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Banking supervision
And Accounting issues Unit
The Director

Paris, September 25th 2013

French Banking Federation Response to the EBA Consultation on draft technical standards in relation to credit valuation adjustment risk (EBA/CP/2013/24)

Dear Madam,

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

The French Banking Federation appreciates the opportunity to share its views on the Consultation Paper issued by the European Banking Authority On Draft Regulatory Technical Standards (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 (Capital Requirements Regulation - CRR).

This proposal raises many concerns which are related to the following matters:

- Interaction with the Market Risk VaR framework : if we support the principle of replicating the market VaR methodology to define credit spread shocks in the CVA VaR, we believe requiring banks to derive the CVA proxy spreads from their specific risk VaR model by the way of some adaptation that fits the RTS criteria would be much better than imposing the application of those criteria to the VaR model itself ;

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- Granularity of the buckets: the proposed wording on the reliance on proxys on "rating" is too prescriptive and leaves less flexibility than the "industry" and "region" buckets. We therefore propose an amendment that EBA should consider ;

- Defaulting to standardized method: the RTS, as is, imply that many proxys would be deemed inappropriate and therefore would require banks to fall back to the standardized method. To conciliate both advanced and standardized methods would be operationally burdensome, so we ask the EBA to be more flexible on the definition of "appropriateness" ;

- Implementation period: should the final RTS remain unchanged, as banks will need to engage in heavy developments, we urge the EBA to consider at least a six-month implementation period after the entry into force.

You will find in the annex attached a more detailed version of these comments and specific responses to the questions of the consultative document.

We thank you for your consideration and remain at your disposal for any questions or additional information you might have.

Yours sincerely,

Jean-Paul Caudal

Annex : French Banking Federation Response to the European Banking Authority Consultation on CVA risks

Our answer is articulated around 2 parts:

- The first part consists in general remarks on the proposal,
- The second part focuses on answers to questions raised by the EBA in the consultation paper.

1. Main concerns around the current proposals

A. Interaction with the Market Risk VaR Framework

We note that the EBA mandate has changed compared to the 2012 consultation in the sense that proxy spreads should now "be determined by the institution's approved internal VaR model for the specific interest rate risk" [Art. 383(7)]. In addition, when the institution's approved internal VaR model for specific interest rate risk does not produce a proxy spread that is appropriate with respect for the criteria of the rating, industry and region of a given counterparty, the institution shall use the standard method [Art. 383(6)] to calculate the CVA own fund requirements on exposures to that counterparty.

Hence, a literal interpretation of EBA mandate could suggest that the term *"proxy spread»* refers indifferently to the proxy used in the regulatory CS01 formula in case no credit spread is available for the counterparty and to the generic credit spread curves that are used to determine spread shocks within internal VaR methodologies.

We believe this literal interpretation is inappropriate and would oblige banks to significantly revamp their VaR model.

More specifically, on one hand:

- We support the principle of replicating the market VaR methodology to define credit spread shocks in the CVA VaR.
- We also agree it is helpful to define the desirable level of granularity of proxy spreads in the absence of observable market data to ensure practises are consistent across industry.
- Finally, we understand the objective of ensuring consistency between the determinations of proxy spreads for the CVA charge and for the VaR-based market risk capital charge. We recall however that the recourse to proxies for spot spread levels is anecdotic in the case of market VaR as situations where no spread level is available in the market VaR occurs intrinsically very rarely since instruments covered by market VaR are in most cases tradable assets that are marked-to market.

On the other hand, if the methodologies used to determine credit spread shocks are subject to the rating/industry/region prescription laid in Article 3 of the RTS, then we would face the following issues:

- First, it would generate a gap between the way banks manage their credit risk positions in the trading book (that scarcely rely on the Article 3 prescribed segmentation, in particular with respect to the "rating" attribute) and the way capital requirement is computed on those positions. Moreover, the suggested link between the proxy spreads for the counterparty and market risk applications if interpreted strictly, since it is not based on statistical evidence, could endanger the back testing performance of the VaR models.

