ISDA Safe, Efficient Markets

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The European Banking Authority
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Subject: Public consultation on the draft Regulatory Technical Standards (RTS) to specify the conditions and the criteria to assess whether the credit valuation adjustment (CVA) risk exposures arising from fair-valued securities financing transactions are material, as well as the frequency of that assessment[1]

The International Swaps and Derivatives Association ('ISDA') and the Association for Financial Markets in Europe ('AFME'), the 'Joint Associations' and their members ('the industry') welcome the opportunity to comment on the EBA's draft RTS on credit valuation adjustment risk of securities financing transactions under Article 382(6) of Regulation (EU) No 575/2013.

The industry believes that the proposed criteria by the EBA to assess the materiality of fair-valued securities financing transactions (FV SFTs) for CVA risk do not consider many aspects of these products, which will lead to disproportionate capital charges.

We propose that the materiality assessment of FV SFTs for CVA risk should be based on a list of non-quantitative conditions similar to the approaches taken by other jurisdictions such as the UK. The UK approach requires banks to assess individual SFTs against non-quantitative criteria linked to their accounting treatment; individual SFTs that meet those criteria are subject to own fund requirements (OFR) for CVA risk. This approach has two advantages over EBA proposals: (i) applying criteria to individual SFTs, rather than the whole SFT portfolio, means that only those transactions subject to material CVA risk are subject to CVA risk own fund requirements; (ii) linking the criteria to accounting treatment means OFR are more sensitive to the risk of potential losses from changing CVA values.

Alternatively, if the EBA is not willing to consider a non-quantitative approach as used in other jurisdictions, we propose the following two-step quantitative process:

- The first step should be based on banks assessing the materiality of FV SFTs from an accounting perspective
- The second step should be based on the <u>marginal</u> impact of FV SFTs in the regulatory CVA

We believe that this proposed approach would more appropriately assess the materiality of FV SFTs on CVA risk. A marginal impact is preferable to a standalone computation on the SFTs perimeter (as proposed by the EBA) due to the non-linearity of the regulatory BA-CVA and SA-CVA formulas. Indeed, computing a

[1] https://www.eba.europa.eu/publications-and-media/press-releases/eba-consults-criteria-assess-materiality-cva-risk-exposures-arising-securities-financing

standalone capital charge on SFTs would likely overstate the actual impact of including these positions in a bank's capital charge.

In addition, we recommend that banks should choose not to reflect hedges in the CVA risk calculation, which will improve comparability between banks.

The EBA is proposing a materiality threshold between 1% - 5%, which we believe is too punitive. There already exists a threshold to assess materiality in the RNIME framework[2]. Therefore, we recommend that the threshold to assess the materiality of SFTs for CVA should also be set at 10%, to ensure consistency with the RNIME framework.

The EBA is also proposing a quarterly frequency of the quantitative materiality test. We agree on the frequency of the test. However, we believe that the rule deciding on FV SFTs capitalization should be amended as follows: if the most recent four quarters assessment have been breached the threshold twice or more then capitalize, otherwise do not.

We believe that consistency with other jurisdictions on the regulatory treatment for the FV SFTs in CVA risk is important to avoid a competitive disadvantage to the European institutions.

In addition, we would like the EBA to clarify the rationale for prioritizing this mandate, given that the original expectation was for this RTS to be finalised by July 2026. On the application date, we propose that the first reference date to calculate capital requirements should be set at least one year from the entry into force of these RTS for the following reasons. Firstly, to allow institutions time to budget and implement the materiality assessment into IT systems and processes. In addition, from the perspective of appropriate capital planning and management, institutions need sufficient time to adapt their capital budget and management to ongoing regulatory changes and particularly in relation to the application of CRR3 from January 1st 2025 and related Level 2 mandates.

We believe that our proposal is more appropriate from an economic standpoint as it will reduce unnecessary operational complexity, ensure consistency with other jurisdictions on the appropriate capital treatment of FV SFTs for CVA risk, whilst also maintaining safety and soundness.

Please do not hesitate to contact the undersigned associations with any questions you may have or in case you would like to discuss the recommendations further. We remain committed to assisting policymakers in achieving the objectives of this important RTS.

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[2] ECB guide to internal models (europa.eu)

Q1. At which level would you suggest to set the materiality threshold? When providing your answer, please provide any rationale and evidence supporting your proposal.

