



Guidelines on the treatment of CVA risk under the supervisory review and evaluation process (SREP)

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Outline

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1. Background: CVA losses and CVA risk

- The financial crisis caused important CVA losses
- CVA losses are P&L losses on derivative transactions due to adverse movements in the credit quality of a bank's counterparties
- CVA losses during the crisis were due to the global deterioration of the credit quality of participants in the derivative market, in particular monoline insurers
- In the EU, the legislator strived to balance between avoiding the negative market impact (both on the real economy and on the use of OTC derivatives as a useful hedging technique, in particular for foreign exchange risk) that an overly conservative CVA risk calculation for certain transactions would entail without however compromising solvency and overall financial stability
- Thus, the legislator decided to exclude certain transactions from CRR own funds requirements for CVA risk but, in accordance with the CRD, this should be without prejudice to the internal capital adequacy assessed under the SREP / Pillar 2 process
- However, the legislator also recognised that further work was needed and mandated the EBA to monitor the own funds requirements for CVA risk and submit a report to Commission, assessing:
 - the treatment of CVA risk as a stand-alone charge versus an integrated component of the market risk framework
 - the scope of the CVA risk charge including the exemption in Article 482
 - eligible hedges
 - calculation of capital requirements of CVA risk

1. Background: CVA Report and its findings

- The CVA report highlighted the materiality of CVA risk that stems from transactions excluded from the minimum own funds requirements
- According to the report findings this risk was largely not captured in most banks' internal capital estimations (ICAAP) causing a potentially significant and systemic underestimation of CVA risk
- With regard to minimum own funds requirements, EBA recommended reconsideration of the EU law exemptions, but only after the forthcoming full review of the Basel CVA framework has been accomplished → the EBA also made concrete proposals in that respect that were supported by many EU supervisors in Basel negotiations
- With regard to internal capital, EBA assessed that it had to take action to ensure convergent supervisory approach to handling of at least 'excessive CVA risks' at the level of SREP → some authorities have already started applying measures, therefore coordination is essential

In search of long-term solution and review of legislation need to have shorter-term solution to introduce consistency in supervisory approaches across the Single Market
→ common Pillar 2 approach

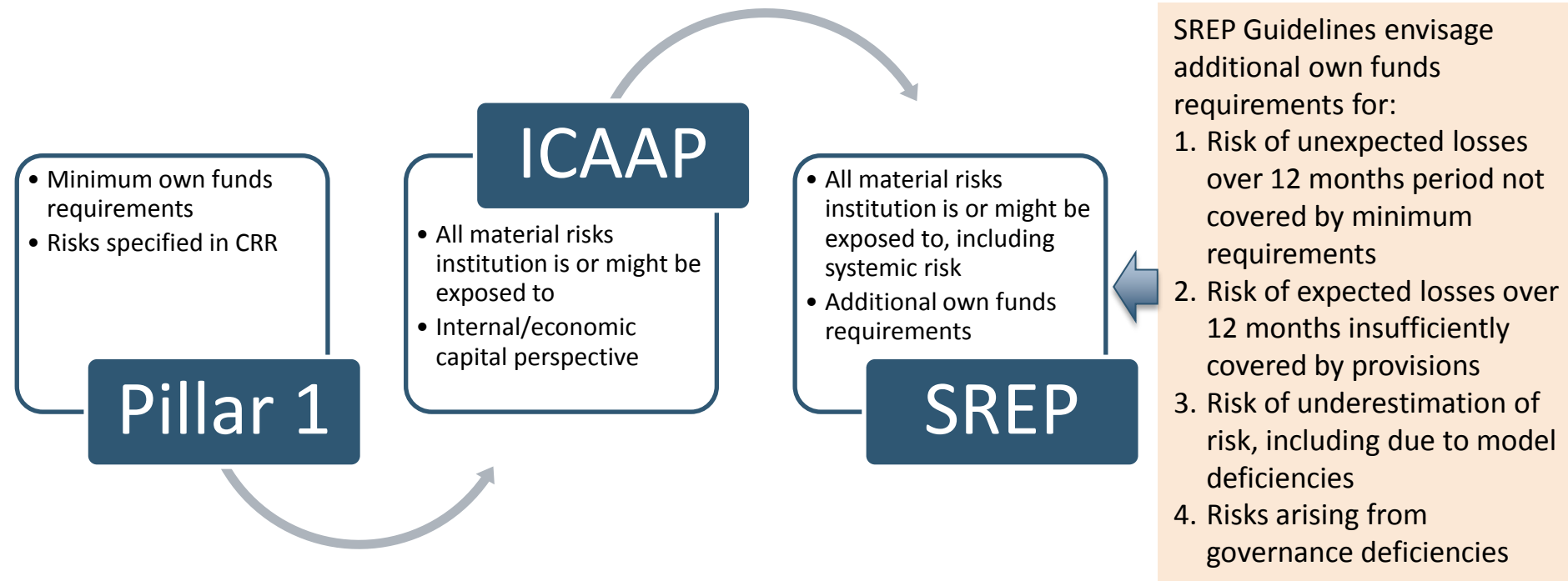
1. Background: CVA Report recommendations

