

Paris, March 9, 2011

The French Banking Federation (FBF) is the professional body representing over 430 commercial, cooperative and mutual banks operating in France. It includes both French and foreign-based organizations.

The French Banking Federation appreciates the opportunity to provide its views on the issues raised in the European Commission consultation on the capitalization of bank exposures to central counterparties (CCPs) and the treatment of incurred CVA.

We believe market infrastructures in general and CCPs in particular are central to the financial system and the rules governing the CCP itself or through the capital charged for the counterparty credit risk inherent in clearing through a CCP demand careful analysis to avoid any possible race to the bottom between CCPs.

In this context, we wish to express our concern on the timing of this consultation compared to other structuring regulatory developments related to CCPs, undertaken either at the international level (joint initiative by the Committee on Payments and Settlement Systems 'CPSS' and the International Organization of Securities Commissions 'IOSCO') or, as mentioned in the Commission's consultation, in the European Union with the European Market Infrastructure Regulations (EMIR).

We understand indeed from the Consultative document that the European Commission intention is to issue a comprehensive legislative proposal before summer 2011 whereas the Basel Committee intends to publish its final report on the consultation and impact study in July 2011 with the view of publishing the final CCP-related rules provisions in September 2011. By contrast, CPSS/IOSCO are planning to issue revised CCP standards for consultation on March 2011 and the European Market Infrastructure Regulation ("EMIR") will be finalized before July 2011.

This is a major concern as those legislations are likely to have significant impacts on CCPs standards and we believe any capitalization of banks exposures to CCPs must be fully consistent with those standards.

We also think that the proposed approaches to CCPs should be underpinned and calibrated based on robust and comprehensive quantitative studies and we can only express our concern on the quality of the data that banks and CCPs will manage to contribute in such tight timeline.

Finally, we welcome the willingness of the Commission to gather views on alternative approaches to the recognition of incurred CVA. We wish to emphasize the importance of a coherent articulation between the capitalization of counterparty risk on one hand and the incentives towards an increased clearing of OTC derivatives through central counterparties on the other hand and believe it is vital that the overall framework preserves the end-users ability to access risk management services.

The French Banking Federation wants to see the instigation of healthy competitive conditions and believes the only way to do so is to establish appropriate regulation and sound, flexible principles that provide the same degree of oversight and governing standards and all financial institutions across all jurisdictions. FBF is looking forward to constructively working with the European Commission.

Section I. Capitalisation of bank exposures to central counterparties

- 1. Are the two conditions and the approach outlined above broadly appropriate? If not, please explain why and how they should be modified?**
- 2. Would the two-tier system ensure the right incentive structure for banks (and, indirectly, for CCPs)? If not, why?**
- 3. Would a single-tier system, i.e. one where only qualifying CCPs would be allowed to exist, be preferable? If so, could making condition 2 a legal requirement for CCPs be considered as a way of doing that? Are there any other ways in which this could be done?**
- 4. Are there any legal, confidentiality or other obstacles that would prevent CCPs to fulfil condition 2?**
- 5. Are there any potential difficulties in applying this approach? If so, which?**

We believe that the concept of qualifying CCPs as proposed in the BCBS consultation paper is too general and we would appreciate that it does not rely exclusively on the CPSS/IOSCO standards which are still under discussion. There is indeed no apparent articulation with other regulatory initiatives related to CCPs, in particular with EMIR in Europe, though as mentioned in the Commission's consultative paper, it is expected to significantly increase the level of regulation for CCPs.

In this context, as mentioned in our response to the Basel Committee consultation (annex 1), we believe that the concept of qualifying CCPs is not granular enough and that consideration should be given to the introduction of one more category that would be the 'highly qualifying' CCPs authorised by the Competent Authorities in the European Union or recognised by ESMA when established in third countries, based on criteria such as quality of the membership, nature of the cleared products, robustness of the risk model, etc..

Having a two-tier set of capital requirements will prompt CCPs to raise their practices above the CPSS-IOSCO minimum standards and allow for the right scale of risk sensitivity.

On the other side, we do not consider preferable having a single-tier system where only authorized or recognised CCPs would be qualifying i.e. other ones would not be qualifying. We feel it would be penalizing to apply non qualifying capitalization rules to CCPs established in third country that would not be recognized within the EU though they comply with CPSS-IOSCO standards.

The second condition set by the Commission for qualifying CCPs is the ability to undertake calculation and/or provide sufficient information to the clearing members to enable the completion of capital calculation. This could be made a legal requirement in the framework of the common EU regulation for CCPs.

With the efforts made to increase the use of CCPs and hence, banks exposures to CCPs, and considering the Commission's proposal in terms of potential role of CCPs in providing banks with inputs for their capital calculation, we believe that strong regulation and effective oversight of CCPs become of the utmost importance. In particular, CCPs should comply with at least the same standards than those applying to banks in terms of audit and validation of their valuation and risk management models.

As the CCP calculations will directly impact banks capital requirements, we also think that banks should have the ability to verify and have full access to CCPs figures and banks regulators should play a role in assessing the suitability of these calculations.

In relation to question 5, we believe it is broadly appropriate to distinguish between qualifying and non-qualifying CCPs but we see potential operational difficulties in applying the approach proposed under section 2.3. of the EC consultation paper.

6. Is the proposed treatment of exposures of banks accessing a CCP indirectly appropriate? If not, why?

7. Could requiring just partial (i.e. omnibus) segregation with gross margining of client positions at CCP level qualify for the same treatment as full segregation? Why?

8. Do you agree with the outlined approach to the capitalisation of trade exposures? If not, why?

9. Should the exception for bankruptcy-remote collateral in case of use of a qualifying CCP be extended also to collateral posted to non-qualifying CCPs, provided that the latter collateral complies with the same conditions? Why?

We first seek clarification of the trade exposures definitions and urge the Commission to issue precise guidelines for their determination, especially as far as listed derivatives are concerned.

We also seek confirmation from the Commission that those exposures should be excluded from the large exposure regime as long as they are held against a qualifying CCP.

With regard to the 2% proposed risk weight to trade exposures, we understand that the Commission's motivation is to prompt banks to clear their trades on CCPs, yet not forgetting that CCPs are not risk-free.

We agree that CCPs are likely to develop exponentially in the next years, hence aggregating a very high level of systemic risk. We question however the rationale and efficiency of addressing this macro-systemic risk through the micro-prudential supervision of banks. We think that CCPs systemic risk would be better addressed through appropriate regulation of CCPs, high risk management standards including robust margining, risk controls and transparency, strong membership's standards, and emergency access to central banks liquidity.

We expect CCPs that would be subject to EMIR (but also probably to Dodd-Frank) ('the highly qualifying CCPs') or that would be qualified as SIFIs to satisfy the criteria mentioned above and we believe that for those, the 2% proposed risk-weight is too high and does not provide the right scale of risk-sensitivity.

