May 9th, 2019

Mr. William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Subject: Industry Concerns with the Revised CVA Framework

Dear Mr Coen,

With the Basel III framework now finalized following the recent publication of the Market Risk standards[1], we are writing to bring your attention to concerns[2] on the impact of the revised Credit Valuation Adjustment (CVA) Framework.

We continue to fully support the objectives of the Basel Committee on Banking Supervision (BCBS)'s CVA reform to capture all CVA risks and gain better recognition of CVA hedges. In this regard, we think it is important to highlight areas of material deficiencies of the CVA framework and provide data in support of the issues and recommendations wherever possible.

Recent analysis[3] conducted by the industry highlights specific design issues that we strongly urge are addressed as part of the upcoming alignment of the CVA standard to the updated market risk requirements. Industry QIS data analysis demonstrates that the final CVA framework will result in a substantial increase in capital requirements of €238 billion (77% increase) in Risk Weighted Assets (RWAs) equating to €19 billion in regulatory capital for participating banks in the study - despite the intended objective of not significantly increasing overall capital requirements. This is due in large part to a decrease of efficiency in the revised CVA framework for index hedges compared to the current existing approach. Indeed, the recognition of index hedges is less than 50% in the new CVA requirements compared to the current rules.

The industry has been working on analyzing the revised CVA framework and produce recommendations to address the issues identified. In that regard, the industry has interacted

[1] https://www.bis.org/bcbs/publ/d457.htm

[2] Such concerns have not been raised in the 2015 consultation process due to the final framework only keeping the Standardised Approach in the CVA rules and removing the Internal Model Approach. Therefore this letter focuses on the impact created from the new framework resulting from the 2017 publication of the CVA standard.

[3] The study has analyzed data submitted by 17 G - SIBs and internationally active banks based in Europe, the United States, Switzerland and Japan. All data submissions were completed on a best - efforts basis, reference date June, 2018.

recently with the Market Risk Group to present its preliminary findings, including the results of the QIS data analysis.

While CVA does not constitute a large portion of overall capital requirements, it is a significant RWA driver for derivatives, which are important tools for end-users' ability to hedge their risks. Most importantly, the industry study found that the new framework's treatment of CVA credit hedges provides perverse incentives for banks to leave positions unhedged. That is due to capital requirements for hedged positions being close to, or even greater than equivalent unhedged positions, therefore creating a gap between sound risk management practices and regulatory capital requirements. This is an important issue the industry feels needs urgent attention before the rules are implemented.

We believe it is equally important that the alignment between CVA and FRTB should be addressed in a consultation targeted at sections of the CVA framework as highlighted in this letter. This is to ensure the coherence and soundness of the rules[4] in light of the stated objectives and avoid unintended capital impact for derivatives business.

In our view such a targeted consultation would not call into question the readiness of regulators and the industry to implement the required changes in line with all other components of the Basel III regulatory reform package.

CVA framework issues

Following the publication of Basel III: Finalizing post-crisis reforms, the industry conducted a QIS in the second half of 2018, finding that implementation of the framework would lead to a significant increase in capital requirements relative to the current framework. The industry analysis finds that the overall capital requirement under the revised CVA approach is on average 1.77 times the capital requirement under the current approach[5]. As part of the QIS analysis, industry also assessed the impact of carrying over the revised Standardized approach risk weights for interest rates (IR) and FX from the updated market risk standards to the CVA framework. We found that this risk weights alignment alone (for FX and IR only) does not address the punitive impact of the revised CVA framework (80% of the contribution derives from Counterparty credit Spread Risk). In particular, the main cause behind this is an excessively conservative overall calibration mainly due to:

- A poor recognition of counterparty credit spread hedges and;
- The significant gap between accounting CVA and regulatory CVA.

A bank's CVA portfolio consists generally of a wide range and diversified set of counterparties where single name CDSs for each of the components do not necessarily exist in the market. Therefore the use of proxy hedges (single names or indices) is very important for CVA risk to

[4] We are encouraged in this regard by the recent consultation by the Basel Committee on the consolidated Basel framework: https://www.bis.org/bcbs/publ/d462.htm

[5] After re-integration of exempted trades (advanced and standardized approaches).

mitigate systematic credit spread risk. In the revised SA-CVA approach, index CDSs are decomposed into a collection of single name instruments and allocated across buckets.

