EBA
European Banking Authority
European System of Financial Supervision

EBA Consultation Paper

on

Draft Regulatory Technical Standards

for credit valuation adjustment risk on the determination of a proxy spread and the specification of a limited number of smaller portfolios

(EBA/CP/2012/09)

London, 11.07.2012

Contents

I. Responding to this Consultation 3
II. Executive Summary 4
III. Background and rationale 5
IV. Draft RTS on the determination of a proxy spread and the specification of a limited number of smaller portfolios 9
V. Accompanying documents 20
a. Draft Cost- Benefit Analysis / Impact Assessment 20
b. Overview of questions for Consultation 25

I. Responding to this Consultation

The EBA invites comments on all proposals put forward in this paper, and in particular on the specific questions summarised on page 25.

Comments are most helpful if they:

- indicate the specific point or question to which the comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Please send your comments to the EBA by email to EBA-CP-2012-09@eba.europa.eu by 15.09.2012, indicating the reference 'EBA/CP/2012/09'. Please note that comments submitted after the deadline or sent to another e-mail address will not be processed.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please indicate clearly and prominently in your submission any part which you do not wish to be publicly disclosed (noting that a standard confidentiality statement in an e-mail message will not be treated as a request for non-disclosure in this regard). Please be aware that any confidential responses may be requested from us in accordance with the EBA's policy on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and/or the European Ombudsman.

Data protection

Information on data protection can be found at www.eba.europa.eu under the heading 'Disclaimer'.

II. Executive Summary

The draft Capital Requirements Regulation (‘CRR’) and draft revised Capital Requirements Directive (‘CRD IV’) set out the prudential requirements for banks and other financial institutions which are expected to apply from 1 January 2013.

The EBA has developed these draft Regulatory Technical Standards (‘RTS’) on the basis of the Commission’s proposed legislative texts for the CRR. To the extent that the proposed text changes in the run-up to its final adoption, the EBA may need to adapt the draft accordingly. The EBA may also introduce other changes into its draft RTS in order to appropriately reflect comments received, including in response to this consultation paper.

Main features of the RTS

This Consultation Paper proposes draft RTS in accordance with Article 373(6) of the CRR relating to the calculation of own funds requirements for credit valuation adjustment (‘CVA’) risk. In particular it requires the EBA to further specify:

i) how a proxy spread should be determined for the purposes of identifying LGD_{MKT} for the calculation required by Article 373(1); and

ii) the criterion of ‘a limited number of smaller portfolios’ referred to in Article 373(4).

The EBA must submit the draft RTS to the Commission by 1 January 2013.

III. Background and rationale

Draft RTS on the determination of a proxy spread and the specification of a limited number of smaller portfolios

On July 20th 2011, the European Commission (EC) issued its legislative proposals to revise the CRD, primarily in order to apply the Basel III[1] agreement in the EU. The proposals have recast the contents of the CRD package, as amended, into a revised CRD IV and a new CRR. These CRR/CRD IV proposals are currently being debated by the Council and the European Parliament as EU legislators in the framework of the Treaty's ordinary legislative procedure.

In anticipation of the finalisation of the legislative texts for the CRR/CRD IV, the EBA has developed this draft RTS in accordance with the mandate contained in Article 373(6) of the CRR as it features in the EC's proposals.

The EBA may need to adapt the draft RTS in accordance with the final version of the CRR text before submitting it to the European Commission for adoption. The EBA may also wish to introduce other changes into the draft text in order to appropriately reflect comments received from interested stakeholders, including in response to this consultation paper.

The nature of RTS under EU law

Draft RTS are produced in accordance with Article 10 of the EBA Regulation[2]. According to Article 10(4) of the EBA Regulation, they shall be adopted by means of regulations or decisions. The EBA expects that the majority of its RTS, including the ones contained in the present consultation, will eventually be adopted as Commission Regulations.

According to EU law, regulations are binding in their entirety and directly applicable in all Member States. This means that, on the date of their entry into force, they become part of the national law of the Member States automatically without need for further transposition into national law.

Presenting these rules in the form of a draft Commission Regulation should ensure a level-playing field by preventing divergent national requirements and thereby facilitating the cross-border provision of EU financial services.