As a consequence, there will be no natural incentive to clear a trade realized with a counterparty benefiting from a good credit quality as:

- The trade exposures to the CCP are higher than OTC trade exposures as, usually, banks do not post initial margins with their banking counterparties and the exchange of variations margins reflecting the mark to market is symmetrical
- The bulk of cleared trades tend to be short term (e.g. front month or front quarter) which makes the 2% Risk Weighting even less attractive.

We would therefore recommend at least lowering the proposed RW for the ‘highly qualifying’ CCPs defined above.

However we believe it is important to differentiate the customer positions from proprietary positions under the clearing member umbrella in the specific cases where relevant laws and standard documentation of the Clearing Member provide enforceable limitation of liability of the Clearing Member toward its client, would a failure of the CCP happen. In this case, and provided this client’s assets are well identified from the ones of the Clearing Member and of the other clients, we believe no capital charge should apply to the Clearing Member as far as those trade exposures are concerned.

Whether indirectly accessing banks would be able to enjoy the same capital treatment as directly accessing ones, would the full segregation (or the omnibus one) and portability conditions both being met is a complex issue.

The Commission proposes the favorable qualifying CCP risk weight for non-member banks exposures provided their assets are segregated and bankruptcy-remote from the clearing member. We would like to draw the Commission attention to the fact that the concept of bankruptcy-remote collateral is not aligned with the CCPs various segregation models prevailing today and relies too much on national bankruptcy laws which are far from being aligned. Therefore, we would suggest basing the most favorable treatment on a notion of “appropriate segregation” as the current legislation both in the EU and in the US will precisely define the level of segregation expected from CCPs and we would recommend that more discussions are dedicated to these sensitive issues in an appropriate forum.

As a general comment, we would like to stress that the incentives given by the Commission in relation to segregation deserve a careful analysis to avoid potential unintended consequences, like the creation of massive liquidity traps if a too high level of margins were to be segregated.

Beyond segregation, we understand that an additional criterion to benefit from the favorable qualifying CCP risk weight is that the non-member bank must be ‘legally ensured’ that another CCP member will take over its trades if the original CM cannot perform (or so-called ‘portability’ concept). Even if the idea of the “legally ensured” portability of the trade is an interesting idea, we wonder how this will work in practice, as, the clearing member commitment to take the position implies taking a counterparty risk on the client. This risk will be unknown at the time of the commitment, creating exposures to counterparties that have not been vetted by the clearing member and will be realized in (most likely) stressed situations (default of a clearing member).

Under the Commission’s proposed wording, if the condition of ‘portability’ can not be legally enforced, the clients will have no incentive to clear their trades as the capital required for their exposure will remain based on the clearing member and not on the CCP even if their initial margins are correctly protected and the mark to market of their position (if bilateral) daily provisioned. The CCPs practices and processes in case of default of a clearing member proved to be robust enough so far; we therefore propose to remove the term ‘legally ensured’ to keep the concept of ‘portability’ flexible enough to accommodate those practices.

As a matter of principle, we think that wherever appropriate segregation and effective bankruptcy remote mechanism do exist, any related trade exposures could be exempted from counterparty credit risk capital charge.

10. Do you agree with the approach to the capitalisation of default fund contribution exposures outlined above? If not, why?

11. Is it possible to improve the outlined approach by making adjustments to the Current Exposure Method? If so, how?

12. Could the outlined approach be used in a situation in which a CCP had multiple default funds covering different types of financial instruments, or would it need to be adjusted? If the latter, how?

13. Are there any other methods for calculating default fund contribution exposures or hypothetical capital that are both simple and easy to supervise? If so, which?

14. Is requiring bilateral capital treatment for trade exposures to a CCP whose total default fund is less than its hypothetical capital a more appropriate way to reflect the risk of being a member of such a CCP? If not, is there any alternative methodology that would allow achieving this goal? If yes, which?

15. Should CCPs be the ones calculating the hypothetical capital or could/should this calculation be performed by someone else? If the latter, who?

16. Do you agree with the proposed treatment of default fund contributions to nonqualifying CCPs and please explain why? In your view, what should be the risk weight associated with these exposures?

The Commission proposes to capitalize banks default funds exposures according to an approach that is based on CCPs 'hypothetical capital' that is an information provided by CCPs.

We have several concerns on the 'hypothetical capital' concept.

First of all, we view the dependency of banks on CCPs to get the hypothetical capital estimation as a major point of attention in the proposed framework and reiterate our call for very robust valuation and risk management models at CCPs level complemented by tight regulation and oversight.

As mentioned in the first section, should CCPs calculate capital requirements or inputs to capital computations, we strongly believe that banks should have the possibility to check and challenge their computations. We note that under the formula proposed by the Committee, the exposure of banks through the default fund is not fully in line with their margin calls relative share in the common participation at the CCP level, making the check very difficult to achieve on the basis of this information. To overcome this difficulty, we suggest that CCPs provide each clearing member with its contribution to the hypothetical capital using a more economic allocation (proportional to the clearing member exposure) as well as the market parameters used for consistency checks purpose.

In addition, should CCPs compute the hypothetical capital themselves, we recommend allowing them to use alternative options to the CEM method.

The CEM method has clearly the merit of simplicity but is overly conservative compared to alternative approaches, in particular the IMM method, and hence is very likely to lead to levels of hypothetical capital requirements that are much higher than the initial margins usually computed using more sophisticated approaches. This might unnecessarily leads to an increase in the initial margins, increasing therefore the cost of clearing and thereby, creating a disincentive to clear transactions.

Alternatively, CCPs could be required to provide sufficient transparent public information to allow banks to assess their own contribution to the hypothetical capital under the supervision of their home regulators.

The Commission proposes to capitalize banks default funds exposures according to a loss waterfall that seeks to take into consideration in a simple manner the risks associated to the default fund contribution.

As the Commission's certainly knows, the CCPs default waterfalls are currently reviewed under EMIR and any determination of the margin adequacy should be sensitive to the CCPs effective waterfall structures as imposed by this forthcoming regulation.

As an example, current European draft legislation suggests that in case of a default, it is first the initial margin and second, the default fund contribution of the defaulting clearing member that are used in priority to offset its own default. Only then the CCPs shareholders default fund and finally (or even simultaneously) the default fund contributed by other CCP members are called to off-set the losses.

In this context, we believe the treatment proposed by the Commission which considers the non defaulting clearing member default fund exposition as a first loss is not risk-sensitive enough, not to say overly conservative. We believe the 1250% proposed risk weight should be recalibrated based on empirical evidence drawn from the Lehman and Bear Stearn experiences;

One other point of attention is that the computation implies that the CCP members are posting regulatory capital in front of their own credit and counterparty risk. Depending on the concentration of the risks of the CCP on its members, this might have a very significant impact on the capital required for each clearing member. If the positions of the members are scattered, the proposed formula, while not technically perfect, has the merit of simplicity and is conceptually acceptable provided a more risk-sensitive risk-weight is applied in accordance with the point mentioned above. Conversely, if some members have significant positions the computation is likely to be a "double jeopardy" and should be reviewed. Due to the tightening of CCPs regulation and the high membership standards that will directly or indirectly result from that, we expect the second configuration to be the most frequent one. In this context, we believe that there is some rationale to remove the clearing member exposures from the hypothetical capital computation before computing its own share of this capital.

