

European Banking Authority
Uploaded via website

Date 25 September 2013
Reference BR2008

Subject: NVB reaction to EBA **CP2013/24** - RTS 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 of regulation (EU) 575/2013 (CRR)

Dear Sir, Madam,

On behalf of the Dutch Banking Association¹ (NVB) I would like to thank you for giving us the opportunity to react to Consultation Paper 2013/24 regarding the draft RTS for CVA risk on the determination of a proxy spread and the specification of a limited number of smaller portfolios. In this letter, we will address our main points on these two subjects.

Proxy spreads:

In line with our previous feedback, our main concern with the proposed segmentation is that there is insufficient data available for the creation of proxy spreads for every combination of rating, sector and / or region. For quite some segments there are simply no names available, and for other segments, the data quality is so bad that proxies for good ratings have a higher spread than worse ratings. Further evidence for this is provided in the annex. Especially the use of a different sector split than the one currently provided by a leading CDS data provider can result in an additional workload with manual remapping of counterparties and approximations.

Also, internal models for specific debt instruments (that have regulatory approval) already use proxy curves. The curves used in these internal models are constructed differently than the ones required by EBA. This can have material consequences, both in terms of an increased workload, and in terms of having to use different two different views (due to the different 'slice and dice'), which leads to discrepancies. Requiring banks to use two different methods is not desirable. Also, the use of the EBA defined proxy spreads can have an impact on back testing performance and the way risks are monitored.

Smaller portfolios:

Banks that have an approved IMM model for regulatory purposes should be allowed to choose between applying the standardised or the advanced CVA charge. Regulatory approval is only given to banks that are able to simulate a large majority of their trades. Technically, it will be very difficult

¹ The Dutch Banking Association (NVB) is the representative voice of the Dutch banking community with over 90 member firms, large and small, domestic and international, carrying out business in the Dutch market and overseas. The NVB strives towards a strong, healthy and internationally competitive banking industry in the Netherlands, whilst working towards wider single market aims in Europe.

to split a Credit Support Annex (CSA) between an IMM and a non-IMM portfolio and to feed these into a standardised and an advanced CVA calculation.

Should EBA conclude that limits are necessary, the final ones should be set less conservatively. Especially smaller banks with more concentrated derivative portfolios will find the suggested limits challenging, particularly the 1% for each individual portfolio. This can have material consequences.

This concludes the main remarks. Please refer to the annex, for the responses to the various questions. In case you have any questions or remarks, please feel free to contact me at your convenience.

Kind regards,



Onno Steins
Advisor Prudential Regulation

Annex - Answers to the questions

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).

A:

For the analysis, CDS data from a representative data vendor was used. The tables shown in this question give the maximum available observations for the proxy curves, as based on the CDS data that is available. The selection of the observations is not based on liquidity but on availability of the 1 year, 5 year and 10 year tenors. The availability would be much lower if only the observations of e.g. Itraxx /CDX indices (which represent the most liquid names) would be taken in to account.

One observation is that in the proposals the category ‘financials’ has changed into ‘banks’, ‘insurance’ and ‘other financial services’. CDS data vendors use a different segmentation:

- Basic Materials
- Consumer Goods
- Consumer Services
- Energy
- Financials
- Government
- Healthcare
- Industrials
- Technology
- Telecommunications Services
- Utilities

It is recommended to keep alignment with existing CDS data vendor sector splits (or only to aggregate across existing sectors).

From the available CDS data the following selection was made:

- Only TIER “SNFOR”;
- Only counterparties that have a CDS for 1 year, 5 year and 10 year are selected (this to assure some liquidity);
- Multilateral development banks are excluded from the sector Financials.

The following mapping was applied:

CDS data vendor	EBA
Consumer Goods	Others
Utilities	Others
Basic Materials	Others
Energy	Others
Industrials	Industrials
Consumer Services	Others
Healthcare	Others
Financials	banks/insurance/other financial services
Technology	Others
Government	Public sector
Telecommunications Services	Others

Taking into account 'region', 'rating' and 'sector' the following table with available counterparties was created:

Count of Spread5y	Column Labels				Grand Total
Row Labels	Asia	Europe	North America	Rest of World	Grand Total
banks/insurance/other_financial_services					
AAA		1			1
AA		5	15	8	33
A	47	68	60	18	193
BBB	25	49	74	19	167
BB	1	26	14	6	47
B	1	16	8	1	26
CCC		6	6		12
D	1				1
Industrials					
AAA				1	1
AA	2	1	2	1	6
A	11	11	22	1	45
BBB	23	27	36	12	98
BB	8	16	23	1	48
B		4	12		16
CCC			3	1	4
Others					
AAA			5		5
AA	24	11	13		48
A	48	58	95	19	220
BBB	69	114	241	39	463
BB	21	44	85	15	165
B	7	15	77	7	106
CCC		5	21	2	28
Public sector					
AAA		10	2	2	14
AA	15	5		9	29
A	14	6		6	26
BBB	11	28	1	17	57
BB	4	9		9	22
B	2	3		6	11
CCC	1	1		3	5

Even though the maximum number of counterparties is taken, not all required generic curves have (sufficient) data to create proxy curves. In many cases the number of available names is (very) low.

Based on the above selection for the 5 year tenor the average was calculated, where (like the CDS data vendor does) the middle 50% of the quotes was used for averaging (to exempt outliers).