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[1] Basel III: A global regulatory framework for more resilient banks and banking systems and Basel III: International framework for liquidity, risk measurement, standards and monitoring. Basel Committee on Banking Supervision, December 2010.

[2] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC.

Background of this draft RTS

In December 2010, the Basel Committee on Banking Supervision (BCBS) published its "global regulatory framework for more resilient banks and banking systems", commonly known as Basel III[3] which aimed at addressing the lessons from the financial crisis.

The CRR proposals relating to own funds requirements translate the BCBS proposals into EU law. Both reforms raise both the quality and quantity of the regulatory capital base. The draft RTS proposed by the EBA in this consultation derive directly from the CRR proposals, which are expected to apply from 1 January 2013.

The proposed draft RTS elaborate certain specific elements of the calculation of own funds requirements for credit valuation adjustment ('CVA') risk. According to Article 371 of the proposed CRR, CVA means an adjustment to the mid-market valuation of the portfolio of transactions with a counterparty. The adjustment reflects the current market value of the credit risk of the counterparty to the institutions, but does not reflect the current market value of the credit risk of the institution to the counterparty. In other words it is the risk of loss caused by changes in the credit spread of a counterparty due to changes in its credit quality. The CVA charge is part of the capital treatment for counterparty credit risk OTC (bilateral) derivative instruments.

The requirements contained in the draft RTS are mainly addressed directly to institutions, although some of them are addressed to competent authorities. All of the proposed requirements are likely to be of relevance and interest to both institutions and competent authorities.

Scope of the RTS on the determination of a proxy spread and the specification of a limited number of smaller portfolios

Article 373(6) of the CRR requires EBA to draft RTS "to specify in greater detail":

(a) how a proxy spread should be determined for the purposes of identifying LGD_{MKT} for the purposes of the calculation required by Article 373(1); and

(b) the number and size of portfolios that fulfil the criterion of a limited number of smaller portfolios referred to in Article 373(4).

[3] International Convergence of Capital Measurement and Capital Standards. Basel Committee on Banking Supervision, December 2010 and further revisions.

Article 373(1) of CRR states that in calculation of Advanced CVA capital charge:

- institutions shall calculate a CVA VaR by using their VaR model (which has to be approved for the specific risk of debt instruments);
- the calculation shall use a formula with several inputs including:
    - ✓ the expected exposure calculated by the internal expected positive exposure ('EPE') model;
    - ✓ CDS spreads over a set of tenors and related to single counterparties;
    - ✓ market implied Loss Given Defaults (LGD_{MKT}), based on the spread of a market instrument of single counterparties;
- in case a credit default swap for a counterparty is not available, institutions "shall use a proxy spread that is appropriate having regard to the rating, industry and region of the counterparty";
- in case a market instrument for a counterparty is not available, LGD_{MKT} "shall be based on the proxy spread that is appropriate having regard to the rating, industry and region of the counterparty".

Article 373(4) of CRR states that institutions which are permitted:

- to use a VaR model for the measurement of specific market risk of debt instruments; and
- to use an internal EPE model for the calculation of the exposure values to counterparty credit risk on the majority of their business, but use other methods (Mark-to-Market Method, Standardised Method or Original Exposures Method) for smaller portfolios,

may be permitted by competent authorities to use the advanced method for the calculation of the CVA capital charge for the portfolios that are not covered by the internal EPE model. This permission may only be granted if "a limited number of smaller portfolios" are excluded from the scope of the EPE model.

The EBA has interpreted the scope of its mandate to draft RTS in this context to cover:

- specification of how a proxy spread should be determined, having regard to the need for an appropriate methodology and the rating, industry and region of the relevant counterparty;

- specification of how the market implied loss given default of the counterparty, namely LGD_{MKT}, corresponding to the applicable proxy spread should be identified for the purposes of calculating the advanced CVA capital charge; and

- specification of both the number and size of portfolios that fulfil the criterion of "a limited number of smaller portfolios" (including the need for that criterion to be fulfilled on an ongoing basis).