Finally, we note that the computation does not limit the capital requirement for the clearing member to the amount of its contribution, which may result in a highly unusual if not unique situation of an effective risk weighting higher than 1250%. While we acknowledge that the actual exposure of the clearing member may be higher than its pre-funded contribution to the default fund, we believe that the unfunded commitment of the clearing members should be measured and limited in amount. In any case, the unfunded commitment of clearing members is clearly senior to the pre-funded portfolio and should not attract the same risk weight.

Section II – Treatment of incurred credit valuation adjustments

17. How do you currently treat incurred CVA

- a) in the regulatory capital for market and counterparty credit risk; and**
- b) in the internal capital adequacy assessment?**

18. Do you separate 1-year and lifetime expected future losses implicit in CVA and if so, how do you do it and how do you treat each part? Could you please characterise how such separation could be carried out? What are the main challenges arising from this separation and the respective treatment?

19. What are the key pros and cons of recognising incurred CVA via provisions/increase of available capital and recognising incurred CVA by reducing the exposure amount?

Banks have a variety of accounting and prudential treatment with regards to incurred CVA.

For most banks,

- Incurred CVA is deducted from the P&L, and as such, deducted from the regulatory capital (and not distributed as dividend). In Europe, according to Article 63 (3) of Directive 2006/48/EC, IRB-compliant banks are allowed to write back their excess of provisions above EL to their Tier 2 capital, with a cap at 0,6% of total RWA. However this overall cap usually makes the treatment of incurred CVA as a provision inefficient in terms of cancelling out the double-counting in capital requirements.
- Incurred CVA is not separated between 1-year and lifetime CVA since it is not yet integrated into the IRB Capital framework. Such separation could be carried out without major difficulties.
- Incurred CVA is not deducted from the exposure at risk (EAD) in the computation of RWAs.
- Incurred CVA is not taken into account in the computation of Market Risk RWAs.
- ICAAP treatment is usually similar to Pillar 1 treatment.

20. What regulatory treatment for incurred CVA do you consider conceptually as the most appropriate and why?

We believe the proposal made by Eduardo Canabarro (Morgan Stanley) to amend the current "capital" charge for counterparty risk (EL + UL) so as to reflect the benefit of CVAs is conceptually the most appropriate regulatory treatment for incurred CVA. This proposal is attached in Annex 2 for your reference.

In order to fit into the 1year capital framework of the IRB approach, this proposal has the CVAs broken down into within and beyond 1 year.

- CVA<1y is always available for offset because it represents a reserve that will systematically be reverted in the next year, whether the counterparty it covers falls into default or not during that period. It is therefore of the same dimension as capital and should replace the (1y) EL in the IRB formula.

- CVA $>$ 1y on the other hand can only offset losses – in the next year – if the specific counterparty it covers falls into default during that period. It should therefore be deducted from the loss in default (EAD*LGD) in the IRB framework.

The resulting “modified” formula is mathematically correct (this has been confirmed by a separate work from Michael Pykhtin from the FED attached in annex 2) and follows the exact same logic that was initially followed to obtain the current IRBA formula. We attach in annex this proposal for your reference

21. If you suggest recognising incurred CVA by reducing the exposure amount when calculating the counterparty credit risk charge, could you please specify the appropriate amount (e.g. CVA only, CVA divided by LGD etc) by which the exposure amount should be reduced and why?

Please see answer to question #20 above: the CVA $>$ 1y should be deducted from the EAD*LGD, and the CVA $<$ 1y from the capital charge itself.

22. If you suggest treating incurred CVA as equivalent to a provision:

- a) **What treatment should be applied to credit institutions applying the IRB approach? Please justify and elaborate on both the effect on capital resources and counter-cyclicality.**
- b) **Should incurred CVA be compared to total EL for counterparty credit risk only or to total EL arising also from credit risk, or against EL on the specific asset, or netting set against which it was taken?**
- c) **Should the respective increase of available capital be limited and if so, please specify the appropriate limit.**
- d) **What treatment should be applied to credit institutions applying the standardised approach?**

23. If you suggest using the approach detailed in footnote 44, please explain why and indicate whether any changes to that treatment are necessary

24. If you suggest a different alternative to the treatments mentioned in questions 21 - 23, please specify its details and why you consider that such treatment would be prudentially sound.

If the approach described in answer to question #20 cannot be implemented, we propose as a more straightforward alternative the possibility to write back the excess of incurred CVA above EL to Core Tier 1 capital (without cap).

26. Please assess the likely consequences and impact (both qualitative and quantitative) of all the options considered above? To the extent possible, please cover both benign and stressed periods for such assessment.

The impact of the proposed CVA capital treatment is available in the QIS provided to the BIS as part of the consultation on the Basel 3 capital rules.

As for the MS proposal it should not be difficult to give a quantitative impact for this method. The impact in capital charge will be limited anyway.

27. Should incurred CVA losses also be recognised in calculation of the CVA capital charge? If so, why and how? Do you recognise incurred CVA when determining VaR of CVA or when calculating CVA sensitivities for hedging purposes? If so, how? Are you able to reflect the maximum loss at individual counterparty level when simulating changes in CVA? How material is the impact?

We think a proper treatment of the CVA capital charge with regards to incurred CVA will only be possible once a comprehensive counterparty credit capital framework for derivatives, unifying the IRB (default) capital charge and the CVA capital charge is available.

28. Please provide an estimate of the impact of the current CRD approach, the Basel III approach and your own suggested treatment for your own firm (differentiated by available own funds, exposure at default and capital requirement).

See answer to question #26.

29. Please provide any further information (both of qualitative and quantitative nature) you consider relevant for the purposes of finalising the upcoming legislative proposal on this issue

One major concern regarding the CVA capital treatment - as currently proposed in the Basel III rules – relates to the lack of a suitable approach proposed to banks that do not compute CVA based on market parameters and do not use CDS to hedge their CVA volatility.

N.B: The above and following remarks also apply the sub-perimeter of illiquid names (including local authorities and project finance SPVs) for banks that otherwise do use CDS to hedge their CVA (on liquid names).

These banks originate and manage client exposures on OTC derivatives in the same way as they do for exposures related to financing/banking activities, i.e. under an “originate to warehouse” type of business model. The potential exposures that they face on these counterparties are within authorized risk appetite and the banks intention is to hold the resulting credit risk to maturity without actively managing it.

Their accounting approach to incurred CVA is usually based on internal ratings mapped to historical probabilities of default and on historical recovery rates.

