Risk Accounting Standards Board's response

to the Consultation Paper on

"Draft Regulatory Technical Standards on credit valuation adjustment risk of securities financing transactions under Article 382(6) of

Regulation (EU) No 575/2013"

EBA/CP/2024/14|8 July 2024

published by the European Banking Authority

Executive Summary

The consultation paper on draft Regulatory Technical Standards (RTS) for CVA risk of Securities Financing Transactions (SFTs) presents a critical opportunity to address the materiality and management of credit valuation adjustment (CVA) risks. However, it also highlights significant challenges due to the lack of standardization in risk exposure quantification approaches across regulatory proposals.

This document proposes incorporating the principles of risk accounting, to enhance the current regulatory framework, providing a more accurate, consistent, and comprehensive approach to risk management.

Key Challenges with Current Approaches

1. **Excessive Reporting Burden**:
    - Regulated institutions face substantial and diverse reporting requirements, often resulting in a significant administrative burden.
    - The current methods demand extensive data collection and analysis efforts, which can divert resources from more strategic risk management activities.
2. **Regulatory Workload**:
    - Regulators are inundated with vast amounts of data that are difficult to standardize and interpret, requiring a particular understanding of each regulated institution's approach to observing the regulation.
    - The lack of a uniform approach to risk quantification complicates the regulatory oversight process, increasing the workload and potential for inconsistencies.
3. **Lack of Industry-Wide Comparability**:
    - Without standardized metrics, comparing risk exposures across different institutions and market-wide becomes problematic.
    - This lack of comparability hampers the ability to benchmark performance and identify systemic risks effectively.
4. **Inconsistent Risk Management Approaches**:
    - Current practices often address each type of risk in isolation, leading to a fragmented and inconsistent approach.
    - This discrete handling fails to provide a holistic view of an institution's risk profile, undermining comprehensive risk management efforts.
5. **Inability to Consistently Add Additional Risks**:
    - The current frameworks lack the flexibility to incorporate new types of risks seamlessly.
    - This rigidity can result in gaps in risk management as new threats emerge, leaving institutions unprepared.

Consequences of These Challenges

These challenges contribute to a broader issue within the industry, where risk management is often viewed more as a compliance necessity rather than a strategic business imperative. This perspective leads to several detrimental behaviors:

- **Compliance-Focused Only Risk Management**:
    - Institutions tend to focus on meeting regulatory requirements rather than genuinely integrating risk management into their business strategy.
    - This compliance-driven approach limits the effectiveness of risk mitigation efforts and, as it has been proven in the past, fails to provide tangible business benefits to the regulated institutions.
- **Reactive Risk Management**:
    - The lack of a proactive, standardized approach results in reactive behavior towards risk accumulations.
    - Institutions respond to risks as they arise and often when they have already produced consequences, rather than anticipating and mitigating them in advance.
- **Rule-Bending and Evasive Behavior**:
    - The complexity and burden of current regulations can encourage institutions to find ways to circumvent rules in order not to induce additional costs.
    - This behavior undermines the integrity of the risk management framework and can lead to systemic vulnerabilities.
- **Loss Management over Risk Management**:
    - Ultimately, the focus shifts from proactively managing risk exposures as they accumulate to reactively managing losses after risk events have occurred.
    - This reactive stance is less effective and more costly in the long term, as it does not prevent risks but only addresses their consequences.

Proposed Solution: using the Risk Accounting method

To overcome these challenges, it is our belief that adopting the risk accounting principles offers a robust solution and here are our arguments:

- **Standardization**:
    - Risk accounting provides a more structured, consistent and objective methodology for quantifying risk exposures as they accumulate, facilitating industry-wide comparability and regulatory oversight, while still providing tangible business benefits, such as increasing profit certainty for the shareholders.
- **Integration**:
    - By integrating risk quantification with financial control systems, risk accounting ensures that risk management is part of the core

business strategy rather than a separate compliance function, thus also encouraging a positive risk culture.

- **Comprehensive Approach**:
    - The holistic nature of risk accounting addresses all types of risks uniformly, allowing institutions to manage their entire risk profile effectively and adapt to new risks seamlessly, as soon as they become a concern.
- **Proactive Risk Management**:
    - The forward-looking elements of risk accounting enable institutions to anticipate and mitigate risks before they materialize, fostering a proactive rather than reactive risk management culture.

