European Banking Federation

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EBF response to the EBA consultation on CVA treatment under SREP

Key points

1) The proposed EBA guidelines do not fit into the objectives of SREP

We should first recall that the main objectives of SREP under the capital adequacy assessment component are:

- Assessment of pillar 1 risks, under an economic capital framework (based on internal models);
- Assessment of additional capital requirements for other non-Pillar 1 risks, considered material (it is not the case of CVA, that represents a pillar 1 risk);
- Evaluate the controls in place;
- Evaluate the resilience of the capital structure under the forward looking stress scenarios.

In our opinion, the proposed guidelines do not respect these principles as they change the agreed rules of a Pillar 1 risk (e.g. by including Pillar 1 exempted counterparties) for Pillar 2 purposes.

2) The proposed EBA guidelines are not in line with the EU objective of finance and growth

In the regulatory context special consideration for non-financial corporates is not isolated to CVA risk - For most corporates there are no obvious alternatives to the OTC derivative (Over-the-Counter) market. In fact one can argue that the main function of the OTC derivative market is to provide products that are tailored to the specific needs of the end-user. We note that under EMIR these firms (non-financial corporates) may also receive preferential treatment i.e. can be exempt from central clearing and initial margin requirements. This was due to concerns about higher trading costs being forced on corporates, both through the cost of connecting to CCPs (if that were even an option for many) and of having to post margin, noting that many corporates in the OTC market today enter into derivative transactions on an uncollateralised basis. Margin as an alternative simply ties up capital and reduces a corporates investment capacity, and naturally reduces the effectiveness of cash flow hedging. It is also not typically in the best interest of many corporates to hold and try to efficiently manage an inventory of financial collateral needed to meet margin requirements. Hence, there are very good arguments for continuing the NFC exemption why a pillar 2 reversal should be avoided or minimised.

Particular attention should be paid to the intra-group transactions. The competitive edge of EU banking groups would be undermined if intra-group transactions were not exempted. In fact, the application of a CVA capital charge to the intra-group transactions would result in a double counting of CVA risk, seen on entity level, in situations where a group of institutions providing centralised market access through one legal entity is faced with a capital charge for CVA risk for both the external and the internal leg of a derivative transaction. This would imply that this setup requires more capital than if each entity within the group accessed the market themselves directly. Inclusion of intra-group transactions may discourage centralized risk management and is not aligned with consolidated accounting (on a consolidated level, the intra-group exposures should be eliminated).

We question why the exemptions considered as valid under Pillar 1 (e.g. exclusion of non-financial counterparties) are not valid for Pillar 2 purposes. Did the reasons underlying those exemptions when CRR was discussed and implemented have become obsolete? If this is true, the approach should be based on a structural change on Pilar 1 framework and not through a Pillar 2 approach. It is noteworthy that this is an undesired scenario that would represent a huge step-back on the agreements recently accomplished on this matter.

3) The proposed EBA guidelines are likely to erode benefits granted to exempted derivatives end-users, namely corporates and sovereigns

When, in the transposition of Basel III into the CRD IV package, capital charges on the counterparty risk arising from derivative transactions were massively increased, the European legislator decided to exclude from this charge the transactions concluded with "end-users", i.e. corporates and sovereign entities, who use derivatives to protect them against potential adverse moves in currencies, interest rates or other financial variables (cf. art. 382 §4 CRR).

It was also the recognition that, although banks dealing with financial institutions should have a strong incentive to apply strict collateral guidelines, and/or clear through CCPs, these constraints should not be imposed on end-users, given that the limited scale of their derivative business does not justify these heavy infrastructure costs. This exemption was strongly supported by corporates and sovereign debt management agencies.

In that respect, the adverse effects of the EBA guidelines on damaging the EU real economy have been stressed by the European Association of Corporate Treasurers (EACT) in a press release[1] published on 7 December 2015. Also the European Parliament expresses concern[2] that valid exemptions in the European Market Infrastructure Regulation (EMIR) for non-financial companies have been partly undone in the Capital Requirements Directive and Regulation with regard to the application of the CVA charge and calls on the Commission to better perform its role in ensuring consistency in policy approach and outcome across different legislative proposals.

It is now put into question by the EBA since the proposed guidelines define the appropriate CVA risk coverage as being proportional to the hypothetical CVA risk capital re-including exempted names.

