European Banking Authority

EBA/RTS/2013/17

20 December 2013

EBA FINAL draft Regulatory Technical Standards

on credit valuation adjustment risk for the determination of a proxy spread and the specification of a limited number of smaller portfolios under Article 383(7) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR)

EBA FINAL draft Regulatory Technical Standards on credit valuation adjustment risk for the determination of a proxy spread and the specification of a limited number of smaller portfolios under Article 383(7) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR)

Contents

1. Executive Summary 3
2. Background and rationale 5
3. EBA FINAL draft Regulatory Technical Standards on credit valuation adjustment risk for the determination of a proxy spread and the specification of a limited number of smaller portfolios under Article 383(7) of Regulation (EU) No 575/2013 (Capital Requirements Regulation - CRR) 7
4. Accompanying documents 14

4.1 Cost- Benefit Analysis / Impact Assessment 14

4.2 Views of the Banking Stakeholder Group (BSG) 17

4.3 Feedback on the public consultation and on the opinion of the BSG 18

1. Executive summary

The Capital Requirements Regulation ('CRR') and the Capital Requirements Directive ('CRD')[1] set out prudential requirements for banks and other financial institutions which will apply from 1 January 2014. The CRR contains specific mandates for the EBA to develop draft Regulatory Technical Standards ('RTS') to specify the conditions for the determination of a proxy spread and the criteria for a limited number of smaller portfolios under Article 383(7).

Regulation (EU) No 575/2013 sets out new requirements for institutions to compute own funds for credit valuation adjustment risk. Article 383(7) of Regulation (EU) No 575/2013 mandates the EBA to prepare draft RTS in this area.

In 2012 the EBA conducted a consultation on draft RTS[2] on credit valuation adjustment risk based on the legislative proposal of the European Commission for Regulation (EU) No 575/2013. Because Regulation (EU) No 575/2013 introduced some relevant changes in relation to the RTS mandate in the European Commission's proposal and in consideration of the first consultation of 2012, the EBA decided to conduct a second public consultation.

While Article 383(7)(b) remained unchanged, the new text of Article 383(7)(a) of Regulation (EU) No 575/2013 changed the mandate as follows: '*EBA shall develop draft regulatory technical standards to specify in greater detail(…) how a proxy spread should be determined by the institutions approved internal VaR model for the specific interest rate risk for the purposes of identifying* s_i *and* LGD_{MKT}'.

Furthermore, a new paragraph Article 383(6) of Regulation (EU) No 575/2013 has been added. This paragraph confirms that institutions should apply the standardised method for the calculation of the CVA risk charge for exposures to those counterparties which do not produce an appropriate proxy spread with reference to industry, rating and region under the advanced method.

Consequently, the RTS do not deal directly with the VaR spread methodology, but specify the criteria that this methodology has to satisfy in order to allow for a proxy spread to be used in the calculation of the advanced CVA charge.

Considering the feedback received during the consultation, and in particular, further evidence that availability of reliable CDS data is an issue for some combinations of rating, industry and region criteria, the EBA decided to reduce the minimum granularity for the attribute of 'industry' (reduced to three categories: 'public sector', 'financials' and 'others') and allow for greater flexibility in the determination of proxy spreads.

Despite having introduced greater flexibility in these draft RTS, insofar as permitted under the legal obligation in Article 383(7), the EBA is concerned that Article 383(7) and hence the legal obligation to implement the approach laid down in these RTS require adjustments to the approved market risk VaR, which may reduce the quality of the market risk VaR or harm its close integration into the daily

[1] Regulation (EU) No 575/2013 of 26 June 2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 and Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

[2] The documentation can be found at: http://www.eba.europa.eu/Publications/Consultation-Papers/All-consultations/2012/EBA-CP-2012-09.aspx

risk-management process of institutions. It should be stressed, however, that the EBA is mandated to produce a report, whereby, in light of the issues raised by the implementation of the CVA risk charge, the relevance of some of the features of the CVA framework, together with the relevance of the provisions of these RTS, may be reconsidered.

Article 456(2) of Regulation (EU) No 575/2013 requires the EBA to produce by 1 January 2015 a report, which will assess:

- 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;
- the calculation of capital requirements of CVA risk.

2. Background and rationale

The Capital Requirements Regulation ('CRR') and the Capital Requirements Directive ('CRD')[3] set out prudential requirements for banks and other financial institutions which will apply from 1 January 2014. The CRR contains specific mandates for the EBA to develop draft Regulatory Technical Standards ('RTS') to specify the conditions for the determination of a proxy spread and the criteria for a limited number of smaller portfolios under Article 383(7) of Regulation (EU) No 575/2013.

Background to the 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[4] which aimed at addressing the lessons drawn from the financial crisis.

The final draft RTS elaborate on certain specific elements of the calculation of own funds requirements for credit valuation adjustment ('CVA') risk. In accordance with Article 381 of Regulation (EU) No 575/2013, 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 integrates the capital treatment for counterparty credit risk on OTC (bilateral) derivative instruments.

It should be noted that the scope of application of the CVA charge has been limited substantially in the final CRR compared to the original CRR proposal. Specifically, the final CRR excludes from the CVA calculation certain non-financial and central government counterparties.

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

Scope of the draft RTS

Article 383(7) of Regulation (EU) No 575/2013 requires the EBA to draft RTS 'to specify in greater detail':

(a) how a proxy spread should be determined by the institution's approved internal model for the specific risk of debt instruments for the purposes of identifying s_i and LGD_{MKT} referred to in Article 383(1); and

[3] Regulation (EU) No 575/2013 of 26 June 2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 and Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

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

(b) the number and size of portfolios that fulfil the criterion of a limited number of smaller portfolios referred to in Article 383(4).

