

Industry Response to the European Banking Authority on CVA risks

To: The European Banking Authority - Subgroup Market Risk

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This Industry response follows the European Banking Authority's ("EBA") roundtable meeting on Credit Valuation Adjustment ("CVA") risk on May 2, 2012 and reflects the Industry's responses to questions posed by the EBA on proxy spreads and market Loss Given Default ("LGD") which are set out in Appendix One.

The Industry acknowledges that many firms have to create new processes to satisfy the requirements of the advanced charge in terms of assigning proxy spreads to significant numbers of counterparties. For the largest global firms, the number with proxy spreads is between 50% and 90% of the population by number (but not exposure or 'risk'). However, the Industry stresses that Basel III and CRD IV¹ do not support prudent risk management through a risk sensitive CVA-variability charge. The current proposals recognise only a limited range of hedges, and no structural risk mitigants such as parental guarantees.

The Industry believes that the EBA should set out minimum standards around the implementation, governance and degree of challenge to which models should be subject. The proposals should not be overly prescriptive regarding methodology. This is further enforced by the fact that many European firms will apply to their supervisory authority in Q3 2012, and any binding technical standard (BTS) published in September 2012 will be difficult to react to if over prescriptive.

The Industry notes that the EBA intends to recognise proxy spreads that are constructed in a way that is similar to existing Value at Risk ("VaR") practices. The industry notes that the range of counterparties (for example, project finance and special purpose vehicles) is far greater than trading book positions, thus posing technical problems more complex than that dealt with in VaR practices. The Industry's preferred option is for a set of minimum standards that support the existing VaR practices, existing accounting CVA practices, with a stronger support for prudent risk mitigation.

¹ Basel III: a global regulatory framework for more resilient banks and banking systems, December 2010 (Revised June 2011).

On the use and granularity of indices constructed for Accounting CVA purposes, the Industry believes that approximately 600 names are likely to trade with some liquidity. However, assuming an even global distribution and choosing 8 ratings, 3 regions, and 3 sectors, leads to less than 10 names making up an 'index'. The Industry notes and supports the fact that the EBA recognise the issue with statistics drawn from small data sets and are unlikely to recommend a minimum number of indices to tackle this problem.

Regarding proxy spread LGDs, generally historical LGDs are the starting point. There are jurisdictional effects which contribute to the lifecycle of credit, whereby for example, in Poland derivatives in distress are converted to loans, specifically provisioned from the CVA, and then worked out over longer time horizons, whereas in Korea, the lawsuits begin almost immediately as problems arise. These differences are then reflected in risk management practices, and the Industry asserts that it is important for the EBA to support risk management. The Industry proposes to develop the following:

- A paper recognising the relatively small sensitivity the overall equations have to the choice of LGD
- To the extent data can be sourced, plotting a distribution of how far from historical LGDs market participants mark their books in the proxy spread space

Regarding the use of the value at risk (VaR) charge on Current Exposure Method (CEM) exposures for a "limited number of smaller portfolios", the Industry thinks the proposal is wrong, since the choice of exposure metric does not influence VaR performance. The Industry outlines that the metric should be a function of exposure and tenor, not number of portfolios.

Appendix one: EBA's Questionnaire on Proxy Spreads for CVA

A. Data availability

CDS spreads

- How many OTC derivative counterparties do you have as of end of December 2011?
- How many CDS spread curves are available for these counterparties?
- At minimum, how many tenors are required to construct these CDS spread curves?

Other spreads

- For how many counterparties (with no CDS data) do you have bond spread data?
- From what other traded instrument could you derive a spread for the purpose of computing the CVA charge? For how many counterparties is such data available?

- If you use another spread for a specific counterparty, what adjustments would you consider to account for idiosyncratic risk?

B. Construction of CDS proxy spreads in the VaR and EPE

- How do you determine proxy CDS spreads for the VaR?
- How do you determine them for the EPE?
- Does your methodology to determine proxy spreads differ in the VaR and EPE? If yes, in what way?
- Do you intend to use the same methodology (VaR and EPE) for the purpose of determining proxy spreads for the CVA?
- How and how often do you intend to review the appropriateness of the proxy spreads used for the CVA?

C. Construction of proxy spreads based on available single named CDS spreads

- Please explain in detail how you intend to construct proxy spreads.
- Are you using a pool of available single named CDS spreads?
- Will you use separate approaches to calculate proxy spreads according to the size and liquidity of counterparties considered? In particular, how will you treat small or very illiquid counterparties vs larger and more liquid counterparties?
- What minimum breakdown will you be considering for ratings, industry and regions and why? Do you intend to include another dimension (e.g. currency, size of the counterparty)?

D. Construction of proxy spreads based on market indices

- Will you be using market indices to construct proxy spreads, and if so, which ones?
- What will be your selection criteria (i.e. minimum number of CDS spreads available for different tenors)?
- How will you derive a proxy spread for a specific counterparty?

E. Construction of proxy spreads based on an available CDS curve of another entity which has the same region, sector and rating as the proxied counterparty

- Will you be using a CDS curve of another entity which has the same region, the same sector and the same rating of a counterparty with no CDS curve available?
- Do you see the spread of a traded name as a good proxy for a spread of an untraded counterparty?
- In particular, will you make adjustments in this case?

F. Identification of market LGDs

- When credit spreads are available, how will you determine the LGD_{mkt} value for the CVA risk charge?
- In the case of the use of a proxy spread when no CDS curve is available for a counterparty, how do you intend to determine the LGD_{mkt} variable?

G. Application of the advanced CVA method to non-IMM portfolios

- How would you define the criterion of "limited number of smaller portfolios" mentioned in Article 373(4) of CRR?
- Are IMM-banks able to calculate their exposure of IMM-positions using the MtM-method?