IV. Draft RTS on the determination of a proxy spread and the specification of a limited number of smaller portfolios

IV. Draft RTS on the determination of a proxy spread and the specification of a limited number of smaller portfolios 9

CHAPTER I - GENERAL PROVISIONS 11

Article 1- Subject matter 11

Article 2 – Definitions 11

CHAPTER II - THE PROXY SPREAD 13

Article 3 – Methodology for the determination of a proxy spread 13

Article 4 – Calculation of the proxy spread 13

Article 5 – Extension of the VaR proxy methodology 14

Article 6 – Identification of LGD_{MKT} 16

CHAPTER III - THE NUMBER AND SIZE OF QUALIFYING PORTFOLIOS 17

Article 7 – Quantitative limits 17

Article 8 – Monitoring of limits and non-compliance 17

CHAPTER IV - FINAL PROVISIONS 18

Article 9 – Entry into force 18

COMMISSION DELEGATED REGULATION (EU) No …/..

of dd mmmm 201y

supplementing Regulation (EC) No xxxx/2012 of the European Parliament and of the Council with regard to regulatory technical standards for credit valuation adjustment risk on the determination of a proxy spread and the specification of a limited number of smaller portfolios

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No xx/xxxx of the European Parliament and of the Council of dd mmmm yyyy on ….[4] , and in particular Article 373(6) thereof,

Whereas:

1. The application of the advanced method to the determination of own funds requirments for CVA risk is liable to involve counterparties for which no credit spread is available.
2. A proxy spread for CVA risk should be based on a clear methodology to support the use of reliable data and to provide a clear, ex-ante framework for dealing with cases where insuffient data is available.
3. Institutions should apply their VaR proxy methodologies as far as possible for CVA risk. In cases where the VaR proxy methodology is not applicable, institutions should extend this methodology by mapping counterparties according to rating, industry and region. Sub-categories should be further specified so far as necessary to reflect the characteristics of positions in the CVA portfolio and with reference to available data.
4. Where no reliable proxy spread for CVA risk can be calculated because of a lack of data and despite aggregating data within a single sub-category, the own funds calculation for CVA risk should be made in accordance with the formula specified for the standardised method.
5. The determination of LGDMKT using liquid traded credit spreads should be consistent with the pricing of single name credit default swaps. LGDMKT values for counterparties based on proxy credit spreads should, in principle, follow the same methodology.
6. For the purposes of permission to use the advanced method for the non-Internal Model Method ('IMM') netting sets, it is appropriate to specify a limited number of smaller portfolios in terms of percentages in relation to the total number and size of portfolios.

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[4] OJ…

To maintain neutral levels of competition it is desirable that any withdrawal of permission should occur when quantitative limits are breached for two consecutive quarters.

7. This Regulation is based on the draft regulatory technical standards submitted by the European Banking Authority to the Commission.
8. The European Banking Authority has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the opinion of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010,

HAS ADOPTED THIS REGULATION:

CHAPTER I
GENERAL PROVISIONS

Article 1- Subject matter

1. This Regulation specifies:
    a. how a proxy spread should be determined for the purposes of identifying LGD_{MKT} for the purposes of calcaulating the advanced CVA capital charge; and
    b. the number and size of portfolios that fulfil the criterion of a limited number of smaller portfolios referred to in Article 373(4) of Regulation (EC) No xxxx/2012,

pursuant to Article 373(6) thereof.

Article 2 – Definitions

For the purpose of this Regulation the following definitions shall apply:

(1) *'portfolio'* means the netting set as defined in Article 267 of Regulation (EC) No xxxx/2012, used for regulatory purposes in the determination of the exposure value for the counterparty credit risk and for which the own funds requirements for CVA risk have to be calculated;

Explanatory box

The definition of regulatory netting set might differ from the definition of legal netting set. A regulatory netting set is homogeneous in the sense that it contains only IMM or only non-IMM trades, respectively, and so a single legal netting containing both types of trades set should be divided into two regulatory netting sets.