Article 383(1) of Regulation (EU) No 575/2013 states that in calculating the Advanced CVA capital charge:

- institutions shall calculate a CVA VaR by using their internal model for the specific risk of debt instruments, which has to be approved by the relevant Competent Authority under EU provisions;
- the calculation shall use a formula with several inputs including:
  - ✓ the expected exposure calculated by the Internal Model Method;
  - ✓ Credit Default Swap (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;
- where a CDS 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';
- where 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 383(6) of Regulation No 575/2013 states that for exposures to a counterparty for which the institution's approved internal VaR model for the specific risk of debt instruments does not produce a proxy spread that is appropriate with respect to the criteria of rating, industry and region of the counterparty, the institution shall use Article 384 to calculate the own funds requirement for CVA risk.

Article 383(4) of Regulation (EU) No 575/2013 states that institutions which have permission:

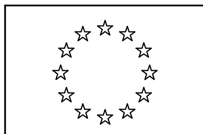
- to use an internal market risk model for the specific risk of debt instruments; and
- to use the IMM for the calculation of the exposure values to counterparty credit risk on the majority of their business, but use other methods (Mark-to-Market Method, Standardised Method or Original Exposures Method)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

may also, subject to permission from the competent authorities, use the advanced method for the calculation of the CVA capital charge for the portfolios that are not covered by the IMM. This permission may only be granted if 'a limited number of smaller portfolios' are excluded from the scope of the IMM.

The scope of EBA's mandate for the draft RTS in this context covers:

- the specification of how a proxy spread should be determined in order to be considered appropriate with respect to the criteria of rating, industry and region of a specific counterparty;
- the 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
- the 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.

3. EBA FINAL draft Regulatory Technical Standards on credit valuation adjustment risk for the determination of a proxy spread and the specification of a limited number of smaller portfolios under Article 383(7) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR)



EUROPEAN COMMISSION

Brussels, XXX
[…](2012) XXX draft

COMMISSION DELEGATED REGULATION (EU) No …/..

of XXX

[…]

supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms, 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 in accordance with Article 383(7)

COMMISSION DELEGATED REGULATION (EU) No …/..

supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms, 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 in accordance with Article 383(7)

of XX Month 2013

THE EUROPEAN COMMISSION,

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

Having regard to Regulation (EU) No 575/2013 of 26 June 2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 and in particular third subparagraph of Article 383(7) thereof,

Whereas:

(1) The application of the advanced method to the determination of own funds requirements for Credit Valuation Adjustment (CVA) risk may involve counterparties for which no Credit Default Swap (CDS) spread is available. Where this is the case, institutions should use a spread that is appropriate having regard to the rating, industry and region of the counterparty (‘*proxy spread*’) by virtue of the fourth subparagraph of Article 383(1) of Regulation (EU) No 575/2013 referring to the concept of s_i.

(2) The Value-at-Risk (VaR) methodology specifies how a proxy should be determined where no credit spread is available, in the context of the calculation of the own funds requirements for market risk. However, in accordance with Article 383(7) of Regulation (EU) No 575/2013, a proxy spread determined by that methodology should only be applied to the determination of the advanced CVA own funds requirements if it satisfies the criteria set out in this Regulation. In order to limit, for the institutions that are required to implement the advanced CVA method, the changes to the already approved VaR that they use for the calculation of the own funds requirements for market risk, where this could lower the quality of the market risk VaR because, in particular, insufficiently reliable CDS data is available, and in order to reduce the distortions in terms of level playing field among institutions that this would create, rules on the determination of proxy spread for CVA risk should provide for the use of broad categories of rating, industry and region, and should allow institutions the necessary flexibility to determine the most appropriate proxy spread based on their expert judgment.

(3) When specifying in more detail how the attributes of rating, industry and region of the single issuers should be considered by institutions when estimating an appropriate proxy spread for the determination of the own funds requirements, as

required by virtue of Regulation (EU) No 575/2013, rules should be established for the consideration of these attributes by reference to minimum categories for each attribute, in order to ensure a harmonised application of these conditions. Further, in order to allow both for more flexibility for institutions and at the same time for more granularity to be provided by them where sufficient, reliable data is available, additional attributes (such as ‘currency’, ‘seniority’ or ‘size of enterprise’) should be allowed to be considered by institutions.

(4) Furthermore, when considering the attributes of rating, industry and region of the single issuers, in cases where a close link exists, such as between a parent and a subsidiary that are sufficiently homogenous having regard to the criteria of rating, industry and region, or between a regional government or local authority and the sovereign, it should be possible to allow for the estimation of an appropriate proxy spread on the basis of the credit spread of a single issuer, where this leads to a more appropriate estimation.

(5) In order to lead to an appropriate computation of the CVA risk charge, a proxy spread should be determined using data that has been observed in a liquid market and assumptions regarding data, such as interpolation and extrapolation of data relating to different tenors, should be conceptually sound.

(6) In order to ensure convergence of practices among firms and to avoid cherry picking, considering that implied probabilities of default (‘PDs’), CDS spreads and LGD constitute one equation with two unknown variables and that the market convention is to use a fixed value for LGD in order to derive implied PDs from market spreads, institutions should use a value for LGD_{MKT} that is consistent with the fixed LGD commonly used by market participants for determining implied PDs from those liquid traded credit spreads that have been used to determine the proxy credit spread for the counterparty in question.

