

## **EBA Guidelines on CVA Risks Will Likely Result in Negative Consequences for the Risk Management of Non-Financial Companies**

German non-financial companies concerned about the erosion of the CRR/CRD IV by Supervisory Guidelines

## Summary

On 12 November 2015 EBA issued the draft Guidelines on the treatment of CVA risk under the supervisory review and evaluation process (SREP) (EBA Guidelines). The draft guidelines follow the EBA report on the credit valuation adjustment provisions according to the Capital Requirement Regulation as of February 2015 (EBA Report). This report was commented on by Deutsches Aktieninstitut<sup>1</sup> in order to summarize the concerns of German non-financial companies about a possible de facto removal of the exemption of Art. 382(4)(a) CRR from CVA capital requirements for derivatives with non-financial counterparties (NFCs).<sup>2</sup>

Our general concerns from our previous position paper remain. We are still of the opinion that the EBA Guidelines should not cover transactions with NFCs exempted under Art. 382(4)(a) CRR.

The concern of non-financial companies persist, although EBA states in the proposed Guidelines that it is mindful that the additional own funds requirements for the CVA risks from transactions with NFCs that may be imposed on banks following a SREP assessment should not simply replicate fully or substantially the hypothetical own funds requirement for CVA risks that would have been imposed on European banks if the CRR exemption did not exist.

In general, we would like to reinforce the following arguments that we have already laid down in the consultation process last year as well as in the open hearing on 27 January 2016.

### **Erosion of the explicit exemption from capital requirements under CRD IV following an SREP assessment is legally questionable**

From a legal point of view it is questionable if Art. 104(1) of the CRD IV can be used to counteract exemptions from capital requirements that have explicitly been granted under the CRR after a long political process. According to Art. 382(4)(a) CRR banks do not have to allocate capital for CVA risks deriving from positions with

<sup>1</sup> Deutsches Aktieninstitut (EU transparency register: 38064081304-25) represents the entire German economy interested in the capital markets. The about 200 members of Deutsches Aktieninstitut are listed companies, banks, stock exchanges, investors and other important market participants. This position paper is based on discussions in the corporate finance/corporate treasury working group which is the central forum of opinion building for the treasury departments of the biggest German non-financial companies in the German market.

<sup>2</sup> Deutsches Aktieninstitut, Briefing Note on EBA Report on CVA, 4 May 2015

non-financial counterparties, provided the relevant non-financial company has not crossed the clearing threshold of EMIR which has been introduced in order to ensure consistency with the EU Derivative Regulation EMIR and in order to avoid negative consequences for the risk management process of NFCs (see below).

We are, therefore, worried that the EBA draft Guidelines de facto neglect the political will behind the CRR exemption – at least partly. This political will has been reinforced by the European Parliament several times since CRR/CRD IV was published in the official journal. In their reaction to the Basle Committee's review on the implementation of Basel III members of all parties in the European Parliament articulated concern about interventions from international bodies into the EU legislative process.<sup>3</sup> In a similar way, ECON recently expressed concern that valid exemptions in EMIR could be partly undone in CRR/CRD IV 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.<sup>4</sup> Thus, the issue of the CVA exemption should also be regarded in the context of the general debate on the division of labor between the EU co-legislators and the supervisory authorities.

### **Economic and political rationale of the exemption should be recognized**

Besides the legal basis we would like to remind EBA on the economic and political rationale why the legislator decided not to establish a CVA capital requirement for derivatives of certain NFCs.

This was decided after rightly recognizing the fact that the derivatives portfolios of NFCs typically have a low risk profile because they are simply mirroring “real economy” business, thereby actually stabilizing the overall risk profile and creditworthiness of the companies themselves. When the market value of the derivative of an NFC turns negative, the hedged position on the company balance sheet (typical example: foreign currency receivables from export) increases in value. Accordingly, an unhedged NFC poses more counterparty risk to banks, bondholders and stockholders than a hedged one. This has also been acknowledged in the IFRS accounting standard IAS 39 for hedge accounting.

Last, not least, the CVA exemption of Art. 382(4)(a) CRR is the logic equivalent to the clearing exemption under EMIR. There was the clear political will not to undermine the EMIR exemption (and the cost savings related to it) through higher capital charges on exactly the same derivative contracts.

