Single Rulebook Q&A

Question ID	2013_402
Status	Final Q&A
Legal act	Regulation (EU) No 575/2013 (CRR)
Topic	Market risk
Article	386
Paragraph	3
Subparagraph	N/A
COM Delegated or Implementing Acts/RTS/ITS/GLs/Recommendations	Not applicable
Article/Paragraph	Not applicable
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Disclose name of institution / entity	Yes
Name of institution / submitter	Avantage Reply Limited
Country of incorporation / residence	UK
Type of submitter	Individual
Subject matter	Exclusion of eligible CVA hedges from the specific risk capital requirements (market risk)
Question	When an institution enters into a transaction to hedge the credit valuation adjustment ("CVA") risk on a portfolio of trades with a non-financial counterparty ("NFC") own funds requirements for specific risk, which falls within the scope of the exemption provided under article 382.4.a (i.e., a NFC that is under the EMIR thresholds), can the institution take advantage of the provision of article 386.3 whereby the hedge is exempt from own funds requirements for specific risk?
Background on the question	Article 386.3 provides that "Eligible hedges that are included in the calculation of the own funds requirements for CVA risk shall not be included in the calculation of the own funds requirements for specific risk as set out in Title IV or treated as credit risk mitigation other than for the counterparty credit risk of the same portfolio of transaction." In accordance with Article

	382.4.a, exposures to NFCs that are under the EMIR thresholds are exempt from own funds requirements for CVA risk. However, in line with sound risk management practices, an institution may decide to hedge the CVA risk (e.g., P&L volatility) [as opposed to the CVA risk capital charge which in this case is nil due to the exemption under Article 382.4.a]. The wording of Article 386.3 may suggest that the hedge does not qualify for the exemption from the specific risk capital requirement as the NFC falls under the exemption conditions provided in Article 382.4. If so, the institution would be penalised for implementing sound risk management practices.
Final answer	Article 386(3) of Regulation (EU) No. 575/2013 (CRR) provides that "Eligible hedges that are included in the calculation of the own funds requirements for CVA risk shall not be included in the calculation of the own funds requirements for specific risk as set out in Title IV or treated as credit risk mitigation other than for the counterparty credit risk of the same portfolio of transaction." Accordingly, CDS hedges of the CVA of OTC derivatives not included in the scope of application of CVA own funds requirements, as provided for Article 382(4)(a) of the CRR, shall be subject to the relevant own funds requirements for specific risk as set out in Part Three, Title IV of CRR, unless they are treated as credit risk mitigation for counterparty credit risk as set out in Part Three, Title II, Chapter 4 of CRR. In particular, according to Article 106(3) of the CRR, when an institution hedges a non-trading book credit risk exposure, or a counterparty credit risk exposure using a credit derivative booked in its trading book by using an internal hedge, the non-trading book exposure or counterparty risk exposure shall not be deemed to be hedged for the purposes of calculating risk weighted exposure amounts unless the institution purchases from an eligible third party protection provider a corresponding credit derivative meeting the requirements for unfunded credit protection in the non-trading book.
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