(7) For the purposes of permission to use the advanced CVA method for a limited number of smaller portfolios, it is appropriate to define a portfolio as a netting set as referred to in Article 272(4) of Regulation (EU) No 575/2013, to consider the number of non-IMM transactions subject to the CVA risk charge and the size of non-IMM netting sets subject to the CVA risk charge, and to limit them in terms of a percentage of the total number of all transactions subject to the CVA risk charge and a percentage of the total size of all netting sets subject to the calculation of CVA risk charge, in order to take account of the different dimensions of institutions.

(8) The use of the advanced CVA method for a limited number of smaller portfolios should cease only when quantitative limits are breached for two consecutive quarters in order to mitigate possible discontinuities also known as ‘cliff effects’. Further, in order to render it possible for competent authorities to perform their supervisory duties, they should be able to know when the relevant thresholds are no longer met; hence institutions should notify competent authorities in those cases.

(9) This Regulation is based on the draft regulatory technical standards submitted by the European Banking Authority to the Commission.

(10) 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:

SECTION I

THE PROXY SPREAD

Article 1

Determining an appropriate proxy spread

1. The proxy spread for a given counterparty shall be deemed appropriate having regard to the rating, industry and region of the counterparty according to Article 383(1), fourth subparagraph of Regulation (EU) No 575/2013, where all of the following conditions are satisfied:
   (a) the proxy spread has been determined by considering all of the attributes of rating, industry and region of the counterparty as specified in points (b) to (d);
   (b) the attribute of rating has been defined by considering the use of a predetermined hierarchy of sources of internal and external ratings. Ratings shall be mapped to credit quality steps, as referred to in Article 384(2) of Regulation (EU) No 575/2013. In cases where multiple external ratings are available the mapping shall follow the approach for multiple credit assessments set out in Article 138 of that Regulation;
   (c) the attribute of industry has been defined by considering at least the following categories:
      - public sector;
      - financials;
      - others.
   (d) the attribute of region has been defined by considering at least the following categories:
      - Europe;
      - North America;
      - Asia;
      - Rest of World.

(e) the proxy spread reflects in a representative way available credit default swap spreads and spreads of other liquid traded credit risk instruments, corresponding to the relevant combination of applicable categories and satisfying the data quality criteria set out in paragraph 4;

(f) the appropriateness of the proxy spread is determined with reference to the volatility rather than to the level of the spread.

2. Additional attributes to those of rating, industry and region shall also be considered when determining the proxy spread where such additional attributes fulfil both of the following conditions:

   (a) they reflect the characteristics of positions in the institution's CVA portfolio;

   (b) they take account of the availability of data that satisfy the data quality criteria set out in paragraph 4.

3. In the process of considering the attributes of rating, industry and region of the counterparty in accordance with paragraph 1, where both of the following conditions are met:

   (a) there is a close link between a regional government or local authority and the sovereign

   (b) either of the following conditions is met:

      (i) the regional government or local authority and the sovereign have the same ratings;

      (ii) there is no rating for the regional government or local authority

   the estimation of the proxy spread shall be deemed appropriate to be made for a regional government or local authority based on the credit spread of the relevant sovereign issuer.

4. All inputs used in the determination of a proxy spread shall be based on reliable data observed on a liquid two-way market as defined in second subparagraph of Article 338(1) of Regulation (EU) No 575/2013. Sufficient data shall be available to generate proxy spreads for all relevant tenors and for the historical periods referred to in Article 383(5) of that Regulation.

Article 2

Identification of LGD_{MKT}

In order to identify LGD_{MKT} for the purposes of calculating the own funds requirements for CVA risk according to the advanced method for a counterparty requiring the use of a proxy spread, institutions shall use a value for LGD_{MKT} that is

consistent with the fixed LGDs commonly used by market participants for determining implied PDs from those market spreads that have been used to determine the proxy spread for the counterparty in question in accordance with this Section.

SECTION II

THE NUMBER AND SIZE OF QUALIFYING PORTFOLIOS

Article 3

Quantitative limits

1. To fulfil the criterion of a limited number of smaller portfolios referred to in Article 383(4) of Regulation (EU) No 575/2013, all of the following conditions shall be satisfied:

    a. the number of all non-IMM transactions subject to the CVA risk charge shall not exceed 15 % of the total number of transactions subject to the CVA risk charge;

    b. the size of each individual non-IMM netting set subject to the CVA risk charge shall not exceed 1 % of the total size of all netting sets subject to the CVA risk charge;

    c. the total size of all non-IMM netting sets subject to the CVA risk charge shall not exceed 10 % of the total size of all netting sets subject to the CVA risk charge.

2. For the purpose of points (b) and (c) of paragraph 1, the size of a netting set shall be the exposure at default of the netting set calculated using the mark-to-market method referred to in Article 274 of Regulation (EU) No 575/2013 by taking account of the effects of netting, in accordance with Article 298 of that Regulation, but not the effects of collateral.

3. For the purpose of paragraph 1, an institution shall calculate, for each quarter, the arithmetical average of at least monthly observations of the ratios of:

    a. the number of non-IMM transactions to the total number of transactions;

    b. the individual size of the largest non-IMM netting set to the total size of all netting sets; and

c. the total size of all non-IMM netting sets to the total size of all netting sets.

4. If the criterion specified in paragraph 1 is not fulfiled for two consecutive calculations referred to in paragraph 3, an institution shall use the standardised method set out in Article 384 of Regulation (EU) No 575/2013 to calculate the own funds requirements for CVA risk for all of the non-IMM netting sets and notify the competent authorities.

5. The conditions set out in paragraph 1 shall be applied on an individual, a sub-consolidated or a consolidated basis, depending on the scope of the permission referred to in Article 283 of Regulation (EU) No 575/2013.