- Second, a large majority of banks that use alternative segmentations would have to perform in-depth review of their internal VaR models even when the latter have received prior approval by their supervisors and exhibited strong back testing performance in the past.
- Third, this in-depth review is particularly unwelcome today since the Basel Committee has launched in 2012 a fundamental review of the trading book which will materially reshape the market risk framework in the medium term. We have a strong concern on the relevancy of launching such significant model and IT developments to implement interim rules that were not called for in the Basel 3 framework.

We believe an interpretation that respect the “spirit” of the EBA mandate would be to require banks to derive the CVA proxy spreads from their specific risk VaR model by the way of some adaptation that fits the RTS criteria but not by imposing the application of those criteria to the VaR model itself.
More specifically, when proxying credit spread dynamics within the credit VaR framework, relying on credit spread levels may be more adequate than relying on ratings. This is because the rating as a credit quality assessment has an update frequency that is not suited for market risk applications in the VaR, which has a time horizon of ten days and in most cases is calculated with a daily horizon. Therefore the rating does not reflect the daily market information that can be captured via alternative credit quality assessments.

In contrast, when proxying credit spread levels within the CVA charge framework, relying on the rating attribute may be the preferred option.
As a result, we advocate that banks should be required to consider the rating/industry/region attributes enclosed in Article 3 <u>as a starting point for proxying spreads</u> both within the credit VaR scope and CVA charge scope but could ultimately come up with different adaptations of these attributes depending on the nature of the proxy (proxy for the spread level or proxy for the spread dynamics) and provided those choices are duly justified.

B. Granularity of the buckets

As illustrated in answer to question 1, many buckets of the proposed segmentation are likely to be poorly populated which will translate into statistically non-significant model parameters.
In this respect, we appreciate the wording retained by the EBA for the “industry” and “region” attributes that require to “*consider”* the proposed granularities which suggest that banks may depart from the proposed lists provided industry and region choices are duly justified and documented.

However, we argue that the rating attribute is too prescriptive for at least two reasons:
- It does not benefit from the flexible wording granted to “industry” and ”region” attributes (we refer here to the word “*considering*”)
- The RTS wording imposes the reliance of proxys on “rating” whereas other credit quality assessment as spread level may be better suited as explained in section A.

As a result, we recommend the EBA to amend Article 3 (1a) and (1b) of the RTS as follows:
(a) the proxy spread has been determined by considering all of the attributes of rating, industry and region of the counterparty;
(b) the attribute of rating has been defined by considering the use of a predetermined hierarchy of sources of internal and external ratings and alternative credit quality assessments. 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. Implementation period

We would like to stress that no impact assessment has been performed so far on the potential consequences of the RTS on credit VaR while they could potentially be far reaching.
Moreover, the methodological changes induced by the RTS on credit VaR are likely to be classified as *"material changes that require permission from the relevant competent authorities"* under EBA consultation paper EBA/CP/2013/02 on the conditions for assessing the materiality of extensions and changes of internal approaches.
Should the final RTS remain unchanged, banks would need to engage heavy developments to comply.
We therefore urge the EBA to incorporate in the RTS a 6-month implementation period after entry into force of the RTS for banks to comply with it.

D. Defaulting to standardized method

CRR Article 383(6) requires institutions to fall back to the standardized method whenever the internal VaR model fails to produce a proxy spread that is appropriate with respect to the criteria of rating, industry and region.
Again, a literal interpretation of the RTS could result in most proxies deemed inappropriate due to the inability of banks to meet the 3 dimension-criteria. We argue that banks should not be defaulted to the standardized method on the ground they are unable to comply with an inappropriate bucketing.
Ultimately all banks, even those with a very limited number of "inappropriate" proxies would have to face the difficulty to conciliate advanced and standardized methods which is operationally burdensome.
We therefore reiterate our request not to be too prescriptive in the definition of "appropriateness" with respect to proxy spreads. For instance, collapsing one of the 3 prescribed dimensions should be an option in case of insufficient sampling to come up with a reliable proxy spread.

2. Answers to specific questions raised by the EBA

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).

The following table provides statistics of available liquid CDS curves per region/rating buckets as of July 2013.
Only curves that are deemed compliant with the liquidity criteria enclosed in Article 3(5) of the RTS have been retained (at least 5 Markit contributions).