We understand that CVA is a fair value concept and CVA risk is a consequence of this. The fair value of a derivative includes the CVA, and as per CVA risk definition (CRR3 Article 381)[3], adverse market movements can increase the CVA. As per CRR3 (Article 382(2))[4], SFTs that are FV under the accounting framework should be included in the OFR only if the institution's CVA risk exposures arising from those transactions are material.

We also understand that from an economic perspective, SFTs that are accrual accounted do not attract fair-value adjustments like CVA. Additionally, SFTs that are FV may also not attract CVA fair-value adjustments as part of the accounting process due to some of the following reasons:

- SFTs are usually very short-dated (between 1 day and 3 months).
- SFTs are self-collateralised and self-funded with daily margining being the standard, as stipulated in the governing master agreement.
- The underlying collateral in many instances is very liquid.
- The repo spread agreed to enter the SFT transaction is an all-in spread that encompasses all relevant information and fair-value adjustments to that agreed and executed spread are not deemed relevant.

In some cases, the above reasons can lead to no CVA FV adjustment for SFTs as part of the accounting process or result in significantly lower CVA risk[5]. Therefore, in line with the market risk methodology of the ECB supervisory review and evaluation process (SREP), if there is no accounting CVA, then there is no CVA risk[6].

We believe that the proposed criteria by the EBA to assess the materiality of FV SFTs for CVA risk do not consider the above characteristics of these products, which will lead to disproportionate capital charges. Given that the assessment of materiality of SFTs for CVA risk exposure will be periodic, we strongly believe that the methodology used should not pose increased operational burden to the banks.

[3] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L_202401623
[4] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L_202401623
[5] Indeed, given that repos are short-dated, applying risk weights calibrated for credit spread moves over a time horizon of 40 to 60 days [CRR 325bd] overstates Regulatory CVA Risk. For instance, a netting set of open repos of 1-day maturity, capitalisation shall be for a 1-day move in credit spreads. There is no issue with the framework for longer dated trades of maturity often much greater that the liquidity horizon over which the credit spread move is calibrated, but clearly becomes an issue when the maturity of the trades is less than the liquidity horizon, resulting in an overstatement of the CVA capital charge.
[6] https://www.bankingsupervision.europa.eu/banking/srep/2023/html/ssm.srep202312_marketriskcontrolsrepmethodology.en.pdf

We propose that the materiality assessment of FV SFTs for CVA risk should be based on a list of non-quantitative conditions similar to the approaches taken by other jurisdictions such as the UK. The definition of the UK PRA's CVA covered transactions includes FV SFTs and it requires a materiality test. The PRA SS12/13[7] lists the situations where SFT should be deemed material for the purpose of CVA risk, although the Supervisory Statement does not specify the frequency of the test. These conditions are generally not expected to be met.

The PRA considers that CVA risk may be material where all the following conditions are met:

- the SFT's counterparty has demonstrated a recent deterioration of its creditworthiness;
- a severe deterioration of the SFT's counterparty's creditworthiness would lead to a previous transfer being accounted for as a sale and therefore the recognition of a derivative that would be included in the scope of the CVA charge; and
- the SFTs do not benefit from adequate credit risk mitigation. An example would be where the SFTs are not included in a master netting agreement that has the effect of reducing exposure to credit risk.

We acknowledge that there could be some marginal cases which would deem the risk from SFTs to be material such as commercial haircuts and the volatility capital add-on; from longer-dated SFTs that may not reflect the credit risk of the counterparty should their credit worthiness deteriorate; SFTs not governed by a master agreement; or SFTs that have significant wrong way risk. Such SFTs would be candidates for inclusion in the calculation of the CVA capital charge.

Alternatively, we propose a more quantitative – and less preferred – process, based on the following steps:

Step 1: The first step of the proposed methodology leverages the bank's fair-value processes with regards to accounting CVA for FV SFTs. Institutions that have sufficiently demonstrated the appropriateness of not including the (subset or full) FV SFTs population in their accounting CVA calculation, forming part of their audited accounts, may rely on that assessment to exclude FV SFTs from the CVA risk charge calculation.
If, however, a bank has not sufficiently demonstrated the appropriateness of not including the (subset of full) FV SFTs population in its accounting CVA calculation to their internal and/or external auditors (or has elected to record accounting CVA for FV SFTs), a materiality assessment is performed by comparing the contribution of FV SFTs on accounting CVA against a threshold of 10%. When below the threshold, the institution has evidenced SFTs CVA risk to be not material and SFTs may be excluded from the CVA risk charge. If the threshold is exceeded, then the assessment should move to step 2.