SECTION III

FINAL PROVISION

Article 4

Entry into force

This Regulation shall enter into force on the twentieth 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]

4. Accompanying documents

4.1 Cost-benefit analysis / impact assessment

Problem definition and objectives of the RTS

Introduction

As per Article 10(1) of the EBA Regulation (Regulation (EU) No 1093/2010 of the European Parliament and of the Council), any draft implementing technical standards / regulatory technical standards developed by the EBA – when submitted to the EU Commission for adoption – must be accompanied by an impact assessment (IA) annex which analyses 'the potential related costs and benefits'. Such an annex shall provide the reader with an overview of the findings as regards the problem identification, the options identified to remove the problem and their potential impact.

In accordance with Regulation No 575/2013, 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 383(7). Those draft RTS should be submitted to the Commission by 1 January 2014.

Problem definition

Issues addressed by the European Commission (EC) regarding counterparty credit risk

The pre-CRR framework had some shortcomings in the treatment of counterparty credit risk exposures arising from derivatives, repos and securities. It effectively addressed the risk of counterparty default and credit migration risk, but not the risk of mark-to-market variations in credit valuation adjustments (CVA). This created concern as a significant portion of institutions' losses during the financial crisis were caused by changes in the credit spreads of counterparties due to changes in their credit quality (also referred to as the market value of counterparty credit risk) reflected in mark-to-market changes in over-the-counter derivative products. To take account of this risk, the own funds requirement for CVA risk was introduced in Regulation No 575/2013. In its impact assessment, the European Commission noted that the introduction of a CVA risk capital charge would enhance institutions' capital buffers and risk management.

Issues addressed by the RTS

The application of the advanced CVA method is mandatory for all institutions holding supervisory approval for estimating expected exposure with the IMM method and computing specific risk of debt instruments using the VaR model. The advanced CVA calculation uses input for each counterparty, such as credit spreads and LGDs. Where this input is not directly observable in the market, the institutions have to find appropriate proxies to estimate the risk with regard to this counterparty. Furthermore, the CRR allows institutions to include a limited number of smaller portfolios in the advanced CVA method which are not modelled using the IMM. These RTS define standards for the determination of proxy spreads and specifies quantitative limits for non-IMM netting sets to be accepted in the advanced CVA calculation.

Objectives of the RTS

The proposals made in these RTS will contribute to:

i. Achieve a common understanding amongst institutions and the EU's national competent authorities about:

   a. the approach to determine a proxy spread in the advanced CVA method, when the spread relating to a specific counterparty is not available;

   b. the extent to which institutions may include non-IMM netting sets in the advanced CVA method.

ii. Ensure harmonisation and consistent practices in these two areas.

Technical options considered

Determination of the proxy spread for the advanced method

The use of the advanced CVA method will create additional compliance costs for institutions, due to the new processes, additional IT and staff resources needed to meet the requirements of the regulation. Feedback from the consultation shows that it is expected that the proxy methodology will have to be applied to a large number of counterparties, thus potentially increasing the additional costs.

In order to minimise additional implementation burdens, the EBA proposes an approach that will define, in a harmonised way, the criterion of appropriateness with respect to the criteria of rating, industry and region. This approach should allow institutions to collect simple and granular data in order to conduct reliable estimations, while allowing for the necessary flexibility in the determination of proxy spreads. Given the limited scope of application, this should not be a threat for the harmonisation of the Single Rule Book.

Defining the criterion of a limited number of smaller portfolios

The conditions proposed will set a standard for institutions and national authorities regarding the extent to which non-IMM portfolios can be included in the advanced method for the calculation of the CVA capital charge. These conditions will ensure that the majority of the exposures included in the advanced CVA calculation are determined by the more differentiated technique of the IMM, while recognising that certain positions might be very difficult to model satisfactorily.

The EBA determined three thresholds that should be applied to non-IMM portfolios. These thresholds were calibrated using the limited data available. The underlying principle for defining these thresholds was to ensure that non-IMM portfolios remain small in absolute and relative terms, so that most transactions are estimated using the most sophisticated approach available.

The proposed conditions require that institutions calculate the exposure for both their IMM and their non-IMM portfolios using the relatively simple mark-to-market method, which should minimise additional costs, and which is also required for the calculation of the leverage ratio. Furthermore, the EBA considers that exceeding the proposed thresholds should be relevant only if it persists for two consecutive quarters, therefore reducing the impact of substantial 'cliff' effects that might be caused by exceptional circumstances and allowing institutions time to take appropriate corrective action.

Impact of the proposals

The EBA has conducted a survey with the national supervisory authorities to identify the population of institutions that are likely to be affected by the RTS, and its potential impact on institutions and national supervisory authorities.

From the survey, only 20 banking groups and institutions in five jurisdictions are expected to calculate CVAs using the advanced approach and therefore be affected by the proposals presented in these RTS. 13 banking groups have been formerly identified as being currently non-compliant with some of the requirements of these RTS.

Costs for institutions

For most of the institutions identified, the most important driver of cost is related to the fact that the application of the provisions of these RTS, as stated in the CRR, could mean considerable costs due to the modification of the existing VaR methodology for market risk, and could lead to a misalignment between the calculation of own funds requirements for market risk and current risk management practices.

Other costs may arise from the necessary strengthening of the IT infrastructure as a result of the implementation of these RTS. In particular, the use of the mark-to-market method to calculate the size of a portfolio is expected to require improvements to the IT infrastructure even if the EBA does not expect these costs to be generally material, since they will diverge among institutions that are using the internal model method (IMM) and depend on the coverage level of their own IMM.

Costs for national supervisory authorities

National authorities will also bear additional costs at they will need to engage more resources to supervise compliance with the new requirements, in particular to verify that the criteria for proxy spreads are met.