The VAR-based CVA capital charge is not suited for these banks and applying a “one size fits all” approach to the CVA capital charge computation can lead to very perverse effects:

- The absence of consistency between the computation method of incurred CVAs (always market-based in the US and mostly rating-based in Europe) and the CVA capital charge (only market-based in the current proposed framework) would result in an artificial volatility either of capital requirements (if banks decide not to hedge those variations) or of P&L (if banks decide to purchase protection via CDS to hedge the counterparty risk and smooth the volatility of the new capital charge).
- In this situation, banks will be pushed by a regulatory provision to change their business model to adapt to this new capital charge and its embedded volatility, thereby creating procyclicality and systemic risk when all banks have to buy CDS at the same time.
- Moreover, in most cases, this change in business model is simply not adapted to the portfolio of European commercial banks that is mostly constituted by end-users that are small corporates with a local dimension and an illiquid counterparty risk.
- This would also directly lead to an increase in end-users cost of hedging because the CVA charge computed with market spreads will be a material additional cost and indirectly impact their cost of funding because banks will hedge the CVA charge and hence create a much higher correlation between the cost of funding of those entities and market spreads.

We therefore regret that the current Basel III text does not propose any viable “internal-rating-based” alternative to the VAR-based approach for IRB banks adopting an “originate to warehouse” approach.

N.B: the “standardized” approach proposed in the last version of the text (December 2010) is not appropriate for these banks either since it was calibrated to market parameters).

This issue has been discussed in a more detailed collective paper published by the FBF on behalf of the French banks (see annex 3), which also provide an alternative approach to the Basel III proposals for banks using rating-based CVA.

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FEDERATION
BANCAIRE
FRANCAISE

ANNEX 1

*Banking supervision
And Accounting issues Unit*

The Director

Paris, February 4th 2011

French banking Federation comments on the BCBS Consultative Document on the capitalisation of banks to central counterparties (BCBS 190)

The French Banking Federation (FBF) is the professional body representing over 430 commercial, cooperative and mutual banks operating in France. It includes both French and foreign-based organizations.

The French Banking Federation appreciates the opportunity to provide its views on the issues raised in the Basel Committee consultation on the capitalisation of bank exposures to central counterparties (CCPs).

We believe market infrastructures in general and CCPs in particular are central to the financial system and the rules governing the CCP itself or through the capital charged for the counterparty credit risk inherent in clearing through a CCP demand careful analysis to avoid any possible race to the bottom between CCPs.

In this context, we wish to express our overarching concern on the timing of this consultation and its lack of coordination with other structuring regulatory developments related to CCPs, undertaken either at the international level (joint initiative by the Committee on Payments and Settlement Systems 'CPSS' and the International Organization of Securities Commissions 'IOSCO') or in specific jurisdictions, in particular the European Union's European Market Infrastructure Regulations (EMIR) and the United States' Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

We understand indeed from the Consultative document that the Committee intention is to publish its final report to BCBS on the consultation and impact study in July 2011 with the view of publishing the final CCP-related rules provisions in September 2011. By contrast, CPSS/IOSCO are planning to issue revised CCP standards for consultation on March 2011 and neither the European Market Infrastructure Regulation ("EMIR") nor the Dodd-Frank rule-making on CCPs will be finalized before July 2011 (not taking into account level 2 regulation by ESMA within the EU).

This is a major concern as those legislations are likely to have significant impacts on CCPs standards and we believe any capitalisation of banks exposures to CCPs must be fully consistent with those standards.

We also think that the proposed approaches to CCPs should be underpinned and calibrated based on robust and comprehensive quantitative studies and we can only express our concern on the quality of the data that banks and CCPs will manage to contribute in the extreme tight deadline imposed for the QIS.

You will find in the annexes attached our general comments and our answers to the issues raised in the consultative document.

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

Yours sincerely,

French Banking Federation general comments on BCBS 190

Definition of qualifying CCPs:

We believe that the concept of qualifying CCPs is too general and we would appreciate that it does not rely exclusively on the CPSS/IOSCO standards which are still under discussion. By contrast, there is no apparent articulation with other regulatory initiatives related to CCPs, in particular with EMIR in Europe and Dodd-Frank in the US, though they are expected to significantly increase the level of regulation for CCPs.

As a matter of example, under Dodd-Frank, a derivative clearing organization needs to comply with 18 core principles in the Commodity Exchange Act (CEA) as well as CFTC regulations, detailing the level of risk management controls, monitoring of positions by counterparties and general transparency. Under EMIR, a CCP should be authorized by ESMA and comply with EMIR requirements, including a minimal capital of €5m, robust risk management and governance arrangements, control of credit and liquidity risk, limited investment policy, controlled default waterfall, stress testing.

As a result, both regulations will settle higher standards than the minimal IOSCO requirements.

In this context, we believe that the concept of qualifying CCPs is not granular enough and that consideration should be given to the introduction of one more category that would be the 'highly qualifying' CCPs designated by ESMA (under EMIR) and by US authorities under Dodd-Frank, based on criteria such as quality of the membership, nature of the cleared products, robustness of the risk model, etc..

Having a two-step set of capital requirements will prompt CCPs to raise their practices above the CPSS-IOSCO minimum standards. In order to avoid a race to the bottom or limit any "adverse selection" effects created by a common level of capital for all CCPs compliant with minimal international standards, we would therefore strongly advise the Committee to consider developing a more granular approach.

The second condition set by the Committee for qualifying CCPs is the ability to undertake calculation and/or provide sufficient information to the clearing members to enable the completion of capital calculation.

With the efforts made to increase the use of CCPs and hence, banks exposures to CCPs, and considering the Committee's proposal in terms of potential role of CCPs in providing banks with inputs for their capital calculation, we believe that strong regulation and effective oversight of CCPs become of the utmost importance. In particular, CCPs should comply with at least the same standards than those applying to banks in terms of audit and validation of their valuation and risk management models.

As the CCP calculations will directly impact banks capital requirements, we also think that banks should have the ability to verify and have full access to CCPs figures and banks regulators should play a role in assessing the suitability of these calculations.

Trade exposures definitions and proposed 2% RW

We first seek clarification of the trade exposures definitions and urge the Committee to issue precise guidelines for their determination, especially as far as listed derivatives are concerned. We also believe that at CPP level it is important to differentiate the customer positions from proprietary positions under the clearing member umbrella.

We also seek confirmation from the Committee that those exposures should be excluded from the large exposure regime as long as they are held against a qualifying CCP.

With regard to the 2% proposed risk weight to trade exposures, we understand that the Committee motivation is to prompt banks to clear their trades on CCPs, yet not forgetting that CCPs are not risk-free.

We agree that CCPs are likely to develop exponentially in the next years, hence aggregating a very high level of systemic risk. We question however the rationale and efficiency of addressing this macro-systemic risk through the micro-prudential supervision of banks. We think that CCPs systemic risk would be better addressed through appropriate regulation of CCPs, high risk management standards including robust margining, risk controls and transparency, strong membership's standards, and emergency access to central banks liquidity.

We expect CCPs that would be subject to EMIR/Dodd-Frank ('the highly qualifying CCPs') or that would be qualified as SIFIs to satisfy the criteria mentioned above and we believe that for those, the 2% proposed risk-weight is too high and does not provide the right scale of risk-sensitivity.