Policy recommendation 3: The EBA considers that the CVA risk generated by EU exempted counterparties can be substantial and should be captured prudentially. Acknowledging the legal impossibility to amend EU exemptions via the delegated act foreseen in CRR Article 456(2) and bearing in mind ongoing discussions in Basel, the EBA recommends that all EU exemptions should be reconsidered and possibly removed in the context of legislative amendments to the CRR, upon completion of a review of the CVA risk charge in Basel as part of the Fundamental Review of the Trading Book.

Policy recommendation 4: Considering that the CVA risk generated by EU exempted counterparties can be substantial and acknowledging the legal impossibility to amend EU exemptions via the delegated act foreseen in CRR Article 456(2), the EBA recommends defining an EBA coordinated approach for yearly monitoring of the impact of transactions exempted from the CVA risk charge and for defining situations constituting a presumption of excessive CVA risks to be considered under SREP.

This approach will be further specified in a guidance on assessing excessive CVA risks under SREP, which will be submitted for public consultation in the course of 2015.

2. General rationale of Pillar 2 approach



1. Minimum own funds requirements (Art 92 of CRR) cover risk of unexpected losses resulting from risks specified in CRR
2. Additional own funds requirements (Art 104(1)(a) of CRD) cover *inter alia* risks of unexpected losses for risks or elements of risks not covered by minimum own funds requirements or the combined buffer requirements (Art 104(2)(b) of CRD), → e.g. concentration risk, IRRBB, conduct risk under operational risk under TSA approach, and systemic risk (Art 104(3)3(d))
3. Additional own funds requirements are determined based on SREP (Article 97) and following EBA Guidelines on common procedures and methodologies for SREP

