Associazione Bancaria Italiana

ABI response to EBA Consultative Document "GUIDELINES ON THE TREATMENT OF CVA RISK UNDER THE SUPERVISORY REVIEW AND EVALUATION PROCESS (SREP)"

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POSITION PAPER

Key points

The Italian Banking Association (ABI) welcomes the opportunity to comment on the EBA consultative document "*Guidelines on the treatment of CVA risk under the Supervisory Review and Evaluation Process (SREP)*".

The proposed Guidelines pertain to the scope of the minimum own funds requirements for CVA risk, applied to EU banks. The EBA outlines a path for identifying banks exposed to an "excessive" CVA risk - also due to the exemptions set out in Regulation (EU) No. 575/2013 (CRR) - and defines a method for calculation of additional own funds requirements that the competent authorities might consider imposing on a bank, pursuant to Art. 104(1)(a) of Directive 2013/36/EU.

ABI expresses some concerns on the proposed framework, as to both motivation and timing, based on the following arguments:
- the reasons underpinning the decision of the EU legislator to grant the exemptions are still valid; therefore, there is no need for urgent adjustment of the CVA risk regulations
- the Basel Committee is outlining a new framework
- the inclusion of intra-group transactions seems not fully justified and might have unintended consequences
- transactions with sovereign counterparties should be treated separately.

The following "ABI remarks" section elaborates further on these concerns. The solutions proposed in the section "Responses to the questions for consultation" should be considered a "second best" option, since repeal of the initiative is the preferred one.

ABI supports the response of the European Banking Federation (EBF).

ABI remarks

1. EU law differs significantly from the scope of the CVA risk capital charge outlined in the Basel III framework, since some derivatives transactions are exempted, depending on the counterparty of the bank. Banks are not required to apply the CVA charge to:
- intra-group transactions
- transactions with sovereign counterparties
- transactions with non-financial counterparties below the EMIR clearing threshold (NFC)
- transactions with pension funds.

After assessing the impact of the cited exemptions (under a CRR mandate), the EBA concluded that the CVA risk generated by the transactions

exempted pursuant to Art. 382(4) is substantial and needed to be captured prudentially[1].
Therefore, the draft Guidelines under consideration identify potential situations of excessive CVA risks, to be considered by the competent authorities under SREP. The EBA also outlines a method for quantifying additional own funds requirements that the competent authorities might consider imposing on a bank, pursuant to Art. 104(1)(a) of Directive 2013/36/EU.

2. ABI fails to see the need for such a measure.

First of all, the EU legislator has recently granted the cited exemptions and the risks of unintended consequences (tackled by all such exemptions) are as yet unchanged. It is worth mentioning the reasons why the main exemptions were granted.

a. The exemption of intra-group transactions, as the EBA itself acknowledges, does not constitute a deviation from the Basel framework in the strictest sense.
The volume of intra-group transactions is often boosted as a result of group strategies. It is quite common practice to pool derivatives transactions with third parties into one or few consolidated entities - thus giving rise to intra-group transactions. So the inclusion of intra-group transactions leads to double counting of the CVA risk capital charge for a given deal, simply because of a more effective risk management strategy.
At consolidated level, intra-group exposures should not be taken into account and should not give rise to any capital charge.
Therefore, the rationale of the EBA in challenging the exemption of intra-group transactions from the CVA risk capital charge at bank level is unclear.

b. The imposition of a capital charge for CVA risk arising from OTC transactions with Non-Financial Companies (NFC) is likely to undermine EU potential for economic growth. These transactions usually represent a tailored product for hedging its own risks for a NFC. A capital charge increases the overall cost of the transaction and could lead NFCs to (a) incur higher costs or needs for posting margins or (b) abstaining from hedging such risks. Both alternatives could hinder smooth economic growth in the EU.

c. Measures like those outlined in the draft Guidelines would affect the volatility of the CVA risk capital charge. This would encourage banks to hedge through CDS. Given the lack of depth of the CDS market, a rise in the CDS rates could affect the interest rates at which non-financial end-users of derivatives borrow money. This is the case for NFC, but also for sovereign counterparties. In periods of intense market turmoil, restraints

[1] EBA Report on Credit Valuation Adjustment (CVA) under Article 456(2) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR).

in the supply of hedging products could occur, with a potential impact on both financial stability and EU 28 fiscal deficits.

3. The issue of risk inherent in positions with sovereign counterparties is currently being discussed at Basel Committee and EU level. A consistent approach to sovereign risk throughout the prudential framework should be maintained. Therefore, any pronouncement concerning the CVA charge should follow an overall approach.

4. The EBA should take into account that the CVA risk charge only came into force in 2014 and banks have just completed implementing it (under the terms prescribed by the CRR). Nonetheless, the known shortcomings in current methodologies for calculation of own funds requirements have prompted the Basel Committee to launch a reform of the prudential framework for CVA risk, now at an advanced stage. The measures described in the Guidelines would entail organizational and IT costs for banks, while in a relatively short time they will have to start implementing the new Basel framework.

In ABI's opinion, the EBA should carefully consider whether or not the proposed measures are really necessary, in order to avoid imposing unnecessary burdens on banks.

5. The EBA should also take into account that the impact of the proposed Guidelines on the stock market would outweigh their direct impact on banks' balance sheets. In fact, in the simplistic reading of the press, the issue of such Guidelines could be seen as meaning that the EBA considers banks' own funds inadequate and that a new wave of recapitalization is imminent. This would further threaten the performance of banks' shares in a period in which they are subject to strong market pressure, potentially giving rise to market abuse and threats to financial stability.

