



FEDERATION  
BANCAIRE  
FRANCAISE

*Banking supervision  
And Accounting issues Unit  
The Director*

Paris, September 14<sup>h</sup> 2012

**French Banking Federation comments on the EBA consultation paper on draft RTS for credit valuation adjustment risk on the determination of a proxy spread and on the specification of a limited number of smaller portfolios (EBA/CP/2012/09)**

Dear Madam,

The French Banking Federation (FBF) is the professional body representing the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 450 commercial and cooperative banks. FBF member banks have 40,000 permanent branches in France. They employ 400,000 people, and service 60 million clients.

The French Banking Federation (FBF) welcomes the opportunity offered by the European Banking Authority) to comment on the draft RTS for credit valuation adjustment risk on the determination of a proxy spread and on the specification of a limited number of smaller portfolios (EBA/CP/2012/09) and fully support the EBA's objective to seek a more consistent framework .

In a nutshell, the French Banking Federation

- is not in favor of modifying and calling into question the current VaR methodologies,
- believes that the minimum regulatory requirements in terms of industry granularity should be limited to Corporates, Financials and Sovereigns,
- and thinks the limit in number of portfolios is not relevant and should be suppressed to keep only a threshold on the size of the portfolios.

The FBF underlines that the Basel3/CRR CVA capital charge requires further developments to achieve a consistent implementation.

**Mrs Isabelle VAILLANT  
European Banking Authority  
Tower 42 (level 18)  
25 Old Broad Street  
London EC2N 1HQ  
United Kingdom**

You will find in the annex our answers and comments to the questions raised in the consultation paper. We thank you for the consideration of our remarks and remain at your disposal for any question or additional information you might have.

Yours sincerely,

A handwritten signature in black ink, consisting of a long horizontal line with a small loop at the end and a shorter line above it.

Jean-Paul CAUDAL

## **French Banking Federation comments on the EBA consultation paper on draft RTS for credit valuation adjustment risk on the determination of a proxy spread and on the specification of a limited number of smaller portfolios (EBA/CP/2012/09)**

As per article 373-6 of the CRDIV, the EBA shall develop and submit to the Commission draft Regulatory Technical Standards (RTS) in order to precise the use and construction of proxy spreads and  $LGD_{MKT}$  used in the CVA advanced calculation (art. 373-1) as well as the notion of "limited number of smaller portfolios" referred to in article 373-4.

We welcome this opportunity to share our views about the proposed standards and fully support the EBA's objective to define a consistent framework for the calculation of the CVA capital charge.

You will be pleased to find hereby our responses to your questions and some additional comments. As a summary French banks

- (i) are reluctant to modify and to call into question their current VaR methodologies,
- (ii) believe that the minimum regulatory requirements in terms of industry granularity should be limited to Corporates, Financials and Sovereigns,
- (iii) think the limit in number of portfolios is not relevant and should be suppressed to only keep a threshold on the size of the portfolios.

### **RTS on proxy spreads**

*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 modeling 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 modeling? If yes, please specify and assess the overall effect on an institution.*

### **Comments to Q1 and Q2:**

The usage of proxies will be done in very different contexts for market VaR and CVA VaR.

- i. The universe of positions with no available credit spread scenarios in the market VaR perimeter is marginal compared to the universe of counterparties subject to the CVA capital charge. Indeed:
  - Positions in Market VaR are associated to a spot credit spread curve (a direct observation of CDS spread or credit spread which could be extracted from bond prices). So market VaR scenarios could be built from historization of those credit spreads. Proxies are used marginally when we have only scarce data.

- In CVA VaR, most counterparties cannot be mapped to a spread curve because no credit instruments on those names are traded in the market (for large global firms, the proportion of counterparties with no credit curves lies between 50% and 90% of the overall population).
- ii. There are well-established practices across the industry regarding proxy spread methodologies applied to market VaR that have already been subject to supervisors' approval, including methodologies that do not rely on the granularity nor the aggregation methods prescribed by EBA within its technical standards proposal. The requirement to use an extended VaR proxy methodology together with the prescribed granularity and aggregation method enclosed within the EBA proposal would force many banks to modify their VaR proxy methodologies even though the latter have already received a formal approval from their supervisors.
- iii. Finally, industry is reluctant to call into question validated market VaR methodologies at a time where the Basel Committee has launched a fundamental review of the trading book.

*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.*

**Comments to Q3 :**

- 1 - In our view, the sub-categories for industry proposed in Article 5.4 are inadequate:
- Sovereigns are not identified as a sub-category whereas that type of counterparty displays very specific credit spread dynamics (and even more so in the midst of the current sovereign debt crisis) and LGD levels ;
  - The segmentation of the corporate counterparties (between raw materials, industrial production and non-financial services) is unnecessarily prescriptive :
    - o Rating and Region are the principal drivers of corporate spreads. The number of liquid corporate CDS curves would not allow to provide the requested industry granularity for most ratings and regions (see table below) ;

Number of corporate CDS curves by rating and region (Markit data as of 12/30/2011)

	Asia	Europe	North America
AAA	0	0	5
AA	26	12	11
A	61	67	112
BBB	100	133	228
BB	36	38	99
B	6	25	65
CCC	1	2	13
Total	230	277	533

- Even where the number of CDS corporate curves would allow more industry granularity (typically BBB corporates), it does not improve the statistical pooling of spreads (see the example of European BBB corporates in table below).