(2) *'non-IMM portfolio'* means a portfolio to which the IMM for determining counterparty credit risk is not applied for the calculation of regulatory exposure;

(3) *'single transaction portfolio'* means a portfolio that includes only one transaction and which is not subject to a legally enforceable netting agreement;

(4) *'size of portfolio'* means:

Option 1: the exposure at default of a portfolio, calculated using the mark-to-market method, as outlined in Article 269 of Regulation (EC) No xxxx/2012, by taking account of the effects of netting, as outlined in Article 292 of Regulation No xxxx/2012, but by not considering the effects of collateral;

Option 2: the 'current exposure' as defined in Article 267 of Regulation (EC) No xxxx/2012 [as the larger of zero and the market value of a transaction or portfolio of transactions within a netting set with a counterparty that would be lost upon the default of the counterparty, assuming no recovery on the value of those transactions in insolvency or liquidation];

Option 3: the standardised CVA capital charge calculated in accordance with Article 374 of Regulation (EC) No xxxx/2012 and referring to the relevant portfolio.

Explanatory box

Article 2(4) provides three definitions of 'size of portfolio'. The choice on the definition of 'size of portfolio' shall be made after the consulatition periode and following the review of the responds to Question 7.

(5) *'total size'* of a (sub)set of portfolios means

under Options 1 and 2: the sum of the size of portfolios belonging to the relevant (sub)set;

under Option 3: the standardised CVA capital charge calculated in accordance with Article 374 of Regulation (EC) No xxxx/2012 in respect of the relevant (sub)set of portfolios.

(6) ‘*VaR proxy methodology*’ means the methodology for determining a proxy spread used in the Value-at-Risk model for the determination of market risk capital requirements for specific interest rate risk, in accordance with Article 352 of Regulation (EC) No xxxx/2012.

CHAPTER II
THE PROXY SPREAD

Article 3 – Methodology for the determination of a proxy spread

1. An institution using the advanced method for CVA risk, in accordance with Article 373 of Regulation (EC) No xxxx/2012, shall have in place a methodology for the determination of a proxy spread for CVA risk which complies with the requirements set out in Articles 3 and 5.

2. The methodology shall define how a proxy spread should be determined for the purposes of calculating the CVA Value-at-Risk as well as the CVA stressed Value-at-Risk.

3. All inputs used in the methodology shall be based on reliable data observed on a liquid two-way market as defined in Article 327 of Regulation (EC) No xxxx/2012. The methodology shall include a procedure to verify and record input data quality and exclude non-compliant data.

4. Interpolation and extrapolation of data relating to different tenors shall be conceptually sound and based on market data satisfying the quality criteria set out in paragraph 3.

5. The methodology shall include a pre-determined framework for aggregating data in accordance with Article 5(7) below. Any modifications to this framework shall be notified to the competent authorities before they take effect.

Article 4 – Calculation of the proxy spread

1. An institution shall use its VaR proxy methodology to determine the proxy spread for CVA risk using all the criteria and analytical drivers used for the calculation of the VaR when the same counterparties are at stake.

Explanatory box

An institution’s Value-at-Risk (VAR) methodology for the determination of market risk capital requirements for specific interest rate risk includes a proxy spread methodology for counterparties for which no credit spread is available. An institution needs permission from its competent authority to use the VaR model for the specific risk of debt instruments in accordance with Article 352 of Regulation (EC) No xxxx/2012.

The EBA believes that the same proxy spread methodology should be used to determine the proxy spread for CVA risk when it relates to same counterparties in the trading book.

Article 373(1) in the CRR specifically mentions when determining the proxy spread for the calculation of CVA risk institutions should always have regards to rating, industry and region criteria. The general VaR methodology as described under Article 354 and following do not specifically include the rating, region and industry criteria in the CRR.

Q1. Please specify if the VaR proxy methodology always takes into account rating, region and industry when determining the proxy spread for the VaR model? Will the minimum prescribed granularity for rating, industry and region in Article 5, if made applicable to Article 4.1, impact institutions’ current methodologies for proxy spread modelling of counterparties in the trading book? If yes, please specify and assess the overall effect on an institution.

2. In cases where the VaR proxy methodology cannot be applied the proxy spread shall be based on an extension of the VaR proxy methodology that takes account of the characteristics of positions in the institution’s CVA portfolio. Any extension of the VaR proxy methodology shall be consistent with the approach set out in Article 5 and shall constitute an extension to the use of internal models as referred to in Article 352(2) of Regulation (EU) No xxxx/2012, separate permission for which should be only granted where competent authorities are satisfied that the requirements of Article 5 have been met.

