BBVA response to the EBA CP on the draft RTS on the procedures for excluding transactions with non-financial counterparties (NFC) established in a third country from the own funds requirements for CVA risk under article 382(4) of the CRR

Madrid, 5 November 2015

BBVA welcomes the opportunity to respond to the EBA consultation paper on the draft regulatory technical standards (RTS) on the procedures for excluding transactions with non-financial counterparties (NFCs) established in a third country from the own funds requirement for credit valuation adjustment (CVA) risk.

The article 382(4)(a) of the CRR excludes from the own funds requirements for CVA risks transactions with non-financial counterparties (EU counterparties as defined in the article 2(9) in EMIR) or with non-financial counterparties established in a third country, where those transactions do not exceed the clearing threshold as specified in articles 10(3) and 10(4) of EMIR.

The response to Single Rulebook Q&A #2013_472 specifies that the institution itself is responsible for taking the necessary steps to identify all non-financial counterparties that qualify for the exemption… Institutions should define appropriate arrangements with non-financial counterparties to ensure they remain informed of their status as regards the clearing threshold on an ongoing basis.

BBVA considers appropriate the publication of the RTS dedicated to the procedures for excluding transactions with NFCs established in third countries; EU banking group transactions with third country NFCs have characteristics that have to be considered in the RTS:

- Many third country NFCs only transact with EU counterparties on occasional basis; they tend to show reluctance in stating on an ongoing basis their status with respect to a foreign regulation.
- Many transactions are taken through subsidiaries of EU banking groups established in the country of the counterparty. These transactions are not in the direct scope of EMIR, but link of the CVA exemption with EMIR's clearing obligation has broadened the impact of this regulation. Under the current draft RTS, the CVA risk exemption to these transactions would apply only when non-EU counterparties state their EMIR status. In our experience, local counterparties of third-country subsidiaries of EU banking groups are reluctant at any time to provide a statement based on a foreign regulation, as they regard these transactions as fully local.

Therefore, the link between the CRR and EMIR on the CVA risk exemption in transactions with NFCs expands of the scope of transactions impacted by EMIR, affecting even fully local transactions in third countries. The RTS should implicitly recognise that obtaining the EMIR status from NFCs established in a non-EU jurisdiction that are transacting locally is much more difficult that obtaining it from NFCs established in the EU, where EMIR is a local regulation. The requirement to obtain the EMIR status to both types of NFCs is not comparable.

BBVA considers that this RTS has to implement a procedure workable for non-EU counterparties, especially for those that do not deal with EU counterparties but with local subsidiaries of EU banking groups, in order to offer these counterparties a fair treatment and to prevent the disruption of domestic third country markets where the presence of local banks owned by EU banking groups is significant.

QUESTION 1: WHAT ARE STAKEHOLDERS'S VIEWS ON THE PROPOSED INTERPRETATION?

BBVA does not fully agree with the proposed interpretation.

Article 382(4)(a) excludes from the own funds requirements for CVA risk transactions with NFCs, regardless of whether these NFCs are established in the EU or in a third country, **where those transactions do not exceed the clearing threshold** as specified in articles 10(3) and 10(4) of EMIR.

BBVA interprets that the application of the exclusion to a transaction depends on whether this transaction helps to make the non-financial counterparty exceed the clearing threshold. Thus, the exclusion would be applied in two cases:

- To all OTC derivatives with a non-financial counterparty when it does not exceed the clearing threshold at a group level, i.e**. to all OTC derivatives with NFCs qualified as NFC-**.
- **To all OTC derivatives NFCs enter into for hedging purposes**, as there are not included on the calculation to determine whether the clearing threshold is exceed (article 10(3) of EMIR states that "*NFCs shall include all OTC derivatives entered into … which are not objectively measurable as reducing risks directly relating to the commercial activity or treasury group activity…*").