As a consequence, there will no natural incentive to clear a trade realized with a counterparty benefiting from a good credit quality as:

- The trade exposures to the CCP are higher than OTC trade exposures as, usually, banks do not post initial margins with their banking counterparties and the exchange of variations margins reflecting the mark to market is symmetrical
- The bulk of cleared trades tend to be short term (e.g. front month or front quarter) which makes the 2% Risk Weighting even less attractive.

We would therefore recommend at least lowering the proposed RW for the 'highly qualifying' CCPs defined above and for CCPs designated as SIFIs.

Hypothetical capital

The Committee proposes to capitalise banks default funds exposures according to an approach that is based on CCPs 'hypothetical capital' that is an information provided by CCPs.

We have several concerns on the 'hypothetical capital' concept.

First of all, we view the dependency of banks on CCPs to get the hypothetical capital estimation as a major point of attention in the proposed framework and reiterate our call for very robust valuation and risk management models at CCPs level complemented by tight regulation and oversight.

As mentioned in the 'qualifying CCPs' section, should CCPs calculate capital requirements or inputs to capital computations, we strongly believe that banks should have the possibility to check and challenge their computations. We note that under the formula proposed by the Committee, the exposure of banks through the default fund is not fully in line with their margin calls relative share in the common participation at the CCP level, making the check very difficult to achieve on the basis of this information. To overcome this difficulty, we suggest that CCPs provide each clearing member with its contribution to the hypothetical capital using a more economic allocation (proportional to the clearing member exposure) as well as the market parameters used for consistency checks purpose.

In addition, should CCPs compute the hypothetical capital themselves, we recommend allowing them to use alternative options to the CEM method. The CEM method has clearly the merit of simplicity but is overly conservative compared to alternative approaches, in particular the IMM method, and hence is very likely to lead to levels of hypothetical capital requirements that are much higher than the initial margins usually computed using more sophisticated approaches. This might unnecessarily leads to an increase in the initial margins, increasing therefore the cost of clearing and thereby, creating a disincentive to clear transactions.

Alternatively, CCPs could be required to provide sufficient transparent public information to allow banks to assess their own contribution to the hypothetical capital under the supervision of their home regulators.

Default fund exposures and proposed capital treatment

The Committee proposes to capitalise banks default funds exposures according to a loss waterfall that seeks to take into consideration in a simple manner the risks associated to the default fund contribution.

We would like to draw the Committee's attention to the fact that CCPs default waterfalls are currently reviewed under EMIR and in the Dodd-Frank Act rule-making process. Any determination of the margin adequacy should be sensitive to the CCPs effective waterfall structures as imposed by those forthcoming regulations.

As an example, current European draft legislation suggests that in case of a default, it is first the initial margin and second, the default fund contribution of the defaulting clearing member that are used in priority to offset its own default. Only then the CCPs shareholders default fund and finally (or even simultaneously) the default fund contributed by other CCP members are called to off-set the losses.

In this context, we believe the treatment proposed by the Committee which considers the non defaulting clearing member default fund exposition as a first loss is not risk-sensitive enough, not to say overly conservative. We believe the 1250% proposed risk weight should be recalibrated based on empirical evidence drawn from the Lehman and Bear Stearn experiences;

One other point of attention is that the computation implies that the CCP members are posting regulatory capital in front of their own credit and counterparty risk. Depending on the concentration of the risks of the CCP on its members, this might have a very significant impact on the capital required for each clearing member. If the positions of the members are scattered, the proposed formula, while not technically perfect, has the merit of simplicity and is conceptually acceptable provided a more risk-sensitive risk-weight is applied in accordance with the point mentioned above. Conversely, if some members have significant positions the computation is likely to be a "double jeopardy" and should be reviewed. Due to the tightening of CCPs regulation and the high membership standards that will directly or indirectly result from that, we expect the second configuration to be the most frequent one. In this context, we believe that there is some rationale to remove the clearing member exposures from the hypothetical capital computation before computing its own share of this capital.

Finally, we note that the computation does not limit the capital requirement for the clearing member to the amount of its contribution, which may result in a highly unusual if not unique situation of an effective risk weighting higher than 1250%. While we acknowledge that the actual exposure of the clearing member may be higher than its pre-funded contribution to the default fund, we believe that the unfunded commitment of the clearing members should be measured and limited in amount. In any case, the unfunded commitment of clearing members is clearly senior to the pre-funded portfolio and should not attract the same risk weight.

Bankruptcy-remoteness of collateral and segregation issues

The Committee proposes a favourable treatment for 'bankruptcy-remote' collateral for clearing member as well as the favourable qualifying CCP risk weight for non-member banks exposures provided their assets are segregated and bankruptcy-remote from the clearing member. We would like to draw the Committee attention that the concept of bankruptcy-remote collateral is not aligned with the CCPs various segregation models prevailing today and relies too much on national bankruptcy laws which are far from being aligned. In addition, our understanding is that the concept of "bankruptcy remote" is only relevant for securities, cash being commingled. Therefore, we would suggest basing the most favourable treatment on a notion of "appropriate segregation" as the current legislation both in the EU and in the US will precisely define the level of segregation expected from CCPs.

As a general comment, we would like to stress that the incentives given by the Committee in relation to segregation deserve a careful analysis to avoid potential unintended consequences, like the creation of massive liquidity traps if a too high level of margins were to be segregated.

Attention should also be paid to CDS used by banks to hedge their loan books for which we urge the Committee to acknowledge that sub-accounts held separately by a bank for CDS hedging the loan book and for the trading book may be netted for the determination of Credit Event calculation and payments, and that CDS held in such accounts hedging the loan book will therefore fully qualify as guarantees received from the CCP.

Treatment of non qualifying CCPs

One important criterion to determine a qualifying CCP will be transparency. We understand from the Committee's proposals that non qualifying CCPs will be considered as not transparent enough and therefore the Committee proposes to use the standard method for credit risk to compute capital requirements on banks exposures to such CCPs.

We think a more risk-sensitive framework would be desirable to encourage non CPSS-IOSCO compliant CCPs the chance to fill the gap with more ancient and advanced CCPs and avoid entry barriers and avoid disincentives to a wider use of CCPs by financial institutions and their clients. More importantly, a more gradual and risk sensitive framework would avoid major disruptions should a CCP suddenly lose its status of qualifying CCP.

Indirect Access and capitalisation of Clients' exposure

Beyond segregation, we understand that an additional criterion to benefit from the favourable qualifying CCP risk weight is that the non-member bank must be 'legally ensured' that another CCP member will take over its trades if the original CM cannot perform (or so-called 'portability' concept). Even if the idea of the "legally ensured" portability of the trade is an interesting idea, we wonder how this will work in practice, as, the clearing member commitment to take the position implies taking a counterparty risk on the client. This risk will be unknown at the time of the commitment, creating exposures to counterparties that have not been vetted by the clearing member and will be realised in (most likely) stressed situations (default of a clearing member).

Under the Committee's proposed wording, if the condition of 'portability' can not be legally enforced, the clients will have no incentive to clear their trades as the capital required for their exposure will remain based on the clearing member and not on the CCP even if their initial margins are correctly protected and the mark to market of their position (if bilateral) daily provisioned. The CCPs practices and processes in case of default of a clearing member proved to be robust enough so far; we therefore propose to remove the term 'legally ensured' to keep the concept of 'portability' flexible enough to accommodate those practices.