AgregatedRegion	Sector	AAA	AA	A	BBB	BB	B	CCC	Grand Total
Asia	Banks			11					11
	Public Sector		3	6	3		1		13
	Industrials			5	13	2			20
	Insurance			2					2
	Other corporate		11	21	29	7	2		70
	Other financial services			5	7				12
Asia Total			14	50	52	9	3		128
Europe	Banks		5	27	12	6	1	1	52
	Public Sector	5	4	3	13	3	1	1	30
	Industrials			7	14	6	3		30
	Insurance			10	2				12
	Other corporate		8	34	59	23	11	1	136
	Other financial services		1	3	5	2	1		12
Europe Total		5	18	84	105	40	17	3	272
N.Amer	Banks			8					8
	Industrials		2	11	14	4	3	1	35
	Insurance		2	3	4		1		10
	Other corporate	2	5	44	101	36	42	12	242
	Other financial services		1	7	18	5	2	4	37
N.Amer Total		2	10	73	137	45	48	17	332
Rest of the world	Banks		4	1	1				6
	Public Sector	1	5	2	11		2	1	22
	Industrials				4				4
	Insurance				1				1
	Other corporate			5	11	2	1		19
	Other financial services			3	1				4
Rest of the world Total		1	9	11	29	2	3	1	56
Grand Total		8	51	218	323	96	71	21	788

From the above table, it clearly appears that granting flexibility with respect to the proposed granularity is essential as some buckets aggregation / dimension collapse will have to be performed in order to adequately calibrate proxy spreads.

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.

As mentioned above, there is no market standard regarding the use of single-named proxies to derive proxy spreads within the scope of specific risk internal models as very few names have a market spread available.

It is however common practise to use such single-named proxies for the management of the incurred CVA. We are therefore favourable to the introduction of such single-named proxies for the sake of computing, as long as it remains an option (and not an obligation) as currently drafted in the RTS proposal.
We finally advocate that CDS on single-named proxies should be recognized as eligible CVA hedges with respect to exposures mapped to such proxies. It would consistently reflect the way incurred CVA is hedged by CVA desks.

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.

We think that proxying the spread of a subsidiary by the spread of its parent company even where no rating is available generally constitutes a reasonable proxy. Actually, we even expect it produces in most cases a more accurate proxy than a generic proxy built on rating/industry/region attributes.
However, it can happen in some situations that such a proxy is not suitable. As a result, proxying the spread of a subsidiary by the spread of its parent company should remain an option subject to appropriate justification.

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.

Same answer as for question 3.
Proxying the spread of a regional government or local authority by the spread of the relevant sovereign seems to us a reasonable proxy including cases where no rating is available for the regional government or local authority. However, it must remain an option.

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

We have no particular suggestion at this stage but we advise the EBA to leave the door open for other single named proxies to be used provided they are justified and authorised by competent authorities. Their use should be recognized in instances where they undeniably constitute more relevant proxies than the generic ones.

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?

We reiterate our view that the threshold in number of portfolios is irrelevant and should be removed.
Only the thresholds in terms of size should be kept.
Otherwise, this will generate undesirable situation like the one where a single portfolio accounting for 10% of the total size of exposures will be eligible to advanced treatment while portfolios representing 20% in number but less than 10% in size would not.

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?

We strongly disagree with the EBA expectation. Taking into account all exemptions from the CVA capital charge enclosed in CRR, we find that as of June 30th 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. Main contributors are commercial banks and insurance companies, fund related activities (regulated and hedge fund) and financial companies."

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.

Again, provided that the draft RTS only applies to the computation of s_i in the CVA CS01 formula, then we have no major objection with the EBA costs and benefits analysis.
On the contrary, should the RTS call into question the way credit spread shocks are determined within internal VaR models, then the impact in terms of implementation cost and risk analysis would be drastic. Concretely, a large majority of banks would face the overwhelming challenge to revisit in depth their credit VaR models within a very tight timeframe without prior assessment of the impacts both in terms of capital charge and risk management.

Finally, the cost/benefit assessment currently ignores the burden to switch between the advanced CVA charge and the standard CVA charge as a consequence of the requirement introduced in CRR Article 383(6) to fallback to standard method in case proxy spreads are deemed not compliant. Indeed, in major institutions, standardized methods are under the Finance function responsibility while advanced methods are under the Risk function responsibility. As a result, switching from a method to the other will be burdensome in terms of workflow and aggregation of results.