In this second point BBVA disagrees with the proposed interpretation in the draft RTS; BBVA considers that not only transactions with NFC- should be excluded of the own funds requirement for CVA risk but also hedging transactions with all NFCs.

The **EBA** made the same interpretation in its **CVA report** published on the 25 February 2015[1]. In particular, in point 3.1.1 under the title "*Divergences with Basel*", in page 33 the report states: "*CRR article 382(4)(a) exempts from the calculation of the CVA risk charge those 'non-hedging' derivative contracts of EU non-financial counterparties which fall below the clearing threshold. **All the existing 'hedging' derivative contracts are also implicitly exempted** since they are not included in the calculation of the total positions, which the thresholds are compared to*". Next paragraph includes the sentence, "*In short, all the OTC derivative transactions with NFC- are exempted from the calculation of the CVA charge, whereas **only a portion of OTC derivative transactions with NFC+ are included in the scope***".

It is important to highlight the relevance of the EBA CVA report; it is the result of the CRR mandate (article 456(2)) to the EBA to submit a report to the Commission with assessment on the own funds requirement for CVA risk, including (article 456(2)(a)) "*an assessment of the scope of the CVA risk charge including the exemption in article 482*".

BBVA agrees with the EBA interpretation in the CVA report, that all the existing hedging derivative contracts are implicitly exempted, and considers that this interpretation should be maintained in this RTS: article 382(4)(a) exemption should be applied to all derivatives NFCs have entered into for hedging purposes.

On the other hand, BBVA agrees with the proposed interpretation that all transactions with a NFC- are excluded regardless of the inception date of the transaction (which means that when a NFC+ becomes a NFC-, all the existing contracts become automatically exempted from the CVA risk capital charge) and that when a NFC- becomes an NFC+ the existing contracts remain exempt until maturity.

1 https://www.eba.europa.eu/documents/10180/950548/EBA+Report+on+CVA.pdf

QUESTION 2: WHAT ARE STAKEHOLDERS' VIEWS ON THE BURDEN THIS MIGHT CREATE FOR NFCs ESTABLISHED IN A THIRD COUNTRY? WHAT COULD BE A CREDIBLE ALTERNATIVE TREATMENT?

Since the entry into force of EMIR, European entities trading with third country NFCs have seen themselves obliged (in most cases) to explain those third country NFCs the categorization of counterparties under EMIR and how to determine if the relevant thresholds have been exceeded. The aforementioned explanations have normally been requested in order for third country NFCs to represent their status under EMIR. Furthermore, third country NFCs have been generally reluctant to give representations regarding their categorization under a regulation that they are not familiar with and, in many cases they have refused to do it. This problem has led to a situation where the exemption of CVA charge could not be applied due to an administrative burden, even when the counterparty was a small NFC (i.e. a SME) clearly out of the scope of NFC+. In short, this legal exemption is really difficult to be applied due to administrative or formal burdens.

It is also important to note that the problem is even bigger when the client deals with a non-EU subsidiary of the European entity. In those cases, the concerns of the third country NFCs related to making a representation under European law are higher, as none of the parties is European and, consequently, subject to EMIR (but CVA charge would apply on a consolidated basis).

In this context, we believe that the Draft RTS should try to avoid any administrative burdens that, in fact, would lead to the in-application of CRR exemption, and be based on proportional reasonable and justifiable criteria. In this sense, EU banking groups should be allowed to use other information (not only consisting on representations of the EMIR status made by each counterparty) that clearly indicates that transactions are excluded from the CVA charge. For example, EU banking groups should be allowed to exclude all transactions with third country NFCs that are banned from entering into derivatives for non-hedging purposes by local laws, or exclude all transactions with third country NFCs that include a note in their financial statements indicating that all their existing derivatives are for hedging purposes. This would broaden the scope of Article 1 of the Draft RTS; publicly available information and any other information submitted by the counterparty would be allowed to be used not only for classifying a counterparty as NFC, but also to determine whether transactions with the counterparty are subject to the CVA charge (i.e. to determine if such transactions have a hedging purpose).