5Y spreads of European BBB corporates by sub-category of industry (Markit data as of 12/30/2011)

	Average 5Y spread	Standard deviation of the 5Y spread	Number of CDS curves
Raw Materials	2.3%	1.9%	16
Industrials	2.2%	1.9%	28
Non-financial services	1.7%	1.3%	50
Other corporates	1.6%	1.3%	39
Grand Total	1.9%	1.5%	133

The table above shows that (i) differences in average spreads across sub-categories are not significant (particularly compared to standard deviations) and (ii) that pooling CDS curves by sub-category does not allow reducing the standard deviation of spreads within a pool.

Therefore, in order to bring statistically significant differentiation by industry given the number of liquid CDS curves, we believe that the minimum regulatory requirements in terms of industry granularity should be: Corporates, Financials and Sovereigns.

2 - If the aggregation by either industry or region is not enough to build a proxy spread, an aggregation by industry and region should be allowed before resorting to the standard CVA capital charge (it would allow to capture market spread movements by rating, which is also the indicator of default probability used in the standard CVA formula).

3 - Finally, aggregating in only 1 dimension is more likely to generate situations where a bucket switches over time from situations where it contains CDS contribution to situations where it contains no CDS contribution and vice-versa. This is typically the case for a bucket containing only 1 CDS contributor which is unequally contributed over time: any exposure to this contributor would alternatively enter the scope of the advanced method (when the CDS is deemed liquid) and the scope of the standard method (when the CDS does not meet the liquidity criteria). It would ultimately create undesirable volatility in the capital charge.

*Q4: Please provide any information and the difference in own funds requirements 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 ?*

**Comments to Q4:**

The impact of the application of Article 5.8 and 5.9 should be contained as we currently estimate that those Articles would apply to less than 10% of the CVA sensitivity.

**Additional comments on Article 3-4:**

Interpolation should also be possible by rating in order to reflect the granularity of internal rating grids.

**RTS on  $LGD_{MKT}$**

**Additional comments on Article 6:**

LGDs implied by CDS spreads (denoted  $LGD_{MKT}$  hereafter) should indeed be used to derive market probabilities of default in the advanced CVA formula i.e. LGDs used in the ratios  $\frac{S_i \cdot t_i}{LGD_{MKT}}$  in the regulatory CVA formula but do not make as much sense as a market recovery estimate (i.e. when used as a multiplier at the beginning of the regulatory CVA formula):

- CDS LGDs for counterparties far from default are essentially a market convention ;
- CDS LGDs reflect losses on senior unsecured debt and are therefore not appropriate for secured exposures (which is typically the case in project finance where interest-rates and forex hedges benefit from the same security package as the structured loan).

As a result, the first LGD appearing as a multiplier at the beginning of the regulatory CVA formula (denoted  $LGD_{NS}$  hereafter) should not be systematically implied from CDS but should rather refer to the risk of each netting set.

We therefore strongly support regulatory CVA formula to distinguish between the 2 LGD appearing in the CVA formula:

$$CVA = LGD_{NS} \cdot \sum_{i=1}^T \max \left\{ 0, \exp \left( -\frac{s_{i-1} \cdot t_{i-1}}{LGD_{MKT}} \right) - \exp \left( -\frac{s_i \cdot t_i}{LGD_{MKT}} \right) \right\} \cdot \frac{EE_{i-1} \cdot D_{i-1} + EE_i \cdot D_i}{2}$$

Accordingly, the derived formulas for Regulatory CS01 would become:

- Where the model is based on credit spread sensitivities for specific tenors

$$RegulatoryCS01_i = 0.0001 \cdot \frac{LGD_{NS}}{LGD_{MKT}} \cdot t_i \cdot \exp \left( -\frac{s_i \cdot t_i}{LGD_{MKT}} \right) \cdot \frac{EE_{i-1} \cdot D_{i-1} - EE_{i+1} \cdot D_{i+1}}{2}$$

- Where the model uses credit spread sensitivities to parallel shifts in credit spreads,

$$RegulatoryCS01_i = 0.0001 \cdot \frac{LGD_{NS}}{LGD_{MKT}} \cdot \sum_{i=1}^T \left( t_i \cdot \exp \left( -\frac{s_i \cdot t_i}{LGD_{MKT}} \right) - t_{i-1} \cdot \exp \left( -\frac{s_{i-1} \cdot t_{i-1}}{LGD_{MKT}} \right) \right) \cdot \frac{EE_{i-1} \cdot D_{i-1} + EE_i \cdot D_i}{2}$$

## **RTS on “limited number of smaller portfolios”**

*Q5: Do the proposed thresholds 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?*

### **Comments to Q5 and Q6:**

In our view, the limit in number of portfolios is not relevant and should be suppressed to only keep a threshold on the size of the portfolios.

For instance, given the proposed thresholds, a single portfolio representing 10% of the total portfolio size would be eligible to IMM-like treatment while portfolios representing 20% in number and 10% in size would not, which seems rather counter-intuitive.

Furthermore, we believe that the 10% threshold on portfolio size is set too low and might prove too difficult to reach to really incentivize institutions to reduce their non-IMM portfolios. Given the current levels of credit spreads, the benefit from using an IMM approach on smaller portfolios rather than the standard method is substantially reduced and might not justify the R&D and IT costs involved in implementing the Internal Model Method on such portfolios (notably for institutions with larger exotic exposures). A threshold set at 20% would seem more adequate.

*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.*

### **Comments to Q7:**

We favor option 1 as it is the measure with less methodological bias and that will provide the highest level of operational control and reliability on a monthly basis.