4) The legal background of the EBA draft guidelines is questionable

The EBA proposed Guidelines are issued on the basis of Article 456(2) of the CRR. This provision foresees the possibility to amend the CVA risk framework via a delegated act adopted by the

[1] Link to the EACT press release: http://www.eact.eu/docs/EACT-Press-Release-on-Letter-to-EBA-re-CVA-Dec15.pdf,

[2] Link to the EP report: http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A8-2015-0360+0+DOC+PDF+V0//EN

European Commission, with the exception of the provisions excluding certain transactions from the own funds requirements for CVA risk.

Article 456 (2) of the CRR entrusts the EBA with a precise mandate consisting in monitoring the own funds requirements for credit evaluation adjustment risk and in submitting a report to the European Commission by 1 January 2015. The European Commission, where appropriate, will adopt the above-mentioned delegated act on the basis of this EBA report.

Additionally, pursuant to Article 382 (5) of the CRR, the EBA is in charge of conducting a review by 1 January 2015 and every two years thereafter, in the light of international regulatory developments. Pursuant to these provisions, the EBA is solely entrusted with monitoring and reporting tasks. As a consequence the legal grounds, namely Article 456 (2) and Article 382 (5) of the CRR, on which the EBA supports its proposed Guidelines, raise some doubt about the validity of the legal basis of the guidelines.

Furthermore, we consider that the EBA goes far beyond the tasks conferred upon it by Regulation n°1093/2010 establishing the EBA. As a matter of fact, the EBA shall contribute to the consistent, efficient and effective application of the acts referred to in Article 1 paragraph 2 of Regulation n°1093/2010 (including CRR and CRD IV) and to foster supervisory convergence. According to Article 16 of Regulation n°1093/2010, the EBA "shall, with a view to establishing consistent, efficient and effective supervisory practices within the ESFS, and to ensuring the common, uniform and consistent application of Union law, issue guidelines and recommendations addressed to competent authorities or financial institutions". However the proposed Guidelines, whereas they are not legally binding, would actually impose a uniform supervisory benchmark triggering automatic measures consisting in additional own funds requirements in case of excessive CVA risk. By doing so, the EBA is clearly exceeding its missions laid down in EU legislation and is actually acting as a supervisor. As a consequence, article 16 of Regulation n°1093/2010 is proving to be an unsuitable legal basis to adopt such measures.

Sharing the final goal of an enhanced supervisory convergence as the one of the primary tasks granted to the EBA according to Article 20 a of Regulation (EU) No 1022/2013 "The Authority shall promote, within the scope of its powers, convergence of the supervisory review and evaluation process in accordance with Directive 2013/36/EU in order to bring about strong supervisory standards in the Union", the approach proposed as based on a quantitative approach seems to go far beyond enhanced convergence. Indeed, it will vanish the judgement that the supervisor is expected to exercise as part of the Supervisory Review and Evaluation Process. EBA instead of promoting the convergence would lead to automaticity in the supervisory judgement unsuitable for the use of the Pillar 2.

5) The guidelines timeline is controversial

As stated here above, the Basel Committee launched in July 2015 a comprehensive review of the CVA risk framework with the aim of answering shortcoming of the Basel 3 framework. We understand that the EBA is actively contributing to the Basel taskforce reviewing current rules. We believe this work is crucial as more risk-sensitive measures (internal or standardized) are key to an efficient capital ratio.

In addition the European Commission published a statement on December 5th 2014 on Basel Regulatory Consistency Assessment of Basel 3 implementation whereby it recommends addressing the exemption issue within the context of the Basel review: "A second issue that materially affects the overall judgement is the result of certain exemptions from capital requirements for credit valuation adjustment (CVA) risk. This issue should be considered in the light of recent, new discussions in the Basel Committee. At its meeting on 22-23 September 2014, the Committee decided to introduce major changes to the requirements for CVA risk."

In this context, we question the relevance of the timing of the EBA initiative that will lead to banks dealing with potential excessive risk exposures on exemptions granted by a European Legislation and based on rules that are being reviewed because deemed unsatisfactory by the Basel Committee itself.

Identified flaws and expected consequences

We do acknowledge CVA on exempted names is not risk free, should be adequately assessed, monitored and risk-managed. We don't challenge this evidence. However we advocate that the EBA proposal fails this objective and is likely to have detrimental consequences. We finally propose few principles for building a sound CVA SREP framework.