Row Labels	Asia	Europe	North America	Rest of World
banks/insurance/other_financial_services				
AAA	0.63%			
AA	0.77%	0.94%	0.87%	1.08%
A	1.08%	1.23%	0.91%	1.24%
BBB	1.79%	2.09%	1.15%	2.66%
BB	4.52%	4.29%	1.90%	6.13%
B	26.08%	5.25%	6.75%	6.58%
CCC		8.48%	3.99%	
D	27.70%			
Industrials				
AAA			0.30%	
AA		0.76%		1.00%
A	0.50%	0.69%	0.51%	0.32%
BBB	1.00%	1.24%	0.83%	1.87%
BB	1.97%	2.18%	2.71%	5.26%
B		3.77%	4.59%	
CCC			9.01%	7.97%
Others				
AAA			0.20%	
AA	0.42%	0.41%	0.32%	
A	0.63%	0.61%	0.48%	0.87%
BBB	0.94%	0.99%	0.95%	1.86%
BB	2.08%	3.09%	2.07%	3.65%
B	4.69%	3.25%	3.52%	8.43%
CCC		8.69%	8.75%	
Public sector				
AAA		0.25%		0.50%
AA	0.62%	0.68%		0.86%
A	0.95%	0.80%		1.12%
BBB	2.36%	2.32%	0.80%	1.80%
BB	3.38%	3.35%		3.16%
B		10.53%		4.30%
CCC	7.66%	10.45%		7.62%

As the table shows, inconsistencies occur e.g. the banks B North America quote is higher than the banks CCC North America quote. Also, please note that statistically, 'region' does not add value to the proxy curve creation. Especially North America and Europe have comparable CDS levels. In order to increase the available data, the regional proposal should be reconsidered.

In article 383, it is described that the internal model for specific debt instruments needs to be used. This framework already uses proxy curves that are approved for regulatory purposes. A different segmentation, as proposed by the EBA, makes review of the VaR model necessary and can have an impact on the (back testing) performance of the VaR model.

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.

A: If the single proxy spread is highly correlated with the counterparty it is ok to use it for the RC CVA determination.

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 appropriate? Please state the reason(s) in favour and/or against it.

A: Two of the three attributes (sector, rating or region) should not be the only basis for applying a proxy spread. If the parent is fully liable for its subsidiary, the spread of the parent should be used in any case.

Q4. Paragraph 4 allows for the proxying of the spread for a regional 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.

A: Yes, the best proxy is the government spread. Although in some cases the central government is not fully liable for the local authority, it still seems the best approximation available.

Q5. Please indicate other particular cases in which single named proxies might be appropriate.

A: Pension funds are temporarily exempt from RC for CVA. At this point, there are no CDSs available for pension funds. Consequently, no relevant rating/sector/region curves are available. A single name proxy might be the best solution, which could be based on for example the relevant sovereign.

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 portfolio exposures not covered by the IMM? Will the defined thresholds of [15] %, [1] % and [10] % cause any impact for your institution?

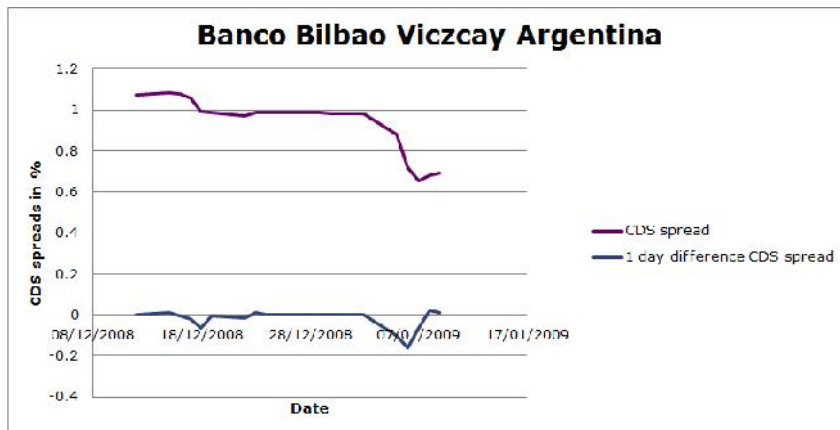
A: We would encourage the regulator to issue clear and consistent guidelines on the allowed size of non-IMM portfolios, when seeking IMM approval. If banks have IMM approval, they should have the freedom to choose between applying the standardised or the advanced CVA charge for the non-IMM portfolios. This because:

- 1) Non-IMM part is small and internationally aligned;
- 2) It is already difficult to split netting sets between IMM and non-IMM for capital purposes, but even more difficult for CVA capital;
- 3) Implementing a hybrid between standardised and advanced CVA can be complicated from a systems point of view and is methodologically inconsistent (by introducing two methods, a misalignment is created between the legally enforceable netting sets and the regulatory netting sets).

If EBA were to conclude that extra conditions are necessary, we strongly recommend reconsidering the percentage as specified for condition b), currently suggested at 1%. This is a very small bandwidth. We propose to apply 3% instead.

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?

A: It is expected that the vast majority of counterparties will have to be based on proxy spreads. It is important to note that only liquid CDS spreads should be used for the regulatory CVA calculations. If CDS spreads are not sufficiently liquid, additional higher or lower volatility can be generated at the moment CDS spreads moves. This will result in non-representative VaR outcomes. Please see the example of the illiquid CDS spread of BBVA.



The picture shows that for many dates the CDS spread does not change, after which a jump occurs. For frequently traded liquid CDSes, such lack of jumps in spreads would not occur.

Indices like Itraxx/CDX are based on the most frequently traded CDS spreads. In general, names outside these indices are not sufficiently liquid. So the names in the indices can be seen as a good estimate of the number of liquid CDS spreads that can be used, which is approximately 450-500 entities including corporates. Applying this method to a banks' derivative portfolio would mean that only 7.5% of the number financial counterparties will receive a single name CDS spread, while all other counterparties will have to be based on proxy spreads.

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.

A: Alignment across the board is desirable. Also alignment within the different capital frameworks is desirable. As already stated, using already developed parts of the Market Risk framework is desirable from a consistency and efficiency perspective.