However, treating an index CDS hedge as a selection of single name hedges is inconsistent with the economic purpose of index CDS hedges (which is to hedge systematic credit spread risk) and therefore does not account appropriately for this particular aspect of CVA hedging in cases where the assumed hedged CVA positions are allocated in different buckets.

Importantly the poor recognition of CVA hedges can create perverse incentives for banks. Due to the lack of hedges recognition and resulting CVA capital impact, they may opt to leave positions unhedged thereby incurring potentially more risk for clients. They also might be required to increase prices on transactions which would as a result limit end-user counterparties' access to derivative products and their risk management abilities. We believe this was not the intention of the regulators and that it represents the type of unintended consequences that the BCBS has committed to review when evaluating the effectiveness, interaction and coherence of its reforms.

In addition there remains a significant gap between accounting and regulatory CVA calculation. While we understand that the Basel standards are intended to represent prudent practice in the calculation of CVA for economic purposes, they do not represent the exit price that is recognized by firms. We understand that prudential regulation is designed to be conservative but the misalignment between regulatory and accounting CVA, which does not properly reflect current market practices and newly implemented regulation (for e.g. the uncleared margin requirements), can have adverse consequences. This can further exacerbate the issue of poor recognition of hedges in the framework, and as a result drive further the capital impact, as banks would be in the position of dealing with inconsistent logic in hedging accounting and regulatory CVAs.

Potential alternatives and solutions

Given the issues identified, the industry is focusing its efforts on proposing viable solutions with particular attention paid to addressing the issue related to the poor recognition of CVA hedges. The following recommendations should offer simple modifications in the CVA standard, building on concepts already existing within the market risk framework:

- Make the necessary changes to hedge recognition to better capture the benefits of hedging the systemic risk of a typically diversified CVA portfolio. Consistently with the FRTB framework, the CVA rules should offer the option to assign indices to separate counterparty credit buckets alongside with an appropriate correlation across buckets. This constitutes a crucial point where specifically the market does not offer enough single name CDS and bank guarantees as an alternative to CVA hedges via proxy instruments. Furthermore, the industry is also assessing further fundamental proposals which could guarantee an accurate risk-sensitivity in the framework.

- Adjust framework parameters (mainly in relation to the imposed MPOR and LGD) and scope (SFTs) to enable more convergence between regulatory and accounting CVA. This becomes even more important considering the uncleared margin requirements which should mitigate counterparty risk exposure (and consequently leads to less CVA risk) during the close-out period.

In formulating these proposals, the industry adopted the following principle: improve proxy hedging recognition across illiquid and liquid counterparties; capture systematic correlation across buckets and improve the consistency with the design of the market risk framework (FRTB).

Conclusion

When finalizing the post-crisis reforms in December 2017 the Basel Committee stated that one of the three overarching principles which guided the reforms was that the Committee actively seeks the views of stakeholders when developing standards.

We commend the Basel Committee's efforts to engage with stakeholders and believe that future modifications to the CVA rules including aligning with FRTB should be subject to a consultation allowing an open process by which the industry can provide views and evidence. We continue to believe that a strong, evidence-based dialogue between the private sector and the regulatory community is of great importance in order to develop robust global standards. We strongly welcome the commitment from the Chair of the Financial Stability Board (FSB) to improve communication and transparency[6] with external stakeholders and facilitate greater input from a wide array of stakeholders. In this regard, we would value the opportunity to continue our interaction with the Basel Committee on the CVA framework.

The industry considers it crucial the proposals herein be taken into consideration in the context of a targeted and specific review of the CVA framework and transposed in the Basel III final standards in order to improve the effectiveness of the revised CVA framework and help ensure a level playing field in the counterparty risk space via a consistent transposition into regional and national laws.

We remain committed to assist the BCBS on the above topics, and stand ready to provide further evidence, technical solutions and alternatives as needed to ensure that the revisions meet the intended objectives.

Yours sincerely,

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International Swaps and Derivatives Association, Inc. (ISDA)

Allison Parent
Executive Director
The Global Financial Markets Association (GFMA)

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Deputy Director, Regulatory Affairs Department
Institute of International Finance (IIF)

[6] http://www.fsb.org/2018/11/fsb-completes-a-review-of-its-processes-and-transparency-to-maximise-its-effectiveness/