Benefits

By establishing harmonised criteria for some aspects of the calculation of own funds requirements for CVA risk in accordance with the advanced method, the RTS will ensure that institutions in different Member States use the same practices and reduce the burden for cross-border firms to comply with different regulatory frameworks.

4.2 Views of the Banking Stakeholder Group (BSG)

No feedback has been received from the BSG.

4.3 Feedback on the public consultation and on the opinion of the BSG

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
General comments			
Interpretation of CRR mandate	Most respondents consider that the interpretation of the CRR text is inappropriate and would oblige banks to introduce significant changes in their VaR models with the following negative consequences: - introduction of a gap between risk management practices and the supervisory treatment; - necessity to review the VaR models, even if they have already received supervisory approval; - this review is particularly unwelcome because in the medium term the market risk models will be subject to substantial changes as a consequence of the fundamental review of the trading book. According to the respondents, an appropriate interpretation that respects the 'spirit' of the EBA mandate would be to require banks to derive the CVA proxy spreads from their specific risk VaR model by way of some adaption that meets the RTS criteria, rather than imposing the application of those criteria to the VaR model itself. Furthermore, when proxying credit spread dynamics in a VaR model, relying on credit spread levels may be more	The EBA acknowledges that the RTS may affect the VaR methodology in the market risk framework. However, the level 1 text (i.e. the CRR) mandates the EBA to establish criteria for a unified proxy methodology.	No change.

	appropriate than relying on ratings, because ratings are not updated on a daily basis. They suggest that the rating/industry/region criteria should therefore be a starting point for proxying spreads both within the scope of the VaR and the CVA charge. However, the bank should be allowed to introduce adaptions depending on the nature of the proxy, provided that such choices are duly justified. For many respondents, the preferred option is the introduction of a set of minimum standards that support the existing VaR practices, as well as the existing accounting CVA practices. They consider that, whilst the EBA should set out minimum requirements around the implementation, governance, validation and degree of challenges to which models should be subject, it should allow for flexibility in choosing the methodology to meet these standards. One respondent emphasises that internal models for specific debt instruments (that have regulatory approval) already use proxy curves, and that the curves used in these models are constructed differently from those required by the EBA. According to this respondent, this can have material consequences (increased workload and the necessity to have two contrasting views), and is therefore not desirable. The use of the EBA-defined proxy spreads is also expected to have an impact on		

	back testing performance and the way in which risks are monitored. One other respondent considers that the RTS do not consider data availability by tenors. Tenor granularity is important for the measurement of market risk, and for this reason the application of the RTS to the calculation of market risk would result in a loss of quality of VaR. This respondent also underlines that, if the RTS has to be applied also to stressed VAR, the prescribed granularity could lead to a significant under- or overcapitalisation because of the specificities of the Lehman crisis.		
Need of flexibility and possibility to use alternative credit quality assessment	Most respondents consider that the approach is excessively prescriptive, and is expected to introduce unnecessary burdens. They explain that, for the largest global firms, the number of counterparties with proxy spreads is between 50% and 90% of the total names subject to the CVA charge, and emphasise that the minimum prescribed granularity would not necessarily lead to statistical meaningful results because many buckets are likely to be poorly populated. The respondents therefore propose the following amendments: - Article 3(1)(a) *‘by ~~reflecting~~ considering all of the attributes of rating, industry and region of the*	The EBA recognises the need for flexibility in the determination of an appropriate proxy spread, in particular considering the limited availability of data. Article 3(1)(a) [new Article 1(1)(a)] and Article 3(1)(b) [new Article 1(1)(b)] have been amended accordingly. However, the EBA believes that, since the level 1 text (i.e. the CRR) establishes the criteria of rating, institutions have to consider the attribute of rating as part of their assessment of the relevance of the attributes of rating, industry and region, and cannot only rely on ‘alternative credit quality assessments’.	Amendments to Article 1(1)(a) and Article 1(1)(b) of these draft RTS.

	counterparty' - Article 3(1)(b) *'the attribute of rating has been defined by <u>considering</u> the use of a predetermined hierarchy of sources of internal and external ratings <u>and alternative credit quality assessments.</u> Ratings shall be mapped to credit quality steps, as referred to in Article 384(2) of Regulation (EU) No 575/2013. In cases where multiple external ratings are available the mapping shall follow the approach for multiple credit assessments set out in Article 138 of that Regulation.'* These amendments should allow banks to depart from the minimum granularity if no data are available. Furthermore, the use of credit spread levels would be allowed.		
Need of an implementation period if the market risk VaR has to be adjusted	Many respondents consider that, should the final RTS remain unchanged, institutions would need to introduce important changes to their VaR models and that, for this reason, an implementation period of six months should be introduced. Another respondent emphasises the fact that, where banks need to adjust the proxy spread methodology in the approved market risk VaR model, an implementation period of at least 6-9 months, plus the time required to seek supervisory approval, will be required.	The EBA recognises that some of the changes will need time in order to be implemented. However, this situation results mainly from the requirement established in the CRR, in particular Article 383(7)(a). The additional time needed for implementation of these RTS does not appear to add significantly to the implementation, but rather clarifies the implementation requirement.	No change.