<sup>3</sup> Reaction to the opinion of the Basel Committee on CRD 4, 5 December 2014, <http://www.europarl.europa.eu/news/iv/news-room/20141205IPR82904/REACTION-TO-THE-OPINION-OF-THE-BASEL-COMMITTEE-ON-CRD-4>

<sup>4</sup> Committee on Economic and Monetary Affairs, Report on stocktaking and challenges of the EU Financial Services Regulation: impact and the way forward towards a more efficient and effective EU framework for Financial Regulation and a Capital Markets Union (2015/2106(INI)), 9 December 2015.

The consequence of even partly removing the CVA exemption would, hence, be a devaluation of the EMIR exemption so that less financial market risk would be hedged and instead ultimately be borne by NFCs – a consequence that cannot be in the interest of the European Union.

Furthermore, NFCs might decide to collateralize their derivative positions in order to avoid additional CVA charges. This, however, would not be possible without additional funding sources because contrary to banks NFCs usually do not have large financial assets on their balance sheets that could be used. Such additional funding will have to be raised in the banking sector. As a consequence, the counterparty risk will not diminish but simply change its nature – from counterparty risk stemming from derivative positions to counterparty risks stemming from financial (debt) positions.

### **Proposed Guidelines may be less proportionate than EBA appears to expect**

We generally acknowledge that EBA aims at a proportionate approach that reduces the number of banks affected and leaves a certain degree of discretion to national supervisory authorities whether and to which extent additional CVA capital requirements would be imposed to banks.

However, we are concerned that the approach will turn out far less proportionate than argued in the consultation paper for several reasons:

Firstly, some important elements in the proposal still need to be calibrated, so that NFCs are not yet able to assess the exact consequences. The tables presented in the preliminary assessment show that the impact may dramatically vary depending on the calibration. We would, therefore, call for sizeable thresholds that retain the existing exemption.

Secondly, we expect most of the bank counterparties that currently enter into uncollateralized derivative positions with NFCs to have relevant CVA exposures according to the proposed relevance test. Also for the significance test EBA data suggests that 50 to 75 percent of the banks will be faced with additional requirements.

If we further assume that uncollateralized derivative transactions with the real economy are rather the business of the larger banks, we expect that most of the relevant counterparties will be negatively affected. In other words: Even if the approach may appear proportionate because EBA excludes banks with smaller portfolios or smaller CVA exposure from additional requirements, it may result in less proportionality in practice for NFCs. Corporate treasury business is mostly done with large international banks, which are able to offer the widest product

range. Smaller local banks neither have the balance sheet nor the expertise to be a major corporate counterparty.

Thirdly, although we appreciate that national competent authorities will have a certain degree of discretion in applying the Guidelines to supervised banks, we expect that the qualitative and quantitative elements will rather serve as a bottom line in supervisory practice because competent authorities may be afraid of being blamed for non-compliance. We are also concerned that risk mitigating factors such as a higher degree of granularity in the derivative positions with NFCs and the variety business models of the NFCs as well as the different nature of the specific counterparty risk in question (no systemic relevance, underlying is “real economy business”) will de facto be disregarded in calculating potential CVA requirements.

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The remainder of this position paper lays down our arguments in detail and briefly answers the questions of the consultation paper.



## 1 Rationale of the CVA exemption of Art. 382(4)(a) CRR

### Consistency with EMIR

The “European Market Infrastructure Regulation” (EMIR) exempts derivatives of non-financial companies from the clearing obligation, provided these derivatives are used for hedging purposes, or do not exceed certain thresholds. This exemption for non-financial companies (NFCs) is reflected in Art. 382(4)(a) CRR. It has been politically acknowledged that it would be counterproductive to establish a CVA capital charge for derivatives of NFCs because this would clearly increase the costs of hedging for NFCs since banks would pass on the additional regulatory costs to the end users. During the debate on the CRR, a group of 17 large and medium-sized companies organised within Deutsches Aktieninstitut estimated additional costs of 124 to 186 million Euros p.a. for them alone, depending on the capital costs of the counterparty banks.

Unfortunately, we are not able to recalculate the expected impact of the proposed Guidelines on the basis of the consultation paper. However, as pointed out above we expect that all relevant counterparty banks that enter into uncollateralized derivatives with NFCs would be faced with additional capital requirements following a SREP assessment. The preliminary assessment of EBA suggests that additions may result in additional CVA requirements of up to 65 percent (table 4), with individual banks facing additional requirements of 1.000 percent. That would be a significant erosion of the relief provided in the CRR.

