14 September 2012

Banking Stakeholder Group

Comments from the Banking Stakeholder Group on the 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)

The European Banking Authority Banking Stakeholder Group (BSG) welcomes the opportunity to provide responses to the European Banking Authority 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).

Since the draft regulatory technical standard is aimed to help institutions some of the questions in the consultation paper are better answered directly by institutions. Due to this the BSG has chosen not to respond to all the questions and has also not had the possibility to provide relevant data to support the responses as asked for by the EBA.

The BSG supports the EBA objective to provide sound guidelines for the determination of proxy spread and the definition of a limited number of smaller portfolios to ensure a consistent implementation across firms. Nevertheless, BSG is of the general opinion that the guidelines are too prescriptive in the proposed methodology and in the granularity for proxy spread buckets. The EBA proposal, as is, may force banks to modify their VaR proxy methodologies even though they have already received a formal approval from the regulators.

Answers to the questions:

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.*

There is a wide range of practises across industry for VaR proxy methodologies. It is clear that not all VaR proxy methodologies take into account rating, regions and industry. The most common approach is that the VaR proxy methodology takes into account both the rating and industry category. However, to also use region as a category is not that common and would probably be difficult outside the US due to lack of CDS data.

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.

Sub-categories for region should as accurately as possible reflect the nature of the sub-portfolios of the institutions business model. It is expected to be challenging for many institutions to provide sufficient data for regions outside the US and thus it is suggested that the regional sub-categories suggested by the EBA should be considered as guidance rather than strict requirements.

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.*

As responded to question 1 and 2, the sub-categories would need to be on a very aggregate level in order to be able to obtain necessary data to determine the proxy spread. Any lack of data would distort the accuracy of determined proxy spreads. To be able to create reliable proxy spreads, several available counterparty spreads would be required within the sub-category. For the sake of illustration, we think the minimum regulatory requirements in terms of industry granularity should be: Corporates, Financials and Sovereigns.

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.*

The BSG is of the general opinion that whenever 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).

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)?*

The BSG is of the opinion that the number of smaller portfolios, even though it is explicitly mentioned in the CRR, is not a suitable criterion for a threshold as it is not risk-sensitive at all.

Moreover, if the Advanced CVA risk method would result in lower risk weighted assets than the Standardized method, the inclusion of these quantitative limits would give the proper incentives. It is however not guaranteed that it will be beneficial to use the Advanced method, it can most likely sometimes be more beneficial to use the Standardized method.

When the non-IMM portfolios are down to 15-20% in size, depending on the institution, the modelling of many further product types is necessary to reduce the total size of the non-IMM portfolios by another percentage. Due to this 15% is a more suitable limit for size than the 10% limit.

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.*

The BSG has chosen not to respond to this question since it is addressed directly to institutions.

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.

The BSG is of the opinion that Option 1 (exposure at default using the mark-to-market method) might be the preferred option as it is the only proposed option which is an exposure metric encompassing forward looking element.

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

As mentioned earlier, should the proposed methodology be too prescriptive, a significant number of firms would have to modify their VaR proxy methodologies and adopt new methodologies to implement proxy spreads.