Application of the CVA standardised method if the VaR fails to produce an appropriate proxy spread	Some respondents express the view that the requirement stated in CRR Article 383(6) should not be interpreted literally because a conciliation of the standardised and advanced approaches would be operationally burdensome.	The requirement of Article 383(6) is established in the level 1 text (i.e. the CRR) and falls outside the scope of these RTS.	No change.
Definition of thresholds	Some respondents consider that the definition of thresholds based on the number of smaller portfolios is not appropriate, since in the case of large dealers it is frequently the case that 80%-90% of the portfolios may amount to only 10%-20% of the exposure, and they suggest that the metric should rather be a function of exposure and tenor.	The number criterion is stated in the level 1 text.	No change.
Splitting between IMM and non-IMM portfolios is complicated	One respondent underlines that banks that have an approved IMM model for regulatory purposes should be allowed to choose between the standardised and advanced CVA charges, and mentions that, from a technical point of view, it is very difficult to split a Credit Support Annex between an IMM and a non-IMM portfolio.	The problem of splitting master agreements into an IMM and a non-IMM part for regulatory purposes does not regard only the calculation of the CVA charge, but more generally also the calculation of the exposure to counterparty credit risk. The possibility of a permanent partial use is stated in the level 1 text and is out of the scope of these RTS. The level 1 text allows for the application of the advanced CVA method to non-IMM portfolios only if there is 'a limited number of small portfolios'.	No change.
Introduction of new idiosyncratic risks to the financial system	According to one respondent, the reliance on a small number of issuers for a proxy will accentuate the impact of idiosyncratic risk from these issuers and also impact any CVA or traded market risk that is using those credit	The necessity to provide criteria for the determination of proxy spreads is stated in the level 1 text. However, the EBA recognises the need for flexibility in the determination of appropriate proxy spreads, and	Amendments to Article 1(1)(a) and Article 1(1)(b) of

	spreads. The creation of proxy spreads based on a limited number of CDS issuers will result in crowded trades, and banks hedging CVA risk will potentially create significant demand for protection of these CDS issuers.	amended Article 3(1)(a) [new Article 1(1)(a)] and Article 3(1)(b) [new Article 1(1)(b)] accordingly.	these draft RTS.
Clarification request: reporting	Some respondents request clarification on the reporting requirement, according to which firms are required to calculate and report the arithmetic average of at least monthly observations of the ratio of 'the individual size of each non-IMM portfolio to the total size of all portfolios' to the local regulator, and whether this means that the arithmetic average for every non-IMM portfolio needs to be reported to the local regulator (which could result in thousands of lines of data from each firm).	The reporting requirement has been dropped.	Amendment to Article 3 of these draft RTS.
Clarification request: treatment of netting sets that are only partially evaluated under IMM.	With respect to the coverage calculation described in Article 5(1)(b) and (c) of the RTS, clarification is sought on how to calculate the 'total size of all portfolios subject to the CVA risk charge'. In particular, ambiguity is left on how institutions should treat the case of a netting set (portfolio) that is only partially evaluated under IMM. Our interpretation is that, during aggregation across all portfolios, the size of IMM and non-IMM portions of the portfolio should be treated as separate portfolios, in order to provide a total size (denominator) that is consistent with the size of the non-IMM portion (numerator).	Article 2(1) defines a *'portfolio'* as a *'netting set 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'*. This means that, if the approved IMM approach provides for such a splitting of netting sets, the same netting sets must be used for the calculation of portfolio sizes.	No change. Most definitions have been moved to the recital section of these draft RTS.

Clarification request: inclusion of non-financial sectors	One respondent considers that the inclusion of non-financial sectors in the proxy spread guidelines contained in Article 3 of the RTS is redundant considering the exclusion of non-financial counterparties from the scope of the CVA VaR, and suggests clarifying in the RTS what purpose other than CVA VaR calculation the non-financial categories are for.	According to Article 382(4)(a), some transactions with non-financial counterparties will still be subject to an own funds requirement for CVA risk. Although standardised OTC derivatives contracts with non-financial counterparties above the clearing threshold will be subject to CCP clearing, all non-standardised OTC derivative contracts with non-financial counterparties that exceed the clearing threshold will be subject to an own funds requirement for CVA risk.	No change.
Responses to questions in Consultation Paper EBA/CP/2013/24			
Q1. Please provide information and data concerning the availability of CDS data with respect to the minimum categories for 'rating', 'industry' and 'region' defined in points (b), (c) and (d).	Some respondents, while agreeing with the necessity of using liquid and meaningful data as an input, stress the fact that there should be a reasonable compromise between granularity and reliability. In particular, they emphasise that, as a consequence of a slowdown in market activity in the CDS market, there are not enough single name data in order to comply with the increased granularity proposed in the RTS. Two respondents presented data constructed on the following criteria: - use of Markit Data with a minimum liquidity score of 4 (the lowest score is 5); - 5 years tenor; - underlying is a senior claim; - underlying entities have external ratings. Following this analysis, 63 (38%) out of 168 possible	Considering the data presented by institutions showing the limited availability of reliable CDS data, the EBA agrees that the granularity should be reduced, in particular with reference to the financial sectors. Furthermore, the EBA would also like to point out that it is possible to use a regression approach, based on the regression of the credit spreads on a set of three dummy variables differentiated by rating, industry and region. The EBA believes that each institution should define data quality criteria as stated in Article 1(5) of these RTS.	Amendment to Article 1(1)(c) of these draft RTS.