### No systemic relevance

As derivatives used by NFCs are in general linked to commercial or treasury financing activities, such derivatives do not pose additional risks to the economy as a whole. A negative market value of the derivative is widely offset by a positive performance of the underlying exposure from operative business (and vice versa). The total risk arising from that constellation is almost zero, making these exposures a form of “right way risk”.

The following example illustrates this fact: A FX derivative to hedge USD revenue against a depreciation of the USD stabilises the Euro revenue of the NFC, because it protects the company against erosion of the value of their accounts receivables. If however the Euro depreciates against the USD, the derivative will have a negative market value from the NFC's perspective and, thus, will create a counterparty risk for the bank from the derivative. As in this case the book value of the NFC has

improved because of the positive exchange rate effect, the change in counterparty risk for the bank in reality is neutralized.

In addition, even the empiric evidence provided by EBA in the report on CVA Risks issued in February 2015 demonstrates the low level of CVA risks of NFCs: CVA losses due to NFC exposures were negligible during the financial crisis in comparison to other counterparties. Table 7 (p. 25) of the report reflects this fact very well as it demonstrates that CVA losses were highly concentrated in exposures to monoline insurers' structured credit instruments and highly speculative ABS (ca. 73% of the breakdown table). It is important to note that these types of investments have been rather uncommon in the corporate sector. Categories of derivatives frequently used by NFCs (such as FX derivatives and interest rate derivatives) have, in contrast, suffered only minor losses (ca. 2% of CVA losses).

For Deutsches Aktieninstitut this evidence is no surprise if you bear in mind the specific nature or counterparty risks related to derivative transactions with NFCs. In addition to the points mentioned above the counterparty risks of NFCs are very heterogenous which is very unlike the nature of the risk exposures with monoline insurers. This heterogeneity rests on both the variety of the business models and sizes of the NFCs. Competent authorities should recognize this fact not only in the Guideline but also in later practice.

### **CVA losses are book losses**

In addition to the previous argument the EBA Report issued in February 2015 argues that the exemption creates a mismatch to the treatment of CVA risks in accounting (p. 50ff. as well as p. 58f.). While this observation seems correct on a stand-alone basis, EBA further seems to give the incorrect impression (at least between the lines) that CVA losses always materialise. This is not true outside accounting logic, though. As long as a counterparty does not default, banks will not lose "real" money from a derivative transaction with a positive market value from the bank's perspective. The default risk is, however, already buffered by bank capital. Even the EBA Report concedes that most banks would still have compliant CET1 ratios would the exemptions be completely lifted. Not surprisingly losses due to counterparty defaults in the abovementioned table presented in the EBA Report added up to only 3% of total CVA losses.

An additional thought: CVA pricing is supposed to reimburse a bank for potential costs resulting from a negative development of the market *perception* (!) of its counterparties' solvency. However, if that perception turns positive over the life of the transaction, only the bank will book a profit.



## Risk contribution of liquidity lines

The proposed Guidelines will make the use of uncollateralized derivatives more costly. EBA appears to take it for granted that uncollateralised derivatives pose a higher risk for banks and thus are particularly problematic and implicitly gives the impression that collateralised derivatives are always preferable from a systemic risk point of view. Though this may be true if only the derivative position is taken into account, it is not true if the risk position of the banking system in total is regarded.

In contrast to banks NFCs typically do not have liquid assets available that can serve as collateral in a derivative transaction. Thus, the posting of (cash) collateral needs to be funded by NFCs, typically by agreeing cash facilities with banks that can be drawn in case the posting of collateral will be necessary. The provision of these cash facilities/credit lines, however, creates another layer of counterparty exposure for the providing bank. The only change might be that different institutes are concerned.

In essence, transforming uncollateralised derivatives with NFCs into collateralised ones would not improve overall counterparty risks for the banking sector. The counterparty risk will simply take another form – instead of counterparty risk from a derivative exposure banks will face a counterparty risk from financing facilities they are providing for NFCs.

In addition, the forced collateralization of derivatives will create a liquidity drain going beyond the expected average of market value moves, as a prudent corporate treasurer would put aside “oversize” credit lines for this purpose which can even accommodate extreme market conditions as seen in the financial crises. The reason is that once such a situation occurs, it will be difficult to impossible to source additional liquidity. Hence, blocked liquidity would tend to be higher than the cash flows from compensating operative business on the balance sheet, which makes even less sense economically. Should companies on average not take this into account, a period of market stress could actually throw some into insolvency - which would rather not happen if exposures remained uncollateralized. As mentioned above, EBA's own analysis of financial crises has shown that “real economy” derivatives (interest rates, F/X) have only been 2 percent of the total CVA losses in the financial crises. Thus, contrary to the intent, the effect of collateralization could be less economic stability in the corporate sector due to additional cash requirements for collateralization over the life of derivative contract.