French Banking Federation Answers to the Committee's requests for comment on BCBS 190

Comments on whether CCPs, CCP overseers, clearing members, transaction repositories or other sources of information and expertise are best equipped to assemble and manage the necessary information to complete calculation of exposures and capital

We believe banks are the best equipped to compute their exposures and capital requirements. CCPs should be required to provide all the necessary information in a fully transparent manner to allow banks to perform their own assessment of the building blocks of their capital requirements under the supervision of their home supervisors. As stated in the general comments, CCPs should be subject to very high risk management standards and regulatory oversight to ensure that the model outputs and data they will provide to banks to complete their exposure and capital computations are fully compliant with the regulatory standards applying to the banks themselves.

Should CCPs compute their hypothetical capital themselves, we strongly recommend that:

- CCPs overseers apply the same regulatory standards than those applying to banks including those applying to model validation
- CCPs provide each clearing member with its contribution to the hypothetical capital using a more economic allocation (proportional to the clearing member exposure) as well as the market parameters used to allow for a full consistency check

Comments on other practicable, simple and supervisable methods for calculating exposure or hypothetical capital and on adjustments to CEM that could improve its utility as a proxy for CCP exposures to its members

As stated in the general comments, we question the appropriateness of using the CEM method to determine the CCP hypothetical capital with regard to its lack of risk-sensitivity, the calibration of its add-on which does not factor-in the high frequency of margin calls for exposures to CCPs and the over-estimation of hypothetical capital needs which could unduly trigger an increase in initial margins and hence in clearing costs.

Should CCP be responsible for the hypothetical capital calculation, we would strongly recommend that more sophisticated approaches than the CEM method ("CEM") be allowed for them to use under the proper supervision of their regulator. At minima, the add on of the CEM method should be recalibrated in a way that is more consistent with the CCPs margining practices and frequency.

Comments with respect to whether an alternative methodology such as requiring bilateral capital treatment for trade exposures to CCPs where its default funds are less than its hypothetical capital exists to properly reflect the risk of being a clearing member in such a CCP

We do not support the proposal of requiring bilateral capital treatment for trade exposures to CCPs where its default fund is less than its hypothetical capital. We think the first priority is to make sure that the determination of the hypothetical capital is performed in a way that is economic enough to allow for a meaningful comparison with the CCP default funds and that any shortfall does not simply result from flawed risk assessments. Then after, we urge the Committee to consider a more risk sensitive waterfall and capital charges that are commensurate with the economic risk of each scenario. The industry would be happy to assist the Committee in the calibration of such economic risk weighting.

IRB Capital on Counterparty Credit Risk

Eduardo Canabarro
Morgan Stanley

The objective of this note is to advance a proposal for the calculation of capital on counterparty credit risk (CCR) according to the Internal Ratings-Based (IRB) framework and taking into account the existence of Credit Valuation Adjustments (CVAs).

For the purpose of this note it is useful to think of CVA as a “credit reserve” to cover expected default losses of the counterparty over the life of the portfolio of OTC derivatives. This is not what CVA really is, but it is useful to think this way within the context of the IRB framework.

The IRB formula for the capital (K) on wholesale exposures is:

$$K = EAD \cdot LGD \cdot [Q - PD] \cdot T$$

where

- EAD is the exposure at default;
- LGD is the loss given default;
- Q is the 1-year probability of default conditional on the 99.9% realization of the systematic credit factor of the ASFR model, see Gordy (2003).¹
- PD is the 1-year unconditional probability of default;
- T is the multiplicative maturity adjustment designed to capture the economic effect of credit migrations over 1 year on the economic value of the credit portfolio.

The objective of the IRB formula is to calculate capital on unexpected loss (i.e. beyond $PD \cdot LGD \cdot EAD$) and to adjust the result to capture the economic impact of credit rating migrations over the one year capital horizon.

We propose modifying the formula above for counterparty credit risk as:

$$K = [EAD \cdot LGD - CVA_2] \cdot Q - CVA_1$$

where

¹ Gordy, M, “A risk-factor model foundation for ratings-based bank capital rules”, *Journal of Financial Intermediation* 12, 199-232.

- CVA_1 is the portion of the total counterparty's CVA that corresponds to default losses over the first year;
- CVA_2 is the portion of the total counterparty's CVA that corresponds to default losses beyond the first year.

The rationale behind our proposed formula is the following:

- CVA_1 is a credit reserve that offsets default losses of the entire credit portfolio over the first year. This is because this reserve will be reverted during the first year even if the specific counterparty does not default. In this way it will reduce total credit portfolio losses.
- CVA_2 is a credit reserve that will be reverted during the first year only if the specific counterparty defaults. If the counterparty does not default, CVA_2 will continue to exist and will not be available to offset default losses of other counterparties. Thus, the benefit of CVA_2 to offset unexpected default losses of the portfolio in the first year is conditional on the specific counterparty defaulting.
- Observe that we count CVA_2 as an offset to unexpected default loss in the first year even though it reflects "expected losses" beyond the first year. We believe that this is proper within the IRB framework since this reserve is available (via its reversion) to offset the default loss of the specific counterparty during the first year, which is the capital calculation horizon.
- The maturity adjustment T has been removed from the capital formula because the variability of the CVA will be captured by the VaR of the CVA.

Numerical example:

$EAD = 100$
 $LGD = 100\%$
 $Q = 10\%$
 $CVA_1 = 1$
 $CVA_2 = 2$

$$K = (100 - 2) \cdot 0.10 - 1 = 8.8$$



French banks proposal for the capitalization of Rating-based credit valuation adjustments

The purpose of this memo is to give a short overview of what are the Credit Valuation Adjustments (CVA) and how they are computed and managed depending on each bank business model, the rationale underpinning the Basel Committee proposal to capitalize CVA volatility as well as the perverse risks and unintended consequences that would result from the universal and uniform application of Basel proposal.

A simple way to mitigate those perverse effects is presented at the end of the memo¹.

1. What are the Credit Valuation Adjustments (CVA) ?

A CVA (Credit Value Adjustment) is the fair value adjustment of the credit price of counterparty risk. It is part of the Fair Market Value required by accounting standards to take into account the deterioration in the credit worthiness of a counterparty of bilateral derivatives.

It is computed at counterparty level and not at deal level which explains why it is dealt with separately from the “counterparty risk free” derivatives valuation.

CVA is a function of Expected Exposure (EE), Probability of default (PD) and Loss Given Default (LGD).

During the life of a derivative contract with a given counterparty:

- A marginal CVA is computed at deal inception,
- CVAs are then re-computed on a regular basis (daily to monthly) and the change of CVAs stock affects the P&L like the rest of the derivatives value. The CVAs change through time either because of changes in the derivative exposure or because of changes in the counterparty credit quality,
- When a deal expires or is unwound, the marginal CVA corresponding to this deal ceases to be taken into account, i.e. the marginal CVA analytically returns to the P&L
- In case of default, the deals are no longer “live”, the total stock CVAs for the counterparty returns from the P&L and is used to either pay the loss or is used as provision for the coming loss.