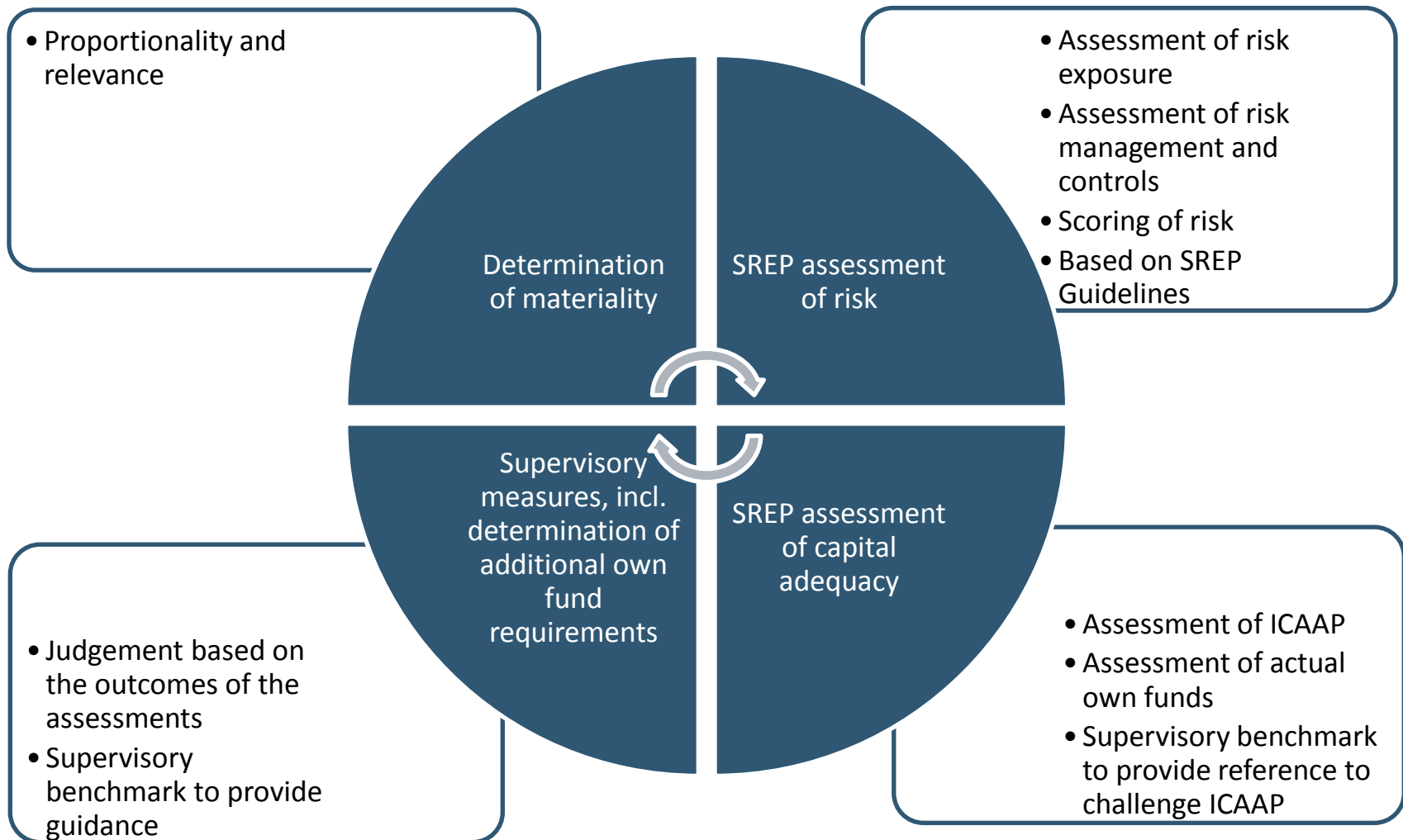
3. SREP guidance for CVA risk

- To implement the policy recommendations of the CVA Report the EBA is working on a two-step approach:
 1. Guidelines on treatment of CVA risk under SREP, which set general criteria for the assessment of materiality, assessment of risks and controls, assessment of capital adequacy and determination of additional own fund requirements
 2. Recommendation addressed to competent authorities that would spell out how the guidelines should be implemented in practice and provide threshold values for all formulas provided in the guidelines
- The draft Guidelines follow the approach to common SREP introduced by EBA in 2014 in its Guidelines on common procedures and methodologies for SREP
- The draft Guidelines are built around fundamental principles and assumptions:
 - Relevance and proportionality – they would affect only a sample of institutions with material derivatives business and CVA risk
 - Respect supervisory judgement – supervisory benchmarks and thresholds just to help supervisors in their decision making

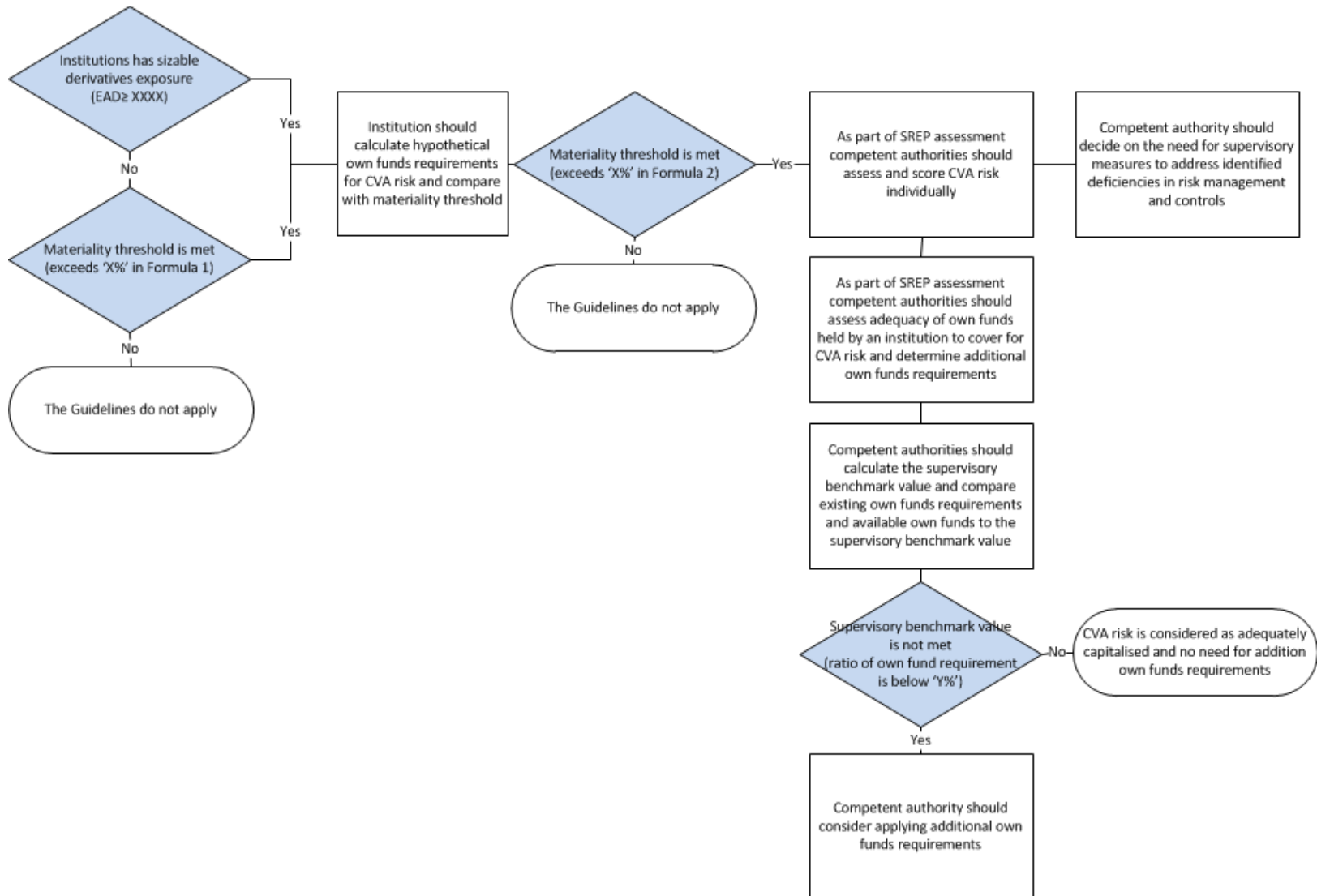
EBA underlines that possible additional own funds requirements applied in accordance with Article 104(1)(a) of CRD should not be based on an automatism (reproducing P1 approaches) but should rely on the outcomes of SREP assessment based on common methodologies