Therefore, it is our position that incorporating risk accounting into the regulatory framework for CVA risk of SFTs can significantly enhance the accuracy, consistency, and effectiveness of risk management practices.

Additionally, risk accounting will provide a common language and system of reference for effective communication between regulators and regulated institutions.

This approach has the potential to addresses the current challenges and promote a strategic, proactive, and comprehensive risk management culture across the financial industry.

At RASB, we are ready to work with you and any other interested stakeholder to test the viability of risk accounting to significantly improve the regulatory landscape, to the benefit of both regulators and regulated institutions.

Q 1: Materiality Threshold for CVA Risk Exposures

Suggested Materiality Threshold

Considering the principles of risk accounting, we suggest setting the materiality threshold for CVA risk exposures arising from fair-valued SFTs at **2%**.

Rationale and Evidence

1. **Quantitative Precision and Comprehensive Risk Measurement**:
    - Risk accounting provides a precise and detailed method for quantifying non-financial risks, including CVA risks.
    - By leveraging Risk Units (RUs) and a standardized Risk Exposure Calculation Method, institutions can achieve a more accurate and granular measurement of their risk exposures, therefore not having to work with potentially misleading proxy parameters.
    - Setting the threshold at 2% balances the need for sensitivity in detecting material risks without overburdening institutions with overly frequent reclassifications of CVA exposures.
2. **Objective and Consistent Methodology**:
    - Risk accounting ensures a consistent and objective approach to measuring risk. The use of a standardized framework for quantifying risks across different transactions helps maintain a level playing field among institutions.
    - A 2% threshold allows for a clear and objective criterion that aligns with the precise quantification capabilities of risk accounting, ensuring that only genuinely material risks are flagged.
3. **Alignment with Integrated Risk Management**:
    - The integrated nature of risk accounting, which combines financial and non-financial risk assessments, supports a holistic view of an institution's risk profile.
    - This comprehensive approach helps in accurately determining the materiality of CVA risks within the broader context of the institution's overall risk management strategy.
    - A threshold of 2% is appropriate to capture significant risks while allowing institutions to integrate this assessment seamlessly into their existing risk management processes.
4. **Historical Data and Trend Analysis**:
    - Risk accounting facilitates the tracking of risk exposures over time, allowing for historical trend analysis and the identification of emerging risks or high-risk exposure concentrations. This proactive capability best supports the quarterly assessment frequency proposed in the RTS.
    - By setting the threshold at 2%, institutions can leverage historical data to ensure that the threshold is robust and reflective of actual risk trends, avoiding both underestimation and overestimation of material risks.

5. **Practical Implementation and Regulatory Compliance**:

   - A 2% threshold is practical and achievable for institutions, given the detailed risk measurement and reporting infrastructure provided by risk accounting. It avoids the pitfalls of arbitrary thresholds by grounding the decision in a robust, data-driven methodology, allowing also for real-time or near-real-time decision making.

   - This level ensures compliance with regulatory requirements while also enhancing the institution's internal risk management capabilities.

In our view, setting the materiality threshold at 2% based on the principles of risk accounting provides a balanced, objective, and practical approach to identifying material CVA risk exposures from fair-valued SFTs.

It also ensures that significant risk exposures are appropriately captured, continuously monitored in their dynamic evolution and effectively managed before generating losses, supporting both regulatory compliance and the institution's overall risk management framework, while providing tangible business value to shareholders.