	combinations do not present a single underlying CDS, while only 30 (18%) possible combinations present more than 10 different CDS spreads. According to several respondents, given the limited availability of data, the RTS should be revised without providing any minimum level of granularity. Other respondents presented data showing similar characteristics, and conclude that the available data is not sufficient to cover every combination of the rating sector and region minimum granularity. One of the respondents used the available CDS data spreads in order to determine proxy spreads. From these calculations, it can be deduced that: - in some cases the estimated proxy spreads present inconsistencies that can be explained by poor quality data (in particular: the proxy spread for a certain region and industry does not always increase if the rating worsens); - the category of 'region' does not add value to the proxy creation as proxy levels tend to be comparable in different regions. Another respondent suggests that the RTS should include a statement regarding the minimum number of CDS spreads required for creating a meaningful proxy spread for a single combination of (industry/region/ rating), and that the RTS should allow for flexibility in the		

	aggregation of different segments. The respondent would be less concerned regarding proxy spread granularity if the proposed levels of granularity were to apply only to the CVA VaR. This respondent underlines that the 'Other Financials' category comprises also some US broker-dealers which, from a business mix perspective, are very similar to banks, and suggests that there should be no level of granularity lower than 'Financial Institutions'. According to another respondent, because of problems concerning the availability of data, the sub-sectors 'Banks', 'Insurance' and 'Other Financial Services' should be aggregated in a unique sector.		
Q2. Please provide information concerning the usefulness, appropriateness and coherence with market practices of the approach to the use of single-named proxies described in Article 3.	Most respondents confirm that there is no market standard regarding the use of single named proxies. One respondent underlines that such proxies are common, however, in the management of the incurred CVA. Most respondents therefore welcome the possibility of using single named proxies, which are in particular appropriate if the single spread is highly correlated with the spread of the counterparty, but only as long as it remains an option (and not an obligation) as currently drafted in the RTS. Some respondents, while supporting the proposal	The answers seem to confirm the utility of single named proxies. Consequently, following the assessment of the relevance of the level 1 attributes of rating, industry and region, institutions are allowed to use single named proxies, where this leads to a more appropriate proxy spread.	No change.

	regarding the use of single name proxies, clarify that, when establishing generic spreads for proxied names, they favour, in general, the use of traded CDS indices, which have observable credit spreads, instead of indices constructed from single name CDS, and request more flexibility in the RTS for using traded indices. They also request that, in order to be coherent with risk management practices, a CDS on a single named proxy should be recognised as an eligible CVA hedge.		
Q3. Paragraph 3 allows for the proxying of the spread of the subsidiary by the spread of the parent company. Where no rating is available for the subsidiary or the parent undertaking or both, should the entities be considered equal in terms of the ratings attribute? Do you think that this treatment is	For most respondents, proxying the spread of a subsidiary by the spread of the parent company is a reasonable approach in most cases, but not in the case of holding companies where subsidiaries often have very different characteristics and risk profiles from the parent company. They suggest that differences in characteristics (e.g. rating) between the two counterparties could be reflected by applying a multiplier. In situations where ratings are not available, a case-per-case review and computation of the multiplier should be used. Such an approach should be subject to supervisory approval. In any case, it should remain an option because it is not always suitable. One respondent expresses the view that if the parent is fully liable for its subsidiary, the spread of the parent should be used even if less than two of the three attributes (rating, industry and region) are equal.	The level 1 text gives no explicit possibility for using a multiplier and to link it to supervisory approval. Furthermore, it is not clear how such a multiplier would be applied in practice. The EBA considers that, when considering the attributes of rating, industry and region, in cases where a close link exists, such as between a parent and a subsidiary that are sufficiently homogenous having regard to the criteria of rating, industry and region, it should be possible to allow for the estimation of a single named proxy spread for the subsidiary on the basis of the credit spread of the parent, and vice versa, where this leads to a more appropriate estimation.	Amendment to Recital 4 of these draft RTS, in order to specify how Article 1 of these draft RTS may be applied in the particular case of a parent undertaking and a subsidiary.

appropriate? Please state the reason(s) in favour and/or against it.	Another respondent also considers that the relationship between the parent entity and the subsidiary should be considered. It is appropriate not to require matching ratings, industry and region if there is an enforceable cross default connection between the two entities. A parent company might have a different industry and region classification of the counterparty, yet the credit spread of the parent remains the best proxy available. The EBA should also allow for alternative credit quality assessment procedures in order to justify proxy spread mapping for subsidiaries. Also, according to this respondent, it is common that there are no external ratings available for subsidiaries that have issued no public traded debt. Rating should therefore not be a prerequisite for the proxying of the spread of a subsidiary. One respondent presented data showing that in 71% of all cases, all companies in a group belong to the same rating class, while in 93% of cases all companies in a group belong to at most two adjacent classes. The suggested approach therefore seems appropriate.		
Q4. Paragraph 4 allows for the proxying of the spread for a regional	Many respondents consider that the approach is appropriate in most cases. For one respondent, the government spread is the best proxy, even if in some cases the central government is not fully liable for the local authority.	The EBA believes that, subject to the requirements of these draft RTS, single named proxies are, in general, appropriate unless the ratings are different. The level 1 text gives no explicit possibility for using a	Amendment to Article 1(3) of these draft RTS.

government or local authority by the spread of the relevant sovereign. Where no rating is available for the regional government or local authority, should the entities be considered equal in terms of the ratings attribute? Do you think that this treatment is appropriate? Please state the reason(s) in favour and/or against it.	According to one respondent, the approach is appropriate in most cases, however it should remain an option because it is not always suitable. One respondent clarifies that it is appropriate not to require matching ratings if there is an enforceable cross default connection between the two entities. Other respondents suggest applying a multiplier when mapping the credit spread of a state-owned enterprise, a regional government or a local authority to the relevant sovereign rating, in order to reflect different characteristics. In situations where ratings are not available, a case-per-case review and computation of the multiplier would be performed. Such an approach should be subject to supervisory approval.	multiplier and for linking it to supervisory approval. Furthermore, it is not clear how such a multiplier would be applied in practice.	
Q5. Please indicate other particular cases in which single named proxies might be appropriate.	One respondent suggests that proxying a counterparty with a proven interest may be considered, subject to regulatory approval, e.g. if company A is linked to company B via an explicit guarantee. Another respondent proposes that, even if pension funds are temporarily exempt from the own funds	The EBA believes that pension funds and exposures to counterparties representing covered bonds should be considered as financial exposures.	No change.