3. Key elements of the draft Guidelines

Draft guidelines cover:



3. Draft Guidelines: supervisory assessment process



3. Draft Guidelines: SREP assessment

Identifying most exposed EU banks

- Banks with non-significant OTC derivative business to be excluded beforehand → most EU banks will be excluded in practice
- Other banks to compute Hypothetical CVA risk charge including currently exempted transactions with (1) non-financial counterparties; (2) sovereign counterparties; (3) pension scheme arrangements and (4) intra-group entities → cover for elements of risks not captured under Pillar 1
- Hypothetical CVA risk charge will be computed based on the current CRR methodology, but with improvements reflecting industry practices → implementation of the EBA CVA report
- Overall CVA risk charge will be compared to bank's total Pillar 1 own funds requirements [Overall CVA risk $\geq x\% \times$ Total Pillar 1]

Assessing material CVA risk and allocated capital

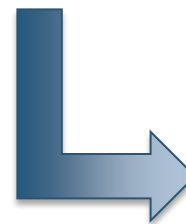
- In particular, competent authorities will assess:
 - Where CVA risk stems from and whether it is concentrated on certain counterparties or types of counterparties
 - Whether the bank captures this CVA risk internally (internal capital, stress testing etc.)
- Competent authorities will form a view on the institutions overall CVA risk and score that risk

3. Draft Guidelines: supervisory reaction

- Where competent authorities confirm that
 - A bank is showing material CVA risk
 - This risk is not adequately managed and/or capitalised internally by the bank
- Competent authorities may decide to take supervisory measures and, in particular, to request additional own funds requirements
- In order to assist competent authorities and promote convergence in the EU, a supervisory benchmark is defined
- Benchmark to be calibrated at a reasonable level, which corrects the bank's situation of outlier and restores its soundness

4. Proportionality and impact assessment

- EBA is mindful of the need to have appropriate analysis for the calibration and impact assessment and is conducting QIS in parallel with the public consultation → 200 banks
- The focus of the QIS is on assessing policy options around thresholds and re-inclusion of intra-group transitions into the calculation of hypothetical own fund requirements
- Policy options being considered for the thresholds:
 - Threshold 1:** 10; 50; 100; 150 mln EUR (or equivalent) } Proportionality
 - Thresholds 2 and 3:** $x = 0.5; 1; 2; 3; 4\%$ } Proportionality
 - Threshold 4:** $y = 40; 50; 60; 70\%$ } Supervisory benchmark factor
- The draft Guidelines also provide requirement for the annual collection of data for the purposes of monitoring of CVA risk and applied additional own funds requirements. Competent authorities will also share data with EBA



EBA will be analysing the thresholds and will recalibrate, where necessary, until long term solution is achieved

5. Next steps

- QIS data to be provided by 28 January 2016
- Answers to the public consultation by 12 February 2016
- Draft Guidelines and Recommendation to be finalised in mid- 2016

6. Questions for the consultation

1. 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?
2. Question 2: What are your views on how Threshold 1 should be calibrated?
3. 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?
4. Question 4: Do you agree with the approach provided for the determination of materiality of CVA risk?
5. Question 5: What are your views on how 'x%' (Thresholds 2 and 3) should be calibrated?
6. 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?
7. 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?
8. Question 8: Do you agree with the approach provided for the determination of supervisory benchmark for material CVA risk?
9. Question 9: What are your views on how 'y%' (Threshold 4) should be calibrated?
10. 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?
11. 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?



EUROPEAN BANKING AUTHORITY

Floor 46, One Canada Square, London E14 5AA

Tel: +44 207 382 1776

Fax: +44 207 382 1771

E-mail: info@eba.europa.eu

<http://www.eba.europa.eu>