Responses to the questions for consultation

Question 1: Do you agree with determining relevance of CVA risk by means of assessing the size of an institution's derivative business using the exposure value for non-QCCP cleared derivatives transactions?

ABI agrees on the proposed benchmark for assessing the relevance in absolute terms of an institution's exposure to CVA risk, with reference to the size of the OTC derivative business, calculated as the exposure value for non-QCCP cleared derivatives transactions.

Question 2: What are your views on how Threshold 1 should be calibrated?

Threshold 1 should be calibrated in light of the objective of identifying relevant exposures, but proposing a suitable level of the threshold does not seem possible at this stage. The draft impact assessment accompanying the EBA Consultation Paper shows figures based on a relatively small sample, if compared with its reference population. Analysis of the results of a larger Quantitative Impact Study, currently underway, should be a condition for any calibration.
According to the EBA proposal, breaching Threshold 1 per se leads to an institution's exposure to CVA risk being qualified as "relevant". Therefore, Threshold 1 capturing 75% of the population implies that 75% of EU banks are assumed to have "relevant" exposures. Strong arguments are needed to prove this, given the huge number of small and very small banks in the EU.
ABI asks for the approach to identifying "relevant" exposures to be reviewed (see also the response to question 4). In order to detect genuinely relevant exposures, the absolute threshold (indicating the size of the exposure to CVA risk) and the relative threshold (indicating the relative weight of the exposure to CVA risk on the total risk exposure) should work together. A simultaneous breach of both the absolute *and* the relative threshold should qualify banks as exposed to a relevant CVA risk.

Question 3: Do you agree with determining relevance of CVA risk by means of assessing the share of own funds requirements for CVA risk to the total risk exposure amount?

ABI agrees with the proposed benchmark for assessing the relevance (in relative terms) of an institution's exposure to CVA risk, based on the ratio of own funds requirements for CVA risks to the total risk exposure amount.

Question 4: Do you agree with the approach provided for the determination of materiality of CVA risk?

The EBA envisages a "materiality threshold" based on the ratio of hypothetical own funds requirements for CVA risks to the hypothetical total risk exposure amount, where "hypothetical" means calculated including exempted transactions. The proposed approach seems reasonable, provided that banks exposed to a relevant CVA risk are identified as outlined in the response to question 2.
In any event, calculation of the proposed ratio would lead to an added burden, due to the inclusion of the exempted transactions. Only banks with a potentially significant CVA risk should be taken into account and asked to perform this calculation (proportionality principle). Taking into account only institutions breaching both an absolute threshold (e.g. based on the CCR exposure) and a relative threshold (e.g. based on the share of CVA out of

total own funds requirements) limits the number of banks that undergo the "materiality" check outlined in Section 4.2 of the Consultation Paper.

Question 5: What are your views on how 'x%' (Thresholds 2 and 3) should be calibrated?

The level of the thresholds should allow institutions where the CVA risk is truly material to be identified.
Analysis of the results of the Quantitative Impact Study will be essential for appropriate calibration of the threshold, since the results presented in the draft impact assessment accompanying the EBA Consultation Paper are based on a relatively small sample.
An appropriate level depends on the approach chosen to identify banks exposed to a relevant CVA risk.

Question 6: Do you agree with the scope of derivative transactions to be included into the calculation of hypothetical own funds requirements for CVA risk?

ABI believes that banks should not be required to apply the CVA risk capital charge to exempted transactions (intra-group transactions; transactions with sovereign counterparties; transactions with non-financial counterparties below the EMIR clearing threshold; transactions with pension funds).
In ABI's opinion, the proposed approach is rather consistent with the rationale underpinning the EBA Guidelines, with the exception of the inclusion of intra-group transactions. Please refer to the response to question 7.

Question 7: Do you agree that intra-group derivatives transactions should be explicitly included into the scope of calculation? If not, what do you think could be a credible alternative treatment of the CVA risk of intragroup transactions?

In ABI's opinion, intra-group transactions should be excluded from the scope of the calculation.
The inclusion of intra-group transactions would result in double counting of the CVA risk at individual level, where a group of institutions provides centralised market access through one legal entity. In these situations, common in practice, banks would bear a capital charge for the CVA risk for both the external and the internal side of a transaction. This would mean that, in the view of the EBA, this setup is riskier than if each entity within the group were to access the market directly.
At consolidated level, intra-group exposures should not be taken into account and should not lead to any capital charge.
The rationale behind inclusion of intra-group transactions in the calculation is therefore unclear, given that it may discourage centralized risk management and is not in line with consolidated accounting.

Question 8: Do you agree with the approach provided for the determination of supervisory benchmark for material CVA risk?

The approach outlined seems reasonable and consistent with the EBA's objectives.

Question 9: What are your views on how 'y%' (Threshold 4) should be calibrated?

As the EBA itself acknowledges, Threshold 4 should be set to a level that does not reverse the exemptions set out by the EU legislator.

Question 10: Do you agree with the approach provided monitoring of CVA risk by competent authorities and EBA and data to be provided to competent authorities for this monitoring?

The proposed approach seems reasonable.
ABI underlines that the proposed Guidelines provide for the reporting of information to the supervisor and do not address the issue of disclosure to the market. In ABI's opinion, in order to maintain a level playing field across the EU, the Guidelines should clearly state that the information should remain confidential and that no detailed disclosure to the market is required. In fact, past experience has shown that, in the absence of common guidelines, the market authorities of the different countries make different choices, placing banks of countries where disclosure is required at a disadvantage.

Question 11: What is your view regarding the potential burden of computing hypothetical own funds requirement for CVA risk at the same frequency as the regulatory CVA VaR and Stressed VaR figures?

The burden - for institutions applying the CVA advanced method - seems acceptable.