As a consequence, **CVAs are not a simple value adjustment** since in case of default of a counterparty, the total amount of the CVAs reserved against this counterparty is available to off-set the related losses.

¹ This memo does not address the issue of double-counting between the CVAs and the current counterparty risk capital charge, which has been discussed in a separate communication.

Thus, CVAs play the role of provisions for counterparty risk; by contrast to credit risk provisions, CVAs are computed on all counterparties including sound ones. Hence, **they allow anticipating the potential losses and provisioning those losses in an early and prudent fashion and are considered as such as a “best practice”**.

2. Practices in terms of computation and management of CVAs are heterogeneous reflecting different business models

Banks compute and manage their CVA according to different business models and/or accounting regimes (in particular FAS v. IAS/IFRS).

The US and European accounting standards (resp. US GAAP and IFRS) converge on the principle that the fair value of a derivative instrument must reflect the « non-performance risk », i.e. must be adjusted by Credit valuation Adjustments that affect the P&L.

However, those two regimes have a different approach to what is an appropriate CVA:

- In the **US accounting framework**, the practice is that banks take into account not only the risk of default of their counterparty but also their own counterparty risk (this is called a bilateral CVA or a DVA : Debt Valuation Adjustment). In addition, the concept of fair valuation is applied according to a strict interpretation resulting in a bilateral CVA that is computed based on market implied default probabilities and recovery rates (we speak about market-based CVAs).

Through this mechanism, the counterparty risk is transformed into a market risk: CVAs are marked-to-market; their variations generate a market risk that is monitored and managed by trading desks as a hybrid position. CVAs are managed under a “trading book” or “originate-to-distribute” business model.

- In the **European accounting framework**, the CVA calculation method reflects the various business models that prevail in Europe.

Some banks have, like US banks, market-based CVA that they manage dynamically in the context of their trading portfolio.

By contrast, a vast majority of the European commercial banks compute and manage their CVA under an « originate to warehouse » business model¹, i.e. by holding on their balance sheet the counterparty risk until maturity similarly to the way they hold the credit risk that is inherent to their loans portfolio.

In this case, instead of inferring the default probabilities and the recovery rates from the CDS market, those banks use their internal ratings and recovery rates as the best available estimate for the default risk of their counterparty (we speak about « rating-based CVAs »).

¹ Commonly called « banking book ».

Rating-based CVAs are more appropriate to the portfolio of numerous European commercial banks, whose « final » counterparties are usually Corporates with a local dimension and illiquid counterparty risk.

- Finally, hybrid approaches combining Rating-based and Market-based CVA can co-exist in the same bank.

3. CVA and Basel 3 : a statement that does not apply to all situations.

According to the Basel Committee, “roughly two-thirds of counterparty credit risk losses were due to CVA losses and only about one-third were due to actual defaults. The current framework addresses CCR as a default and credit migration risk, but does not fully account for market value losses short of default”. The Basel Committee proposes therefore to add to the existing capital charge for counterparty risk, a new capital charge to cover the losses due to CVA variations.

According to available data, it seems that a significant portion of those losses has been experienced by banks having an « originate to distribute » business model and was primarily due to CDS spread deterioration.

By contrast, the Basel Committee statement does not apply to commercial banks with an « originate to warehouse » business model: Those banks have not exhibit the same sensitivity to credit spread volatility since their CVA are computed based on less volatile « credit » parameters consistently with their managing intent (holding the counterparty risk linked to their commercial clients to maturity).

4. The Basel Committee proposal gives a major importance to the CDS markets.

The objective of a capital charge on CVAs is to cover unexpected losses due to CVAs volatility; the proposed method implies to compute a proxy of CVA sensitivities to market spread variations (or CDS spreads) and apply a market risk charge to capitalize those sensitivities. This method would apply in a uniform way to all banks regardless of the way CVAs are accounted for. As a consequence, it implies to force a computation of CVAs that is based on market spreads to derive the regulatory capital charge that aim to cover the CVAs volatility risk.

5. Setting a unique approach to CVAs can lead to perverse risks and consequences

a. Artificial volatility of P&L or capital requirements

We believe CVA are a best practice and the two methods to compute CVA are equally appropriate as they correspond to different situations, be it with regard to the business model or the nature of the counterparty.

The « market based CVA » that is based on CDS spreads is appropriate in some situations (eg for large international counterparties for which there is a deep and liquid CDS market and/or if the bank actively hedges the risk), whereas the « ratings based CVA », that is based on

internal credit assessment, is appropriate in other situations (eg for counterparties with a local dimension for which there is no CDS quotes or if the banks holds the risk on its balance sheet up to maturity).

The regulatory treatment should be neutral with respect to that: it should neither favor a business model compared to another nor assume that all counterparties « benefit » from a liquid CDS market.

In other terms, the capital charge must be consistent with the risk that it seeks to cover: if the CVAs are computed based on market spreads, it is consistent to compute the CVA capital charge using those same market spreads; if the CVAs are computed using internal ratings (historical default probabilities and recovery rates), then the CVA capital charge should be based on historical parameters and not on market parameters.

Should the Basel Committee proposals apply as such, a bank that compute rating-based CVAs that are not sensitive to market spread variations would be imposed a capital charge that is extremely sensitive to those variations.

The absence of consistency between the computation method of CVAs and the CVA capital charge would result in an artificial volatility:

- Either of capital requirements (if banks decide not to hedge those variations)
- Or of P&L (if banks decide to purchase protection via CDS to hedge the counterparty risk and smooth the volatility of the new capital charge, these derivatives positions will generate MtM movements that will affect the P&L).

One can also deem that imposing to banks using an « originate to warehouse » a capital charge on the CVA variations based on market spreads leads to capitalizing a risk of P&L volatility that they simply don't have.

b. Impact on the cost of funding of Corporates

The European Market Infrastructure Regulation EMIR (as well as the Dodd Franck Act) requires the mandatory central clearing of standard derivatives by end 2012. At this stage of the discussions, we understand that Central banks and Public Entities in charge of managing public debt would no be impacted by this regulation. We also understand that Corporates would be exempted under certain thresholds, as well as potentially some pension funds and/or financial institutions that have a very small activity on derivative instruments.

This exemption aims at avoiding imposing material operational and liquidity costs to entities that do not generate a systemic risk.

In addition, transactions that would not be eligible to compulsory clearing (non standardized derivatives) but that are executed by entities that have an obligation of clearing will have to be collateralized under conditions defined by the European Commission and the Regulators. Entities that would be exempted from the central clearing requirement would also be exempted from the collateral obligation.

As a consequence, entities that will be the most affected by these new capital requirements on CVA would be the « exempted » entities: mostly Corporates and

Sovereigns who, in general, do not clear their derivatives and do not collateralize them either.

