect the interplay, consistency and coherence between the basic acts and delegated and implementing acts; stresses again that political decisions have to be made by the co-legislators within the basic act, and should not be left to the delegated acts, which are meant 'to supplement or amend certain non-essential elements of the legislative act' (Article 290 of the Treaty on the Functioning of the European Union); insists that the Commission and the ESAs, when drafting delegated and implementing acts and guidelines, stick to the empowerments laid down in the basic acts and respect the co-legislators' agreement; regrets that in the past the supervisory authorities, in drawing up implementing acts, have not always adhered to the mandate set out by the European legislators; deplores that the coordination between the Commission (delegated acts) and the ESAs (technical standards) is insufficient and may therefore negatively affect the quality of compliance."

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The EBA Guidelines are based on a flawed supervisory benchmark

We believe that the proposed supervisory benchmark suffers a major weakness: It is based on a hypothetical own funds risk measure, which is not risk sensitive and is disconnected from the economic risk truly incurred, monitored and managed by European banks. In addition, the threshold measure is based on exposure at default, a non risk-sensitive measure. CRD IV Article 73 explicitly requires banks to ensure "the risks to which they are or might be exposed" are adequately covered by capital. The economic risk that needs to be monitored and adequately capitalized as part of the ICAAP assessment arises from accounting CVA variability. This is because the fair value adjustment accounting for the cost of counterparty risk embedded in the price of a derivative is accounting CVA, which reflects the current thinking in terms of CVA risk management, and not regulatory CVA. In addition, stress tests allow banks to assess any capital shortfall not adequately capturing current and future risks including CVA risk. Therefore, CVA risks stemming from the EU exemptions are already properly managed, and excessive CVA risk should already be assessed and captured under Pillar 2 processes.

Furthermore, the Basel Committee, in its first consultative paper on the review of the CVA risk framework[3], acknowledges the current Basel III regulatory CVA is ill-defined and outdated since one of the objectives of the on-going review is to better align regulatory CVA with accounting CVA: *"The current regulatory CVA formula used in the Advanced Approach does not incorporate many of the hedging strategies banks now employ under various accounting regimes, particularly with regard to the market risk drivers of CVA, and has thus become outdated."* For example, market risk hedges and some proxy credit risk hedges are not deemed eligible hedges and therefore attract additional CVA capital charges, even though these hedges are reducing banks' real economic risks. All in all, we firmly believe the proposed supervisory benchmark is flawed whatever the calibration of the "y" parameter because it solely relies on the theoretical concept of regulatory CVA, a concept that is outdated and disconnected from economic risk. Using the Pillar 1 CVA formula may give seemingly comparable outputs, but this will actually fail to meet the SREP objectives of true comparability, relevance and proportionality as these outputs will be disconnected from the real risks (eg. exclusion of market risk hedges). It will therefore misrepresent the actual risks, leading to flawed conclusions.

With respect to the Basel revisions we believe that i) retaining the risk sensitive Internal Model Approach ("IMA") is imperative to appropriately capitalise for the economic risk of end-users that are not able to post collateral, and ii) the regulatory framework should align as much as possible with the approaches that drive risk management decisions. Forcing banks to adopt a standardized model or capitalising for inappropriate, excessive benchmarks based on the concept of regulatory CVA would penalize prudent economic hedging in the normal course of business and promote herding behaviour during periods of market stress.

[3] http://www.bis.org/bcbs/publ/d325.htm

Exemption of Intragroup Exposures

The industry strongly believes that the existing exemption for intragroup transactions in the CVA capital framework should be retained.

Banks typically do not hold a CVA reserve for intragroup exposures in the Accounting CVA or internal risk management of CVA. This is because OTC derivative exposures between entities are typically fully cash collateralized and, where CVA risk is measured on a bilateral basis, an increase in CVA asset from a change in credit spread would be offset by a commensurate reduction in CVA liability, producing no meaningful change to net CVA. Furthermore, it is highly unlikely that the credit quality of one entity within a banking group would be significantly deteriorating relative to the credit quality of another entity in the group as creditworthiness is likely to be measured from the same CDS curve.

We also note that the proposed EBA supervisory benchmark actually goes beyond Basel III requirements with the inclusion of intragroup transactions in the hypothetical own funds requirements for CVA risk. Indeed, the Basel Committee clarified in FAQ 2e.1 of the Frequently asked questions on Basel III counterparty credit risk[4] that intragroup transactions are not in the scope of the CVA capital charge: *"As per the group consolidated reporting, no regulatory capital charge (including a CVA charge) applies to intercompany transactions".*

Furthermore, elsewhere within the Regulatory framework transitional relief has been granted in Regulatory Technical Standards governing the clearing obligation under the European Market Infrastructure Regulation (EMIR) to allow intragroup trades with entities in third countries to be exempt from mandatory clearing requirements in the absence of equivalence determinations. Under the Clearing Obligation regulation for Interest Rate Swaps, intragroup transactions are only exempt from the clearing mandate provided the conditions laid down in Article 3 of EMIR are met. One of the conditions, under Article 3 of EMIR, for a transaction to qualify as an intragroup transaction is that, if one of the counterparties is established in a third country, the European Commission (EC) has adopted an implementing act under Article 13(2) in respect of equivalence of that third country.

However, the EC has yet to provide for any equivalence determinations under Article 13, and took the decision to allow a deferred date of application of the clearing obligation for OTC derivative contracts concluded between a counterparty established in a third country and another counterparty established in the EU belonging to the same group[5].

The deferred application should ensure that those contracts are not subject to the clearing obligation for a limited period of time (three years) in the absence of implementing acts pursuant to Article 13(2) of EMIR. We therefore believe that, since the CVA exemptions were originally intended to

[4] www.bis.org/publ/bcbs237.pdf

[5] Which are included in the same consolidation on a full basis, and are subject to an appropriate centralised risk evaluation, measurement and control procedures.

align with the mandatory clearing requirements in EMIR, the intragroup clearing exemption precedent should be extended to the CVA framework.

Recommendations

The industry expects shortcomings with the current CVA framework to be addressed at the Basel level. We acknowledge that CVA risk on exempted names does exist, and that banks' management of these risks should be adequately assessed and monitored. National supervisors should carefully consider the actual CVA risk using existing SREP processes to identify any material unmanaged CVA risk. In this context we believe that:

- The ICAAP assessment and stress tests undertaken by banks allow them to assess the adequate level of capital consistently supporting all current and future risks including CVA risk. One key objective of the CVA SREP is to assess whether a bank's ICAAP for CVA risk is sound, reliable and exhaustive.

- Any proposed guidelines should not override the exemptions granted by the CRR using a flawed pillar I CVA formula, but should instead look to enhance or leverage existing common principles for a sound evaluation of internal capital adequacy assessments.

- Additionally, should the EBA decide to use a supervisory benchmark, we recommend that such a benchmark relies on firms' internal risk management measurement of CVA not regulatory CVA.

- Finally, we recall that European firms already take conservative capital deductions relating to CVA uncertainty under the Prudent Valuation framework. EBA guidance under the SREP framework should require supervisors to review the extent of any possible double count to ensure that the same risk is not capitalized twice.

Yours sincerely,

Mark Gheerbrant	Michael Lever
Head of Risk and Capital	Managing Director, Head of Prudential Regulation
ISDA	AFME