Q 2: Additional Comments on the Consultation Paper

Integration of Risk Accounting Principles

1. **Enhanced Quantification of CVA Risk**:
    - The risk accounting method offers a detailed and granular approach to quantifying virtually any type of risks, including CVA risk. By employing Risk Units (RUs) and the Risk Exposure Calculation Model, institutions can achieve a more accurate understanding of their CVA risk exposures. This method ensures that the CVA risk of fair-valued SFTs is measured precisely, reflecting the actual risk profile more accurately than the proposed ratio-based approach alone.
2. **Comprehensive Risk Management Framework**:
    - Risk accounting supports an integrated risk management framework that aligns financial and non-financial risk assessments. This holistic approach ensures that CVA risks are not evaluated in isolation but as part of the broader risk exposure landscape of the institution.
    - Implementing such a framework can enhance the overall effectiveness of risk management practices, providing deeper insights and facilitating better and more timely decision-making.
3. **Consistency, Comparability and Objectivity**:
    - The standardized methodology of risk accounting ensures consistency, comparability and objectivity in risk measurement across different institutions.
    - This reduces the potential for subjective interpretations and promotes a level playing field for all market players.
    - The use of objective criteria for assessing materiality, as enabled by risk accounting, aligns with the regulatory goals of transparency and comparability.
4. **Detailed Reporting and Monitoring**:
    - Risk accounting provides detailed and continuous reporting capabilities, allowing for real-time monitoring of CVA risk exposure accumulations.
    - This continuous oversight is beneficial for both regulatory compliance and internal risk management.
    - Institutions can generate comprehensive reports that detail risk exposures, trends, and potential future impacts, enhancing the quality of information available for decision-making.
5. **Forward-Looking Risk Assessment**:
    - Unlike traditional methods that may focus primarily on historical data, risk accounting incorporates quantitative forward-looking elements.
    - This proactive approach enables institutions to anticipate and mitigate potential risks before they fully materialize, thus preventing or at least minimizing losses.

- By using risk accounting, institutions can better prepare for future challenges and adjust their strategies accordingly.

6. **Alignment with Regulatory Requirements**:
   - The risk accounting method aligns well with the regulatory requirements outlined in the consultation paper.
   - Its emphasis on accurate, continuous, consistent, and comprehensive risk measurement supports the goals of the draft RTS.
   - By integrating risk accounting principles, institutions can enhance their compliance with the CVA risk assessment and reporting requirements.
7. **Adaptability and Flexibility**:
   - Risk accounting is adaptable to various risk types and regulatory frameworks.
   - Its flexibility allows institutions to tailor the risk assessment process to their specific needs while maintaining compliance with regulatory standards.
   - This adaptability ensures that the method remains relevant and effective in the face of evolving risk landscapes and regulatory changes.
8. **Improved Governance and Oversight**:
   - The detailed and structured approach of risk accounting enhances governance and oversight of risk management practices.
   - By providing clear and quantifiable measures of risk, risk accounting enables boards and senior management to exercise more effective oversight and ensure accountability for risk management decisions.

Specific Recommendations for the Consultation Paper

1. **Incorporate Risk Accounting Metrics**:
   - Consider incorporating risk accounting metrics such as RUs into the assessment framework for CVA risk exposures. This would provide a more nuanced and accurate measure of materiality, enhancing the overall effectiveness of the regulatory standards.
2. **Expand Reporting Requirements**:
   - Expand the reporting requirements to include detailed risk accounting reports that provide insights into both current and projected CVA risk exposures.
   - This would enhance the transparency and comprehensiveness of risk disclosures and will provide practical mitigating steps and approaches.
3. **Promote Consistency Across Institutions**:
   - Encourage the adoption of standardized risk accounting practices across institutions to ensure consistency and comparability of CVA risk assessments.

- This would support the regulatory objectives of fairness and transparency in the financial sector.

4. **Foster Continuous Improvement**:
    - Establish a feedback loop where institutions regularly review and update their risk accounting practices based on new data, emerging risks, and regulatory developments.
    - This continuous improvement process would ensure that risk management practices remain effective and up to date.

Integrating the principles and practices of risk accounting into the framework for assessing CVA risk of SFTs can significantly enhance the accuracy, consistency, and effectiveness of risk management.

By adopting a comprehensive and detailed approach, institutions can better fulfill regulatory requirements, improve their risk oversight, and ensure robust management of CVA risks.

Practical Scenario: Deploying Risk Accounting to Comply with Proposed CVA Risk Regulations

Background

A financial institution, ABC Bank, needs to comply with the proposed regulatory technical standards (RTS) on Credit Valuation Adjustment (CVA) risk of Securities Financing Transactions (SFTs).