	requirement on CVA, the CDS spread of a pension fund could be proxied by the relevant sovereign. Another respondent considers that the credit risk of the asset pools backing covered bonds is mostly GDP related and suggest that the sovereign CDS spread should therefore be used a proxy for counterparties representing such covered bonds.		
Q6. Do the proposed thresholds of [15]% for the number of non-IMM portfolios, of [1]% for each individual non-IMM portfolio, and [10]% for the total size non-IMM portfolios, together with the definitions, provide an incentive for institutions to limit their	Most respondents consider that, although the IMM method, in general, delivers more conservative own funds requirement, the thresholds will not constitute an incentive to expand the scope of the IMM. The main reasons why some firms use the IMM for the majority of their exposures and the standardised approach for a subset of portfolios is driven by systems, modelling and data constraints. These issues may mean that certain portfolios remain on the standardised approach, even if there is a capital incentive to move them to the IMM approach. One respondent, however, considers that the thresholds and the penalty of having to use the standardized approach provide an incentive for institutions to ensure that portfolios not covered by IMM are at a minimum. According to one respondent, banks that have an approved IMM model for regulatory purposes should be allowed to choose between the standardised and	The criteria of a limited number of smaller portfolios in order to apply the advanced CVA method to non-IMM portfolios are required in the level 1 text. The EBA considers that any netting set exceeding the 1% threshold cannot be considered to be of a ‘smaller’ size. The EBA considers that, for the purposes of measuring size, the consideration of collateral would be misleading.	No change.

portfolio exposures not covered by the IMM? Will the defined thresholds of [15]%, [1]% and [10]% cause any impact for your institution?	advanced CVA charges because i) the non-IMM part is small and internationally aligned; ii) the splitting between IMM and non-IMM netting sets is difficult for the CCR measurement and is even more difficult for the calculation of the CVA capital charge; and iii) a combination between the two methods is complicated and inconsistent. Most respondents also believe that the threshold in terms of number of portfolios is irrelevant and should be removed. According to them, a threshold based on the number of transactions is not needed because the capital charge is not driven by the number of transactions and firms should not be penalised for not having adopted the IMM to small portfolios that only attract small capital charges. According to some respondents, the thresholds are not expected to have a material impact on larger institutions. Another respondent, however, considers that the thresholds are potentially too low, which is confirmed by another respondent, for whom the limits are too prescriptive and too granular and that, the total size as referred to in Article 5(1)(c) is a sufficient threshold. Another respondent believes that the 1% threshold is too small, and suggests a value of 3%. According to some respondents, the definition of 'size' should take account of collateral. Another respondent		

	considers that the MtM measure to compute the size of a portfolio is not sufficient risk sensitive. The respondent therefore proposes the use of the CVA VaR of the portfolio, based on the portfolio's exposure calculated by the MtM method and including the effect of collateral.		
Q7. The EBA expects that only a limited number of counterparties / names will receive a proxy spread. Do you agree with this conclusion? If not, could you explain why and state how many of your names will require a proxy spread?	The vast majority of respondents disagree with the statement and explain that, due to the current slowdown in activity on the OTC market, there will be a significantly larger number of counterparties with no observable credit spread and that, for larger institutions, more than two thirds of the names will require a proxy spread. Some respondents clarify that, as of 30 June 2013, more than 90% of counterparties included in the CVA capital charge need to receive a proxy spread for the sake of computing the CS01 formula which represents more than 50% of the total CS01. The main contributors are commercial banks and insurance companies, fund-related activities (regulated and hedge fund) and financial companies. Another respondent clarifies that, as at end-June 2013, 68% of their counterparties receive a proxy spread, which accounts for 15% of the Group's CS01 and mainly stems from transactions with small/medium financial institutions across Europe. Another respondent confirms that it is expected that the		Change to the impact assessment section.

	vast majority of counterparties will have to be based on proxy spreads because only liquid CDS spreads should be used in the calculation of the CVA charge. Another respondent emphasises that a large party of derivative counterparties do not have publicly traded debt and therefore no liquid CDS market.		
Q8. Do you agree with the above analysis of the costs and benefits of the proposals? If not, please provide any evidence or data that would further inform the analysis of the likely cost and benefit impacts of the proposals.	While pointing out that the draft rules could harmonise practices across Member States and support the creation of a level playing field, most respondents urge the EBA to define more reasonable criteria. All respondents consider that if these RTS were also to be applied to Marker Risk VaR models, the impact on costs would be drastic. They would therefore favour an application of these RTS to the proxies used for CVA purposes only. Most respondents also emphasise that changes to Market risk VaR models would have to be performed by January 2014 and will need to receive supervisory approval. Most respondents consider that the cost-benefit analysis ignores the burden to switch between the advanced and standard CVA charges as a consequence of the requirement introduced in Article 383(6) to fall back on the standard method should proxy spreads be deemed	The EBA acknowledges that the application of the provisions of these RTS, as stated in the level 1 text, could imply important costs relating to the modification of the existing VaR methodology and could lead to a misalignment between the calculation of own funds requirements for market risk and current risk management practices A valuation of the costs of the fallback to the standardised approach is not considered necessary, because this provision is contained in the level 1 text. This is true also for the requirement to apply the standardised approach if the thresholds are exceeded.	Change to the impact assessment section.

	not compliant. Some respondents consider that the new proxy logic leads to a misalignment between the accounting CVA and the calculation of own funds requirement for CVA risk and that firms will have to create new operational units having the sole function of dealing with regulatory CVA in addition to existing units. Finally, one respondent mentions that unexpected costs may arise in order to calculate the size of portfolios.		