We also would like to express our concern with regards to Article 2 that establishes that institutions shall "ensure and document" that non-financial counterparties established in a third country calculate their positions in OTC derivative contracts in accordance with the provisions of EMIR. Institutions should not be obliged to make any verification as they will never be in a position to guarantee any calculations made by other entities. The contrary seems to be required in Article 2 when using the word "ensure", which in favor of the legal certainty of EU entities, should be removed. This approach is consistent with ESMA's view reflected in its Q&A document published in relation to EMIR. In particular, in OTC Question 4:

"Responsibility of the FC and NFC Is the FC responsible for assessing whether its counterparty is a NFC above or below the clearing threshold?

OTC Answer 4: NFCs which trade OTC derivatives are obliged to determine their own status against the clearing threshold. ***FCs should obtain representations from their NFC counterparties detailing the NFC's status. FCs are not expected to conduct verifications of the representations*** *received from NFCs detailing their status and may rely on such representations unless they are in possession of information which clearly demonstrates that those representations are incorrect."*

In our view, any additional requirements/verifications would seem disproportionate, extremely burdensome and unrealistic in practice. We would like to stress that European entities cannot

monitor and/or guarantee that their counterparties are calculating their positions in OTC derivatives according to EMIR. We understand that this is not the idea of the Draft RTS, however clarification in this respect would be appreciated.

QUESTION 3: WHAT ARE STAKEHOLDERS' VIEWS ON THE RELEVANCE OF THE INCLUSION OF A SPECIFIC FREQUENCY? WHAT IS STAKEHOLDERS' PREFERRED OPTION?

The procedure EU banking groups should follow in order to determine whether transactions with third-country NFCs have to be excluded from the own funds requirement for CVA risk should take into account that:

- Some OTC derivatives are performed through local subsidiaries of EU banking groups established in third countries.
- Many third-country NFCs only enter into OTC derivatives with EU counterparties on occasional basis.
- All transactions with a NFC- are excluded during the life of the transaction; the exclusion is maintained even if the counterparty later becomes a NFC+.
- All OTC derivatives entered into by NFCs for hedging purposes are implicitly excluded (EBA CVA Report).

Taking all together, BBVA considers that the procedure of information EU banking groups should receive in order to decide whether the exclusion should apply to an OTC derivative transaction should work as follows:

- EU banking groups should **be able to use any information available that clearly indicates that all transactions with a counterparty should be excluded from the CVA charge**, e.g. a local law banning the counterparty from entering in non-hedging OTC derivatives, or the inclusion of a note in their financial statements declaring that all their existing OTC derivative positions are for hedging purposes.
- In case such information is not available, any procedure stipulated in the RTS should be only demanded **at the inception of a transaction** (Option A of the draft RTS),
- It should be **sufficient** for such procedure to cover **any of** the following points:
  - **Whether the transaction is used for reducing risks directly relating to the commercial activity or treasury financing activity of the counterparty (hedging)**
  - **Whether the third-country NFC would be qualified as NFC- if it were established in the EU.**

Allowing third-country NFCs just to state whether their transactions are for their hedging purposes would overcome their reluctance to state their status under a foreign regulation. It would be much easier for EU banks, especially for their local subsidiaries established in third-countries, to receive a valid statement from their non-EU NFCs. It also would prevent the CRR to treat unfairly non-EU counterparties and to disrupt local markets in third-countries whether the presence of subsidiaries of EU banking groups is significant.

BBVA also considers that **this procedure** would **fully respect article 382(4)(a)**, as transactions that do not exceed the clearing thresholds would be fully identified, and that the requirements would be **proportionate** for third-country NFCs that only trade with EU counterparties on an occasional basis or do not trade at all directly with any EU counterparty but with non-EU subsidiaries of EU banking groups.