Article 5 – Extension of the VaR proxy methodology

1. An institution shall map each counterparty to an appropriate sub-category defined by its rating, industry and region.

2. The proxy spread corresponding to a particular sub-category shall be conservatively estimated, taking account of all reliable data within the sub-category, being based on the CDS market as far as available and satisfying the quality criteria set out in Article 3(3).

3. An institution shall develop a hierarchy of sources of internal and external ratings. In cases where multiple external ratings are available, an institution shall follow the approach set out in Article 133 of Regulation (EU) No xxxx/2012. If no rating for a particular counterparty is available, credit quality step 3 shall apply. Ratings shall be mapped to credit quality steps, as referred to in Article 374(2) of Regulation (EU) No xxxx/2012. Any modifications to the hierarchy of sources of internal and external ratings shall be notified to the competent authorities before they take effect.

4. An institution's sub-categories for industry shall include at least the following:
   - raw materials;
   - industrial production;
   - non-financial services;
   - financial services;
   - other sectors.

5. An institution's sub-categories for region shall include at least the following:
   - Europe;
   - North America;
   - Asia;
   - rest of the world.

6. Any further specification of the sub-categories shall reflect the characteristics of positions in the institution's CVA portfolio and take account of the availability of data satisfying the quality criteria set out in Article 3(3).

7. An institution shall add additional categories, such as 'currency', 'seniority' or 'size of enterprise', where these provide an appropriate differentiation and sufficient data is available within each specified sub-category.

Explanatory box

Q2. Will the proposed use of the extended VaR proxy methodology and/or the minimum prescribed granularity for rating, industry and region when determining a proxy spread for CVA risk impact institutions' current methodologies for proxy spread modelling? If yes, please specify and assess the overall effect on an institution.

Where possible please provide relevant data to support your response.

8. Where no data is available for a counterparty in relation to the intersection of relevant sub-categories of rating, industry and region, the proxy spread shall be determined by aggregating data within the sub-category for either industry or region. The aggregation shall follow the pre-determined framework set out in the institution's methodology for the determination of a proxy spread referred to in Article 3(1). The reason for the aggregation shall be recorded.

> Explanatory box
>
> Q3. Please provide information and data concerning the availability of CDS data relevant to the intersection of sub-categories ("rating","industry" and "region") and the application of the aggregation rules specified in Article 5.8

9. Where the approach set out in paragraph 8 does not provide a proxy spread for a counterparty, an institution using the advanced method shall calculate the own funds requirements for CVA risk for that counterparty in accordance with the formula specified for the standardised method in Article 374 of Regulation (EU) No xxxx/2012.

> Explanatory box
>
> Alternative policy options are i) not to allow an institution to aggregate data within a sub-category and therefore to delete Article 5.8 or ii) to allow an institution to aggregate data within the sub-categories for both industry and region in Article 5.9.
>
> Q4. Please provide any information as to the difference in own funds requirements for the portfolio of counterparties following the application of the approach set out in Article 5.8 and Article 5.9 or the alternative policy options here described.

Article 6 – Identification of LGD_{MKT}

1. The identification of LGD_{MKT} for the purposes of calculating the own funds requirements for CVA risk using a proxy spread shall be based on:
   a. the market convention of LGD_{MKT} corresponding to single named credit default swaps;
   b. the determination of the particular proxy spread in accordance with Articles 3 to 5.

CHAPTER III
THE NUMBER AND SIZE OF QUALIFYING PORTFOLIOS

Article 7 – Quantitative limits

1. The number of non-IMM portfolios (excluding single transaction portfolios) that fulfil the criterion of a limited number of smaller portfolios referred to in Article 373(4) of Regulation (EC) No xxxx/2012 shall not exceed [15] % of the total number of portfolios (excluding single transaction portfolios).

2. The size of non-IMM portfolios (including single transaction portfolios) that fulfil the criterion of a limited number of smaller portfolios referred to in Article 373(4) of Regulation (EC) No xxxx/2012 shall not exceed [10] % of the total size of all portfolios (including single transaction portfolios).
3. The specification of the criterion set out at paragraphs 1 and 2 shall be applied on a stand-alone or a consolidated basis, depending on the scope of the proposed permission.