6) A flawed supervisory benchmark

Notwithstanding our above-mentioned concern that defining a quantitative measure of "appropriate risk coverage" in a Pillar 2 framework is questionable, we consider that the proposed supervisory benchmark suffers a major weakness: It is based on a hypothetical risk measure disconnected from economic risk truly incurred and monitored. CRD IV Article 73 explicitly requires banks to ensure "the risks to which they are or might be exposed" are adequately covered by capital. The economic risk that needs to be monitored and adequately capitalized as part of ICAAP arises from accounting CVA variability. This is because the fair value adjustment accounting for the cost of counterparty risk embedded in the price of a derivative is accounting CVA not regulatory CVA.

The Basel Committee, in its first consultative paper on the review of the CVA risk framework , acknowledges the current Basel 3 regulatory CVA is ill-defined and outdated since one of the objective of the on-going review is to better align regulatory CVA with accounting CVA: "The current regulatory CVA formula used in the Advanced Approach does not incorporate many of the hedging strategies banks now employ under various accounting regimes, particularly with regard to the market risk drivers of CVA, and has thus become outdated."

All in all, we firmly believe the proposed supervisory benchmark is flawed whatever the calibration of the "y" parameter because it solely relies on the theoretical concept of regulatory CVA, a concept that is outdated and disconnected from economic risk.

We note that the proposed supervisory benchmark actually goes beyond Basel 3 requirements with the inclusion of intragroup transactions in the hypothetical own funds requirements for CVA risk. Indeed, the Basel Committee clarified in FAQ 2e.1 of the Frequently asked questions on Basel III counterparty credit risk that intragroup transactions are not in the scope of the CVA capital charge: "As per the group consolidated reporting, no regulatory capital charge (including a CVA charge) applies to intercompany transactions". We are concerned that the EBA is taking an overly conservative stance with respect to the definition of the appropriate level of risk coverage.

7) Expected consequences

- **A disincentive for end user sound risk management practice:**

The EBA guidelines will increase the cost of derivatives for end users (corporates and sovereigns counterparties) entering into these instruments for hedging purpose. Indeed the poor calibration of the Basel 3 CVA risk capital charge -that is used as the base for the EBA guidelines- leads to punitive capital cost for uncollateralized derivatives. Many end users of derivatives can't -for operational reasons or more fundamentally for lack of access to liquidity- collateralize their derivatives transactions. This was acknowledged by the European Market Infrastructure Regulation that exempts corporates using derivatives for hedging purpose from clearing obligation.

However by facing much higher costs for entering new hedging transactions due to the EBA guidelines end users will be left with an unpleasant dilemma:

a) Keep using derivatives for hedging purpose thus increasing the cost of producing goods, impacting their competitiveness and ultimately passing this incremental cost to consumers; or
b) Stop using derivatives and effectively keep the market risk on their balance sheet. This would make them riskier, leave them exposed to market movements and potentially hamper their operations.

- **An incentive for banks to use Credit Default Swap and the negative feedback loop it may create for bonds primary issuance by corporate/sovereign:**

The Basel 3 CVA risk capital charge is fully calibrated on inputs coming from the Credit Default Swap market. The fully market driven nature of the charge gives a strong incentive to banks to use credit default swaps in order to mitigate its volatility that would not be sustainable in a stress period. Given the lack of depth of this market that has been shrinking over the last few years, there is a genuine risk that a surge of protection buyer -banks hedging the CVA risk capital charge- will push CDS levels higher and feed into the level at which corporates and sovereigns borrow money in the bond market. This negative feedback loop phenomenon would make it more expensive for end users to finance their operations and is of a particular concern in period of stress where raising money could become extremely difficult and costly.

- **A reliance on the Credit Default Swap market for sovereign exposures that is at odd with EU position:**

Numerous sovereigns, especially in Europe, have been and keep on using derivatives to actively managed public debt and in most cases these derivatives exposures are not collateralized (or collateralised under "1 way" arrangements where the sovereign is receiving collateral but never posts, or sometimes posts non-eligible own asset collateral) thus creating potentially large exposures for banks. The incentive for banks to use credit default swaps to limit the volatility of the Var on CVA capital charge will be particularly acute on these derivatives exposures. Indeed given the procyclicality nature of the Var on CVA capital charge, exposure to sovereign counterparties will clearly be more prone at creating large volatility of banks capital base and so are likely to be a priority in terms of hedging and risk management with Credit Default Swaps. The European sovereign crisis highlighted the contamination risk towards other sovereigns and banks that an unbalanced risk appetite in the credit default swap market may create. This was the very reason the European Union decided to curb their use and introduced rules to ban "naked" credit default swap end of 2011. We believe that the removal of sovereign exemptions from a Var on CVA risk solely calibrated on the Credit Default Swap market will send the wrong signal and will be at odd with the position of the European Union vis-à-vis the use of these instruments to manage sovereign risk. In periods of intense market turmoil, restraints in the supply of hedging products could occur, with a potential impact on both financial stability and EU 28 fiscal deficits.