The new regulations require a quarterly assessment of the materiality of CVA risk exposures from fair-valued SFTs, using a quantitative ratio to determine materiality.

Step-by-Step Deployment of Risk Accounting

1. **Integration of Risk Accounting Framework**
    - **Objective**: Implement the Risk Accounting framework to measure and report CVA risk exposures comprehensively.
    - **Action**: ABC Bank integrates the Non-Financial Risk (NFR) calculation capability into its existing risk management systems. This capability uses Risk Units (RUs) to quantify non-financial risks, including CVA risks from SFTs.
2. **Setup of Risk Units (RUs) for CVA Risks**
    - **Objective**: Quantify CVA risk exposures using Risk Units.
    - **Action**: The bank's risk management team identifies all fair-valued SFTs and assigns Risk Units based on their potential CVA risk. This involves:
        - **Data Collection**: Gathering detailed transaction data, including market value, counterparty information, and risk factors.
        - **Risk Weighting**: Applying risk weights to each SFT to calculate its CVA exposure in terms of RUs.
3. **Calculation of Aggregate CVA Risk**
    - **Objective**: Aggregate the CVA risk exposures from all fair-valued SFTs.
    - **Action**: the NFR calculation capability aggregates the RUs assigned to individual SFTs to calculate the total CVA risk exposure. This total is then used to compute the ratio of CVA risk from SFTs relative to the overall CVA risk of the institution.
4. **Quarterly Assessment and Reporting**
    - **Objective**: Perform the quarterly assessment required by the RTS.
    - **Action**: At the end of each quarter, ABC Bank:
        - **Calculates the Ratio**: Computes the ratio of the aggregate CVA risk from fair-valued SFTs to the total CVA risk.
        - **Compares with Threshold**: Compares this ratio against the materiality threshold set by the RTS (e.g., 2%).

- **Historical Comparison**: Reviews the ratios from the previous three quarters to ensure consistency and avoid frequent changes in the inclusion/exclusion of SFTs in the CVA capital requirement.

5. **Regulatory Compliance and Reporting**
    - **Objective**: Ensure compliance with the RTS and provide detailed risk reports.
    - **Action**: ABC Bank generates comprehensive risk reports that include:
        - **Detailed Breakdown**: A breakdown of CVA risk exposures by individual SFTs and their respective RUs.
        - **Aggregate Figures**: The aggregated CVA risk from SFTs and the computed ratio.
        - **Trend Analysis**: Historical data and trends over the last four quarters to provide context and demonstrate compliance.
6. **Continuous Monitoring and Improvement**
    - **Objective**: Maintain ongoing compliance and improve risk management practices.
    - **Action**: ABC Bank establishes a continuous monitoring process, using the NFR calculation capability to track real-time changes in CVA risk exposures. The risk management team regularly reviews and updates the risk weights and assessment criteria to reflect changing market conditions and emerging risks.

Benefits of Using Risk Accounting

1. **Accuracy and Consistency**:
    - The use of RUs provides a precise and standardized measure of CVA risk exposures, ensuring consistency across reporting periods and regulatory submissions.
2. **Detailed and Comprehensive Reporting**:
    - Risk accounting allows for detailed breakdowns and comprehensive reports, facilitating better understanding and management of CVA risks.
3. **Proactive Risk Management**:
    - The forward-looking elements of the NFR calculation capabilities enable ABC Bank to anticipate and mitigate risks proactively, rather than merely reacting to regulatory requirements.
4. **Regulatory Compliance**:
    - By integrating risk accounting, ABC Bank ensures robust compliance with the RTS, avoiding the pitfalls of arbitrary thresholds and enhancing overall risk governance.
5. **Holistic Risk View**:

- The integrated approach of risk accounting provides a holistic view of all risks, enabling the institution to manage its entire risk profile effectively and adapt to new regulatory standards seamlessly.

Deploying the risk accounting method in support of the proposed CVA risk regulations enables financial institutions like ABC Bank to achieve precise, consistent, and comprehensive risk management. This approach not only ensures regulatory compliance but also fosters a proactive and strategic risk management culture, ultimately enhancing the institution's resilience and stability in the face of evolving financial risks.