Explanatory box
Q5. Do the proposed thesholds of [15]% for the number and [10]% for the size of smaller portfolios, together with the definitions, provide an incentive for institutions to limit their portfolio exposures not covered by the Internal Model Method (IMM)?
Q6. Will [15%] and/or [10]% cause any impact for your institution? If there will be an impact, please specify and assess the overall effect on the institution.
Q7. Which of the three definitions of 'size of porfolio' as defined in Article 2(4) would you use to determine the [10]% size ratio? Please provide reasons for the selected definition and details of any alternative options you would propose.
Where possible please provide relevant data to support your response.

Article 8 – Monitoring of limits and non-compliance

1. An institution shall monitor the fulfillment of the criterion of a limited number of smaller portfolios as specified in paragraphs 1 and 2 of Article 7 on a regular basis. For each reporting period for supervisory reporting of own funds, an institution shall calculate the arithmetical average of at least monthly observations of the ratios of:

   a. the total number of portfolios (excluding single transaction portfolios) and the total number of non-IMM portfolios (excluding single transaction portfolios); and

   b. the aggregate total size of all portfolios (including single transaction portfolios) and the total size of non-IMM portfolios (including single transaction portfolios).

2. If the criterion specified in paragraphs 1 and 2 of Article 7 is not fulfilled for two consecutive quarters, competent authorities shall withdraw the institution's permission to use the advanced method for CVA risk for the non-IMM portfolios.

3. Where an institution's permission to use the advanced method for CVA risk has been withdrawn pursuant to paragraph 2, competent authorities may only grant that permission again where they are satisfied that the institution fulfils the criterion specified in paragraphs 1 and 2 of Article 7.

CHAPTER IV
FINAL PROVISIONS

Article 9 – Entry into force

This Regulation shall enter into force on the day following that of its publication in the Official Journal of the European Union.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Commission
The President

[For the Commission
On behalf of the President

[Position]

V. Accompanying documents

a. Draft Cost- Benefit Analysis / Impact Assessment

Introduction

According to the CRR proposals, the EBA should develop draft RTS with regard to the determination of a proxy spread and the specification of a limited number of smaller portfolios in connection with own funds requirements for credit valuation adjustment ('CVA') risk related to Article 373(6). Those draft RTS should be submited to the Commission by 1 January 2013.

Procedural issues and consultation process

Throughout the elaboration of its draft RTS, EBA has closely followed the work of international organisations dealing with related topics, in particular that of the Basel Committee on Banking Supervision (BCBS).

Under Basel II, the risk of counterparty default and credit migration risk were addressed but mark-to-market losses due to credit valuation adjustments (CVA) were not. During the financial crisis, however, roughly two-thirds of losses attributed to counterparty credit risk were due to CVA losses and only about one-third were due to actual defaults.

The BCBS published in December 2010 its "global regulatory framework for more resilient banks and banking systems" aimed at addressing the lessons of the financial crisis[5]. The BCBS aims to raise the resilience of the banking sector in particular by strengthening the regulatory capital framework.

The Basel III framework sets out capital rules for CVA risk that include standardised and advanced methods. At the time it issued Basel III, the BCBS noted that the level and overall suitability of the standardised CVA risk capital charge was subject to review in a final impact assessment targeted for completion in the first quarter of 2011.

On 1 June 2011, the BCBS completed its review and finalised the Basel III capital treatment for counterparty credit risk in bilateral trades. The review resulted in a minor modification of the credit valuation adjustment, which is the risk of loss caused by changes in the credit spread of counterparty due to changes in its credit quality (also referred to as the market value of counterparty credit risk).

The impact study showed that the standardised method as originally set out in the December 2010 text of the Basel III rules could be unduly punitive for low-rated counterparties with long maturity transactions. In order to narrow the gap between the capital required for CCC-rated counterparties under the

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[5] Revised version published on 1 June 2011.

standardised and the advanced methods, the BCBS agreed to reduce the weight applied to CCC-rated counterparties from 18% to 10%.

