ISDA® Safe, Efficient Markets

Basel Committee on Banking Supervision,
Bank for International Settlements,
Centralbahnplatz 2, CH-4002
Basel, Switzerland

22 February 2012

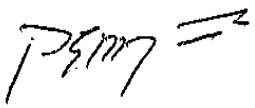
Dear Sirs,

Basel Committee on Banking Supervision ("BCBS") Consultative Paper on application of own credit risk adjustments to derivatives

The International Swaps and Derivatives Association ("ISDA") welcomes the opportunity to provide industry response on the BCBS's Consultative Paper. The industry and ISDA strongly support the work of the BCBS and are keen to assist in the development of appropriate risk sensitive regulations which are consistently applied internationally.

We remain available to discuss these matters with you further. Please do not hesitate to contact the undersigned if you would like any further information or explanation.

Yours faithfully



Peter E M Sime

Head of Risk and Research

ISDA

International Swaps and Derivatives Association, Inc.
One Bishops Square
London E1 6AD, United Kingdom
P 44 (0) 20 3088 3550 **F** 44 (0) 20 3088 3555
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

ISDA and Industry Response to BCBS Paper on

Application of Own Credit Risk Adjustments to Derivatives

Basel Committee on Banking Supervision Paper 214 issued December 2011

1. Introduction

The industry together with ISDA[1] ("the Industry") appreciate the opportunity to respond to the above paper. We understand 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 paper focuses on gains and losses arising from changes in the credit worthiness of counterparties to OTC derivatives and Secured Financing Transactions ("SFT's") without examining the relationship to gains and losses arising from a Firm's other liabilities such as debt issued held at fair value. The wording of paragraph 75 of the Basel proposals[2] requires Firms to derecognise gains and losses arising from changes in a Firm's credit worthiness, but is silent on gains and losses arising on the inception of trades as opposed to subsequent changes to these amounts. Accordingly, as currently drafted, the paper introduces significant differences in the capital treatment of funding raised in the form of issued debt vs. uncollateralized OTC derivative liabilities which we believe will lead to distorted incentives and an unnecessary increase in transaction costs (with a corresponding negative impact on liquidity).

We have consulted extensively with the industry and it is clear that, given the large number of current drivers of change, Firms are being forced to significantly restructure their business models. Firms are at differing stages of this process and require clarification as to the effect on their businesses from initiatives including:

- The detail around the segregation between retail and wholesale banking, and their funding, resulting from the Independent Commission on Banking in the UK (the Vickers' report)
- The implementation at Level Two of the EMIR proposals in Europe
- The final form of the Dodd Frank proposals and the Volcker Rule
- The structure and number of Central Counterparties ("CCP's") and the consequential effects on netting sets
- The collateral and funding requirements of whatever segregation models are chosen

Until these are better understood, and there is more certainty around the resulting business structures, we think it is premature to employ a "one size fits all" approach to cover all business models and valuation methodologies at this time.

[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

2. Recommendation

While Firms recognize the Basel Committee's desire to eliminate from CET 1 any component that depends on a Firm's idiosyncratic credit spread, the Industry disagrees with the Basel proposal to not recognize any component of the CVA liability (see section on terminology below). We describe below two alternative ways that a component of the CVA liability could be recognized that would not entail a gain in CET 1 from a widening of a Firm's idiosyncratic spreads.

We therefore argue that regulators should delay imposing rules for the capital treatment of CVA until a consensus has emerged as this may lead to the penalisation of approaches that price funding more conservatively and manage funding commitments better. We also believe the Industry should be given more time to devise methods for computing the impact of changes in credit spreads to CVA that would be satisfactory to the Committee.

We recognize that there may be other approaches than the two we detail below. We are committed to continue working with the industry to conduct a review of Industry practice in these areas and welcome further discussions with regulators to identify constructive solutions.

3. Terminology

In undertaking this work we have found a divergence in the terminology used by Firms. We believe that this has been further exacerbated by the language used in the BCBS paper. It would be very helpful to the industry to rationalize nomenclature along the following lines.

The Industry believes that gains and losses which arise from changes in a Firm's own debt referred to herein as Debt Valuation Adjustment ("DVA") are fundamentally different to the bilateral changes which arise in SFT's and OTC derivatives from changes to a Firm's counterparties' creditworthiness, and that of its own. We propose referring to the former as Credit Valuation Adjustment ("CVA") asset and the latter as CVA liability.

We have used the term 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.

4. Analysis of Basel Proposal

In particular our concerns are:

4.1 Uncollateralized OTC derivative liabilities represent a valid, diversified alternative funding source. Firms actively manage this funding source along with their other liabilities. Accordingly uncollateralized derivative liabilities should be treated consistently with other forms of funding:

- At trade inception, there is no reduction in CET 1 capital if a firm issues debt at its own spread, regardless of whether it is accounted for on a fair value or accrual basis. The current approach for CVA liability in capital produces the same result at trade inception. However, the proposed approach of deducting inception CVA liability adjustment is inconsistent with the Basel III treatment of debt issuance and is unnecessarily punitive to the derivative business.

- Post trade inception it is clear that the current approach of not deducting any CVA liability impact from the CET 1 is aggressive relative to the treatment of issued debt held at fair value. However, the proposed deduction is considerably more punitive than for other liabilities and is inconsistent with Basel III para 75 which requires firms to

"only derecognize gains and losses arising from changes in a Firm's credit worthiness". The Basel Committee seems to have done this because they believe the calculation would be more subjective and difficult for derivatives. While solutions may be complex, and complexity may vary from Firm to Firm, we do feel that it is appropriate for Firms to agree with their regulators on a bilateral basis how to comply with Basel III para 75, rather than apply a blanket conservative approach which will introduce distorted incentives (see below).