Step 2: The second step of the proposed methodology proposal is to compare the marginal impact of including FV SFTs in regulatory CVA under CRR3 against a threshold. As stated previously, a marginal impact is preferable to a standalone computation on the SFTs perimeter as proposed by the EBA due to

[7] SS12/13 Counterparty Credit Risk - December 2023 (bankofengland.co.uk)

the non-linearity of the regulatory BA-CVA and SA-CVA formulas. Below we outline the proposed ratio to compare against the materiality threshold and the key components of the proposed methodology.

$$Marginal\ impact = \frac{OFR\ CVA\ (derivatives\ and\ FV\ SFTs)}{OFR\ CVA\ (derivatives)} - 1$$

Threshold: There is already a materiality assessment in the market risk framework and in particular the RNIME[8], where institutions should ensure that their models accurately capture all material risks. A threshold of 10% has been assigned to assess whether risks are material. We believe that the appropriate threshold to assess the materiality of FV SFTs should be consistent with the existing RNIME framework. Thus, we recommend to assign a similar threshold of 10%.

Choice of approach: We believe that banks should have the flexibility to choose a metric that will not impose operational complexity. Thus, a bank should be allowed the optionality to choose a mix of SA-CVA and BA-CVA, identical to the one used for OFR, or to use BA-CVA across all its exposures which will enhance comparability. Similarly, when using BA-CVA, a bank may opt for calculating exposures identically to those used for CCR risk as this provides the benefit of operational simplicity or opt for CCR exposures calculated with standardised approaches only for added comparability.

Hedges: We propose that banks should have the option to not reflect hedges in the CVA risk calculation as there may be no hedging strategy in place for SFTs if not capitalised at the time of the assessment. Additionally, this would alleviate operational issues with hedge allocation when using the BA-CVA by using the simple reduced BA-CVA instead of the Full BA-CVA.

Frequency: We believe that a reasonable time (such as 6 months) should be provided to a bank to capitalise FV SFTs for CVA risk exposure should they fail the materiality test and to provide sufficient time to adapt their calculation systems as well as internal and external reporting and disclosures.
We understand that the requirement of the four consecutive ratio assessments to exempt SFTs from the regulatory CVA capital charge [Article 1], stems from the intentions by the EBA to limit the volatility in the treatment of FV SFTs (i.e. in and out of the CVA capital charge framework).

However, we believe that the rule deciding the treatment of FV SFTs should be amended for the following reasons:

1. The proposed time it takes, four consecutive assessments below the threshold, to be exempted from capitalising CVA risk of fair valued SFTs is excessive. If the past level of FV SFTs' CVA risk justifies including, then exempting FV SFTs should be made possible over a shorter time period.
2. There may be instances where for a quarter, the share of FV SFTs regulatory CVA may increase. However, this should not automatically lead to a capitalisation of FV SFTs. Only if there is a pattern of frequent material FV SFTs CVA risk over time, should it be capitalised.

[8] ECB guide to internal models (europa.eu)

To meet the objectives of 'stability in outcomes' together with 'sufficient reactivity to portfolio changes', we suggest a simple approach: if over the most recent four quarters the quantitative assessment is over the materiality thresholds twice or more, then FV SFTs should be capitalised for CVA risk. To the contrary, if over the most recent four quarters the quantitative assessment is breached only once (or never), then FV SFTs should be excluded from the scope of OFR for CVA risk.

Q2. Do you have any additional comments on this consultation paper? If yes, please specify and motivate.

In addition to the proposal by the industry to assess the materiality of FV SFTs for CVA risk exposure under CRR3, we would like to reiterate the different approaches taken by other jurisdictions such as the UK with regards to the capitalisation of FV SFTs for CVA risk exposure. Moreover, in the current US NPR, an SFT is considered not to be a CVA risk covered position and hence out of scope of CVA risk-based capital requirements[9].

We believe that misalignment with other jurisdictions on the treatment of FV SFTs, will result in a competitive disadvantage to the European institutions.

[9] US NPR: A banking organization generally does not calculate CVA for cleared transactions or for securities financing transactions (SFTs) for financial reporting purposes. Consistent with this industry practice, the proposal would not consider a cleared transaction or an SFT to be a CVA risk covered position and therefore would not extend the CVA risk-based capital requirements to such positions.