All other aspects of the regulatory capital treatment for counterparty credit risk and CVA risk remain unchanged from the December 2010 Basel III text. Overall, the BCBS estimates that, with the addition of the CVA risk capital charge, the capital requirements for counterparty credit risk under Basel III will double the level required under Basel II (i.e. when counterparty credit risk was capitalised for default risk only).

The CRR/CRD IV proposals relating to the CVA capital charge transform the BCBS proposals into binding requirements under EU law, while taking into account EU specificities. The European Commission has performed a comprehensive impact assessment covering in particular the proposed changes in the CVA risk charge[6] and also held a public consultation on possible measures to strengthen bank capital requirements for counterparty credit risk[7].

Furthermore, the cumulative impact of the CRR/CRD IV proposals in terms of the additional overall capital that the EU banking industry needs to raise, as well as administrative costs, economic impact in the transitional period, and long-term economic impact, have all been assessed.

This draft RTS put forward by the EBA in this consultation derive directly from these CRR/CRD IV proposals.

The EBA held a roundtable meeting with industry experts whose input has been taken into account in the most technical parts of the drafts RTS.

The EBA has included in this consultation a number of questions, the answers to which will complement the existing cost-benefits analyses and will allow finalisation of the RTS by the EBA for onwards submission to the European Commission. Further this RTS is required to be submitted to the European Commission by the deadline of 1 January 2013.

The EBA's RTS mandate

Article 373(6) of the CRR requires EBA to draft RTS "to specify in greater detail":

a) How a proxy spread should be determined for the purposes of identifying LGD_{MKT} for the purposes of the calculation required by Article 373(1); and

b) the number and size of portfolios that fulfil the criterion of a limited number of smaller portfolios referred to in Article 373(4).

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6 http://ec.europa.eu/internal_market/bank/docs/regcapital/CRD4_reform/IA_regulation_en.pdf

7 http://ec.europa.eu/internal_market/bank/regcapital/new_proposals_en.htm

The EBA has interpreted the scope of its mandate to draft RTS in this context to cover:

- specification of how a proxy spread should be determined, having regard to the need for an appropriate methodology and the rating, industry and region of the relevant counterparty;
- specification of how the market implied loss given default of the counterparty, namely LGD_{MKT}, corresponding to the applicable proxy spread should be identified for the purposes of calculating the advanced CVA capital charge; and
- specification of both the number and size of portfolios that fulfil the criterion of “a limited number of smaller portfolios” (including the need for that criterion to be fulfilled on an ongoing basis).

Objective of the RTS

The objective of these technical standards is to (i) achieve a common understanding amongst the EU’s national competent authorities on the approach for use in the determination of a proxy spread and LGD_{MKT}in the Advanced CVA method, (ii) define the criterion of a limited number of smaller portfolios referred to in Article 373(4) CRR, iii) create more transparency for institutions when applying the proxy spread and LGD_{MKT} into the Advance CVA model and iv) enhance the consistency amongst institutions in this area.

Policy options

On the proxy spread and LGD_{MKT} the appropriate balance has been sought in the RTS between providing a comprehensive list of requirements as to how the proxy spread should be determined and how the LDG_{MKT} should be calculated whilst applying a more principles-based approach without an overly prescriptive methodology.

The EBA is proposing a principles-based approach where banks have to pre-define their own methodology following the principles set out in the RTS. This approach allows for some flexibility and takes account of differences in the CVA exposures of institutions; at the same time it minimises the scope for ‘cherry-picking’ in the choice of proxies. In order to avoid additional implementation burdens, the CVA proxy methodology builds on the existing VaR proxy methodology, which is or will already be approved by competent national authorities as part of the internal model approval process. In cases where the existing methodology doesn’t cover the counterparties relevant for the A-CVA calculation, institutions should extend this methodology by applying the principles outlined in the RTS which include conservatism, suitability as regards

rating, industry and region; and coherence with the characteristics of the specific portfolio and availability of reliable data.

In order to define similarity the category "rating" has be broken down in 6 different sub-categories (corresponding to credit quality steps), the category "industry" in at least 5 sub-categories (corresponding to broad economic sectors) and the category of "regions" in at least 4 sub-categories (corresponding to the main continents). Since the availability of market data concerning credit spreads is limited, the EBA is trying to balance the number of breakdowns per category and proposes the aggregation in the dimensions of either "industry" or "region", for intersections between in subcategories for which no market data are available.