- **Some banks exiting the derivatives business with corporates/sovereigns leading to a less competitive offer:**

As mentioned previously the EBA guidelines will push banks to use more credit default swaps in order to limit the volatility of their capital base. However many corporates –in particular SMEs- do not have active CDS and so the variability of the related CVA capital charge can't be hedge properly by banks. This will surely encourage some banks to limit or even suppress their offer of derivatives products to this client category. As such SMEs would be left with less bank counterparties willing to enter hedging derivatives transactions and a less competitive market that will ultimately lead to less favourable economic terms

Due to heavy wave of regulation in Europe, we notice that banks are announcing their willingness to reduce their derivatives activity in particular with counterparties not traded under a collateralization agreement. Imposing an additional CVA risk capital charge ill-calibrated is likely to accelerate this trend and leave end users with limited options.

8) Principles to be put forward

As a preliminary remark, we would deem essential to recall that supervisors in Europe, including the ECB, have broad powers under respectively Article 104 of CRD IV and Article 16 of Council Regulation No 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, to impose on institutions to hold additional own funds if a risk is not sufficiently covered by prudential requirements under CRR. Therefore we do question if EBA would act within its powers in designing a supervisory pattern which would vanish the correct supervisory assessment of each business model in order to define the right level of capital add-ons to address an excessive CVA risk.

Now, should the EBA still deems necessary to introduce quantitative benchmark in its CVA SREP guidelines, we argue that any proposal should not aim at substantially eroding the exemptions granted by the CRR but rather at putting forward common principles for a sound evaluation of internal capital adequacy assessments.

As stated before, on the one hand, we agree that CVA on exempted names is not risk free but on the other hand we consider that regulatory CVA fails to adequately reflect the risk incurred. In other words, we agree the importance of making sure no excessive risk is held for CVA risk. In that respect, the Internal Capital Adequacy Assessment framework of each bank should provide an integrated view of all risks and as such should be assessed on the full OTC derivatives perimeter (including on exempted names). We disagree to use a portion of the Basel 3 capital measure as the reference point.

One key objective of the CVA SREP should be to assess whether a bank's ICAAP for CVA risk is sound, reliable and exhaustive. We deplore the lack of consistency between the supervisory benchmark (based on regulatory CVA) and what should be the outcome of a sound ICAAP (i.e. based on accounting CVA).

Should the EBA finally retain the principle of a supervisory benchmark, we recommend that such a benchmark relies on accounting CVA not regulatory CVA.

European banks are subject to a strict regime of prudent valuation including on CVA risk. Additional value adjustments are to be deducted from CET1. There is in theory no overlap between Additional Value Adjustments that aims at capturing the uncertainty of the CVA at a given point in time and the CVA risk charge that aims at capturing the uncertainty of the CVA variation. Both measures are defined at a high confidence level (respectively 90th and 99th) and directly affect the solvency ratio. In practise, we argue that there is a risk of overlapping between both measures if not implemented consistently with one another. It is well established that CVA is not observable in isolation in the market, and overlaps with many other fair value elements, which is at once the consequence and reason for the diversity of approaches highlighted in the February 2015 EBA report on CVA". This economic fact is the reason for which it is difficult to have fully distinct approach for CVA variability and its Prudent marking. In our view, a fully distinct approach mechanically leads to undue capital layers. If the aim of the guidelines is to ensure sound and harmonized supervisory approach to CVA risk, it must take into consideration the current ability of entities to observe the market, the exact models and the potential for overlap between the Prudent Value charge and the CVA capital charge.

Finally, we are concerned that a strict application of the SREP guidelines could render SREP processes systematic and inappropriate. A "one-fit-all" process is likely to jeopardize the relevance of supervisory reviews because it will fail to capture special situations. We strongly believe that supervisors must keep the ability to appreciate specific cases and take customised remedial actions different from those enclosed in the guidelines if deemed necessary.