4.2 We believe the current proposal leads to distorted incentives. A Firm that traded an uncollateralised derivative with a high Expected Negative Exposure at fair value (which we assume includes CVA liability) would suffer an immediate capital reduction, whereas the Firm could avoid the reduction in capital if they changed the terms to make it worse from a funding perspective (e.g. agreed to a one way CSA in which it posts but does not receive collateral). Unless addressed, we believe that trading costs will increase, invariably leading to a reduction in liquidity.

4.3 The pertinence of CVA liability needs to be considered in the context of the valuation of the rest of the balance sheet. The valuation methodologies employed for both collateralized and uncollateralized derivative assets and liabilities, traditionally discounted at Libor, are evolving. If the Firm reflects the cost of funding in the valuation of uncollateralized asset-like derivatives[3] which are funded (at least in part) with uncollateralized "liability-like"[4] derivatives, the Firm would have a strong argument against the deduction of CVA liability.

5. Alternatives

We indicated above our preferred way forward is for the Basel Committee not to make any changes prior to a more fundamental discussion on the topic. It may nevertheless be worthwhile to introduce two different potential alternatives to demonstrate why a single solution is not straightforward. The first alternative is based on a change to the proposed calculation. The second alternative is conceptually more geared to reflect some of the changes that are occurring in the market place and improvements in risk management. We would not like to see a solution being implemented that would undermine such improvements.

5.1 Approach Based on Market Index

One possible approach the industry considered was to calculate CVA liability on the basis of a market index spread (Market CVA liability) – one example would be to use an investment grade corporate CDS spread[5]. Such an approach would include the Market CVA liability in the value of a Firm's capital (which would not widen if the bank's idiosyncratic spread widened). The market index represents 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.

Furthermore, including the Market CVA liability in CET 1:

- 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

[3] We define asset (like) derivatives to be those with a positive MTM currently or in the future

[4] Liability (like) derivatives are those which have a negative MTM currently or in the future. As such they attract DVA.

[5] At present this is a hypothetical construct; the Industry still needs to work on how this might be developed.

valuations incorporate general credit widening, reflected in an index, as well as the idiosyncratic spread of each counterparty)

- Can be considered a prudent measure of a Firm's capital before failure as it can realize a greater value than that amount by either terminating a netting set with a counterparty or by transferring a 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 by the inclusion of the Market CVA.
- Would reduce the volatility of capital during a crisis.
    - If implied volatilities increased both EPE (expected positive exposure) and ENE (expected negative exposure) will increase in magnitude. They would increase because a risk neutral EPE and ENE would be simulated using implied volatilities rather than historic volatilities. A unilateral CVA (i.e. one that only included the CVA asset) would become larger in magnitude as implied volatilities increased, reducing the value of capital (all else held constant). In contrast, the inclusion of the Market CVA liability in CET 1 would reduce the volatility of capital because both the CVA asset and the Market CVA liability would increase in magnitude if implied volatilities increased.
    - Similarly, if general credit spreads widened during a crisis, a unilateral CVA would have much larger change in value than a bilateral CVA that included the Market CVA liability.

In summary, if either implied volatilities increased, or if general credit spreads increased, or both, the inclusion of the Market CVA liability would reduce the volatility of CET 1. In addition, as explained above, the inclusion of the Market CVA liability in CET 1 would be a reasonable and prudent estimate of the value of the derivative portfolio both before failure and after failure, should the latter occur.

5.2 Approach Based on Funding Costs

As mentioned above, the valuation methodologies employed for both collateralized and uncollateralized derivative assets and liabilities, traditionally discounted at Libor, are evolving. The value of a derivative reflects expected (risk neutral) cash flows discounted at the cost of funding and credit risk. If the Firm uses a higher cost of funding than Libor to compute the value of an uncollateralized derivative asset, this will lead to a change in the value through a "funding valuation adjustment" (FVA). This FVA overlaps with CVA liability[6] if a Firm used a cost of funding based on its own bond curve. If the funding cost of the uncollateralized derivative assets are reflected in their valuation, there is a strong argument that the Firm should only deduct the net funding cost/benefit, as they would offset (including from a solvency perspective).

Increasingly, firms are recognizing that uncollateralized OTC derivatives liabilities represent a real funding benefit. Netting CVA liability against funding costs (Funding Valuation Adjustment, "FVA") can be considered to be a measure of the funding benefit of an uncollateralized derivative liability. In other words, if the uncollateralized derivative liability did not exist (or was collateralized) the Firm would have to issue debt to replace the funding.

If a Firm's spreads (and hence the cost of funding used for FVA) increase, both the value of the funding benefit arising from the derivative liabilities (i.e. CVA liability) and the funding cost of the derivative assets (FVA) increase. Therefore, we propose that, if a Firm were to price the funding costs of uncollateralized derivative assets in this way, CVA liability should be deducted only to

[6]This is because both FVA and CVA are modeling the impact of the Firm's (market implied) probability of default; as spreads widen, this both reduces the fair value of uncollateralized OTC derivative liabilities, and, equivalently, reduces the fair value of uncollateralized OTC derivative assets (via FVA)

the extent that it exceeds the increase in FVA. Note that with this proposal there would never be a net increase in capital from an increase in spreads.