In case after aggregation there is still no market data available for specific counterparties the EBA is proposing to calculate the own fund requirements for CVA risk for those counterparties via the standardised method.

On the criterion of a limited number of smaller portfolios referred to in Article 373(4), the EBA is proposing not to apply fixed thresholds to determine the number and the maximum size of portfolios but to express these in terms of percentages with respect to the total number of portfolios (excluding single transaction portfolios) and to the total size, respectively. The reason for this approach is to avoid discriminating between institutions with different scales of activity (i.e. commercial versus investment banks) which might entail very different characteristics in the average size and number of portfolios. In relation to the "size of a portfolio" the EBA considers that there is a trade-off between simplicity and the risk sensitivity in how "size" is defined. For this reason the EBA is currently evaluating three different definitions. There are: i) exposure measured by the Current Exposure Method, ii) mark-to-market value (floored at zero), and iii) standardised CVA capital requirement. The EBA is seeking the optimal threshold for both the size and the number criterion to constitute an incentive to extend the scope of the Internal Model Method (IMM); at the same time it recognises that certain positions might be very difficult to model satisfactorily and should therefore be excluded from the scope of IMM.

Further, the EBA considers that a breach of these thresholds should be relevant only if it persists for two consecutive quarters, therefore avoiding the impact of substantial 'cliff' effects that might be caused by exceptional circumstances and giving time for institutions to take appropriate corrective actions.

The likely economic impacts[8]

The EBA recognises the short timetable for institutions to implement the Advanced CVA charge including this BTS by 1 January 2013. Any potential model changes will lead to some implementation burdens, such as the additional compliance and system development costs for implementing this framework; for institutions; however the EBA views that in the incremental costs and benefits in relation to this RTS are unlikely to be of any material significance relative to the overall additional capital requirements that institutions need to take into account for counterparty credit risk.

The EBA includes in this consultation a number of questions to stakeholders to assist in the EBA's impact assessment analysis and to allow finalization of this RTS for submission to the European Commission by 1 January 2013.

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8 The EC IA guidelines refer to social and environmental impacts as well. However considerations of these impacts are unlikely to be relevant for this EBARTS. The potential exceptions being social impacts on employment, standards and rights related to job quality and impacts on (financial) crime.

b. Overview of questions for Consultation

Q1. Please specify if the VaR proxy methodology always takes into account rating, region and industry when determining the proxy spread for the VaR model? Will the minimum prescribed granularity for rating, industry and region in Article 5, if made applicable to Article 4.1, impact institutions' current methodologies for proxy spread modelling of counterparties in the trading book? If yes, please specify and assess the overall effect on an institution.

Q2. Will the proposed use of the extended VaR proxy methodology and/or the minimum prescribed granularity for rating, industry and region when determining a proxy spread for CVA risk impact institutions' current methodologies for proxy spread modelling? If yes, please specify and assess the overall effect on an institution.

Where possible please provide relevant data to support your response.

Q3. Please provide information and data concerning the availability of CDS data relevant to the intersection of sub-categories ("rating","industry" and "region") and the application of the aggregation rules specified in Article 5.8.

Q4. Please provide any information and the difference in own funds requirments for the portfolio of counterparties following the application of Article 5.8 and Article 5.9 and the policy options described in the explanatory box.

Q5. Do the proposed thesholds of [15]% for the number and [10]% for the size of smaller portfolios, together with the definitions, provide an incentive for institutions to limit their portfolio exposures not covered by the Internal Model Method (IMM)?

Q6. Will [15%] and/or [10]% cause any impact for your institution? If there will be an impact, please specify and assess the overall effect on the institution.

Q7. Which of the three definitions of 'size of portfolio' as defined in Article 2(4) would you use to determine the [10]% size ratio? Please provide reasons for the selected definition and details of any alternative options you would propose.

Where possible please provide relevant data to support your response.

Q8. What would be the incremental costs and/or benefits were you to implement this proposal?

Where possible please provide relevant data to support your response.