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 by reference to an Industry Index

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 prudential, 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.

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 is 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).

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

[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) at 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 use a market index (to be employed consistently and without adjustment by each Firm) to quantify required deductions from CET1 to the extent that own credit spreads are wider than the index (i.e., reflect idiosyncratic credit spread widening). One example would be to use an investment grade corporate CDS spread[8]. For example, each Firm will replace their own credit spread with the observable credit spread for the investment grade corporate index in the calculation of both CVA liability and FVA (as applicable to the particular Firm). A deduction to CET1 would only be required to the extent own credit is wider than that of the index.

There are multiple benefits to this approach it is considered to be:

- Prudent as banks will not be able to increase their CET1 due to idiosyncratic widening of their own credit spreads;
- both simple to understand and implement;
- applied consistently across the Industry (e.g., same index);
- a reasonable estimate of the total market value of the derivative portfolio should the Firm fail and the derivative netting sets be sold in a liquidation sale.
- prudential in that it eliminates idiosyncratic credit widening should the Firm become severely distressed, but respects the symmetry between the fair value assets and liabilities (i.e., asset side valuations incorporate general credit widening, reflected in an index, as well as the idiosyncratic spread of each counterparty)
- a prudent measure of a Firm's capital before failure as it can realize a greater value than that amount by either terminating netting set with a counterparty or by transferring netting set to a better rated third party. Each action would tend to be transacted at the full bilateral CVA and would tend to increase CET 1 by a larger amount than estimated using a market index;

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

[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] At present this index is presented for illustrative purposes, the Industry commits to consult and agree on a proposed index for consideration by RMG by July 31 2012.

- a mitigant to CET1 volatility during a crisis because of the symmetrical treatment of assets and liabilities[9].

While this approach may result in a deduction for trade inception CVA that has already been priced into the trade (which should not, strictly speaking, be deducted) such amounts will be partly mitigated through use of an index and are considered an acceptable compromise.

Monetisation of DVA

This was set out in the Industry response dated February 2012 which advocated decomposing the calculation of the CVA-liability into a component based on an index spread (systemic component of CVA-liability) and a component based on the idiosyncratic spread of the firm relative to the index spread (idiosyncratic component of CVA-liability):

Prior to default, the troubled firm could sell derivative netting sets to third parties. If it did, the market value of those netting sets would be calculated using a bilateral CVA. The troubled firm would thus essentially realize the systemic component of the CVA-liability, because the CVA-liability calculated by the buyer would include that systemic component.

Similarly, if the troubled firm defaulted but continued as an ongoing entity because of new investors, the market value of each netting set to the new investors would be calculated using a bilateral CVA.

Section C to the Annex of the BIS paper correctly states that the issuer of a bond has a liability for the full par value of the bond, independent of market spreads, Similarly, an obligor that is in bankruptcy owes its counterparties the risk free market value a netting set, for all netting sets with negative risk free value – it does not owe its counterparty the risk free market value adjusted with a bilateral CVA. The bilateral CVA is needed to calculate market value, not credit exposure.

[9] For example, if both counterparty and index credit spreads widen during a crisis the volatility of CET1 is reduced by allowing the use of a market index to proxy non idiosyncratic credit spreads relative to the current Basel proposal.