## Implications of EBA's proposed Guidelines

A (partial) removal of the exemption of Art. 382(4)(a) would always result in a significant increase of hedging costs and consequently always limit the real economy's ability to hedge against financial risks stemming from commercial and

treasury finance activities. Accordingly, the volume in hedging operations is likely to decrease – either because costs are deemed too high by NFCs or because of banks' refusal to trade with low rated companies. As a result, financial market risk would increasingly have to be borne by NFCs if the exemption was really removed – a result that cannot be in the interest of the European Union and exactly the result the legislator wanted to avoid by granting the exemption.

As pointed out above we expect the most relevant international bank counterparties to be negatively affected by the proposed Guidelines. Consequently, even though the Guidelines may be proportionate regarding the number of banks affected, this is definitely not from a NFC's point of view. The negative effect would concentrate on NFCs that have a high credit standing so that they currently do not need to collateralize their derivative transactions.

## 2 Responses to the Questionnaire

**Question 1: Do you agree with determining relevance of CVA risk by means of assessing the size of an institution's derivative business using the exposure value for non-QCCP cleared derivatives transactions?**

See question 2.

**Question 2: What are your views on how Threshold 1 should be calibrated?**

As the highest relevance thresholds EBA is willing to consider is 150 mln EUR, we expect that most if not all of the relevant international counterparty banks will cross that threshold. This is why we are of the opinion that the relevance test may only be proportionate with a view on the banking industry as a whole but not with regard to a NFC's perspective of limited counterparty choices in practice. Not all banks are able to offer the full range of products these companies require. If EBA sticks to the idea to cover transactions exempted under Art. 382(4)(a), we suggest to significantly raise the threshold.

**Question 3: Do you agree with determining relevance of CVA risk by means of assessing the share of own funds requirements for CVA risk to the total risk exposure amount?**

See question 5

**Question 4: Do you agree with the approach provided for the determination of materiality of CVA risk?**

See question 5

**Question 5: What are your views on how 'x%' (Thresholds 2 and 3) should be calibrated?**



Unfortunately, NFCs are not able to assess how many banks will cross the x%-threshold depending on how it will be calibrated.

However, we are generally of the opinion that EBA should introduce sizeable thresholds to maintain the existing exemption of Art. 382(4)(a) CRR. Otherwise, we would expect that most if not all of the relevant international counterparty banks will pass the x%-threshold. This is why we are of the opinion that the materiality test may only be proportionate with a view on the banking industry but will not be proportionate from a NFC's perspective.

**Question 6: Do you agree with the scope of derivative transactions to be included into the calculation of hypothetical own funds requirements for CVA risk?**

No. We are of the opinion that at least derivative transactions with NFCs exempted by Art. 382(4)(a) CRR should be out of scope. The economic and political rationale of the exemption would otherwise be neglected.

**Question 7: Do you agree that intra-group derivatives transactions should be explicitly included into the scope of calculation? If not, what do you think could be a credible alternative treatment of the CVA risk of intragroup transactions?**

**Question 8: Do you agree with the approach provided for the determination of supervisory benchmark for material CVA risk?**

We basically appreciate EBA's proposal that only a certain share of the full additional hypothetical own funds requirements should be applied to banks with significant CVA exposures. In case the EBA sticks to the proposal also to include derivative transactions of NFCs, we propose to calibrate the y%-threshold so that the existing exemption prevails.

However, we would also like to reiterate our view that the nature of risks relating to derivative exposures to NFCs differs from other counterparty risks (right way risk, heterogeneity of business models, granularity of exposures, no systemic importance, low default rates even in the financial crisis, please compare introductory comments further up) that justify the exemption and should be taken into account by supervisory authorities when using discretion under the Guidelines.

**Question 9: What are your views on how 'γ%' (Threshold 4) should be calibrated?**

See question 8

**Question 10: Do you agree with the approach provided monitoring of CVA risk by competent authorities and EBA and data to be provided to competent authorities for this monitoring?**

**Question 11: What is your view regarding the potential burden of computing hypothetical own funds requirement for CVA risk at the same frequency as the regulatory CVA VaR and Stressed VaR figures?**



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