By making their capital requirements sensitive to credit spreads variations, commercial banks will be incited – by a regulatory provision – to hedge themselves by simultaneously buying credit derivatives on the same counterparties.

Protection purchase, be it on single name CDS or on indices, will squeeze a market that is structurally less liquid than that of the large international financial institutions.

In addition, the use of CDSs to hedge the CVA volatility risk will lead to a higher correlation between the Corporates costs of funds and CDS levels, potentially creating systemic risk.

The benefit of the EMIR exemption for Corporates seems therefore seriously undermined by the capital charge on CVA if computed based on market spreads.

It will become extremely difficult for a Corporate to determine whether it is more economical to centrally clear its derivative transactions or to bear the correlated impact on its CDS level linked to the additional capital charge.

c. Questions-marks on the depth and quality of the information derived from the CDS market.

The Basel Committee proposed methodology relies on the assumption that the value of CDS is the ‘fair value » of the probability of default (and the loss given default). However, there is no such deep and liquid CDS market for most European Corporates, not to say no market at all for SMEs, Public entities such as local authorities or project finance entities, for which there is a real need in terms of hedging products.

This statement raises two questions:

- Do market spreads really reflect the probability of default and what is the part of the price that is in fact attributable to contagion effects, liquidity squeeze, volatility / over shooting with regard to the credit driven information?
- Which counterparties of high enough quality will be able to sell significant amounts of protection when all the commercial banks will be net buyers? How does the proposed rule articulate with the current thinking on shadow banking?

d. Unlevel playing field

The Basel Committee current provisions favor a business model while the ability of banks to adopt such model (actively managing their CVAs and capital charge on CVAs) would in any case be limited since the proportion of liquid names in the CDS market is by far lower in Europe than in US.

6. Proposal for a dual approach reflecting the risks taken under each business model

We believe the Basel Committee proposals must be reviewed to take into account the duality of approaches to CVAs that is clearly prevailing in Europe. This could be done in a very simple way that does not alter the Committee’s proposals but simply adjust them to generate a

capital charge that is consistent and commensurate with the risks born by banks that use rating-based CVAs¹.

More precisely and with a view of adopting a simple approach, we propose to use the standardized method proposed by the Basel Committee for both market-based CVAs and rating-based CVAs but with a different set of parameters depending on whether CVAs are computed based on ratings or based on market spreads.

For market-based CVA, the choice between the advanced method and the standardized method would be governed by the principles outlined in the Basel text: that it is to say that only banks having an IMM approval and a specific risk VaR model approval for bonds would be allowed to use the advanced method while all other banks would have to use the standardized method.

For rating-based CVA, only the standardized method shall be applied using rating-based parameters.

In the standardized method, the choice between market-based parameters and rating-based parameters should be governed by the business model under which the bank is computing and managing its CVA and the accounting approach to CVA as validated by external auditors. This is to avoid any regulatory arbitrage between a market-based and a rating-based capital charge on CVAs. As such, if and when a bank was unable to justify, accounting-wise, the use of rating-based CVAs under its business model, this bank would have to compute its capital charge on CVAs using the market-based CVA.

To that effect, we propose the following wordings:

Clarification of the scope for the advanced method (paragraph 98):

“98. Banks with IMM approval for counterparty credit risk and approval to use the market risk internal models approach for the specific interest-rate risk of bonds and monitoring their credit value adjustments as a market risk and computing them based on market spreads, must calculate this additional capital charge by modelling the impact of changes in the counterparties’ credit spreads on the CVAs of all OTC derivative counterparties, together with eligible CVA hedges according to new paragraphs 102 and 103, using the bank’s VaR model for bonds. This VaR model is restricted to changes in the counterparties’ credit spreads and does not model the sensitivity of CVA to changes in other market factors, such as changes in the value of the reference asset, commodity, currency or interest rate of a derivative. Regardless of the accounting valuation method a bank uses for determining CVA, the CVA capital charge calculation for each counterparty must be based on the following formula:”

Wording for the standard method (paragraph 104)

Under the standard method, market-based CVAs are subject to a standardized formula involving weights that have been calibrated by the Basel Committee based on market data.

¹ A fall-back approach based on a pure exemption of certain counterparties from the capital charge on CVA is presented in Annex 2

Rating-based CVAs under the standard method should be subject to the same standardized formula but involving weights that would be calibrated on historical data (for example Moody’s or S&P transition matrix over a stressed period).

We propose to modify the last sentence in paragraph 104 in the following way:

“The weights are given in this table. They are based on the external rating of the counterparty *and depend on the business model under which CVA are computed and managed. Market-based w_i shall apply when the credit institution monitor its CVAs as a market risk and compute them based on market spreads and rating-based weights w_i shall apply when the credit institution monitors its CVA as if it holds them until the maturity and computes them based on its historical default probabilities and recovery rates*

:

Rating	Market-based weight w_i	Rating-based weight w_i
AAA	0.7%	0.02%
AA	0.7%	0.02%
A	0.8%	0.1%
BBB	1.0%	0.3%
BB	2.0%	2%
B	3.0%	4.5%
CCC	18%	18%

The calibration methodology and the range of levels obtained over various calibration periods are presented in Annex I.

The Rating-based weights displayed in the table above correspond to the stressed period of 2000-2004 which experienced the worst migration probabilities over the last decade. For ratings below BB, the Rating-based weights are higher than the Market-based weights proposed by the RMMG. The European Supervisory Authorities and the Commission could consider the opportunity of capping those levels by the ones provided by the RMMG.

Finally, since the proposed alternative calibration is taking into account rating migrations, this approach captures the variability of the CVA in a way that is fully consistent with the business model of banks using rating-based CVA, as much as the VAR-based CVA charge is consistent with the business model of banks using market-based CVAs.

As a result this approach should also give right to the removal of the maturity adjustment in the IRB capital charge.

Annex 1

Proposed methodology to calibrate the Rating-based w_i used in the standardized formula

Knowing that the proposed shocks for the "trading book" approach are

- a one year time horizon market spread shocks during the stressed period
- 99% percentile level which is obtained by multiplication of the standard deviation by 2.33

We propose to calibrate historical PD deviation

- using a one year time horizon migration matrix (here S&P). It is transformed computing migration probabilities excluding defaults for which there is already a regulatory capital requirement through the Basle II credit counterparty risk capital charge.
- we determined for each rating the worst rating level which could be attained leaving apart 1% of cases (yellow cells in the matrix). So the "worst" PD deviation is the new PD level minus the original one.
- as this number is already a 99% percentile we divide it by 2.33 to keep this coefficient unchanged in the standard formula.
- Lastly we propose to apply the standard IRBF LGD level of 45% to obtain expected loss deviations for a one year time horizon at a centile of 99%

Results of calibration on different historical periods are given in following table:

rating	historical period			
	1990-2009	2000-2009	2000-2004	2007-2009
AAA	0.00%	0.02%	0.00%	0.00%
AA+	0.00%	0.01%	0.05%	0.00%
AA	0.00%	0.02%	0.02%	0.01%
AA-	0.00%	0.01%	0.06%	0.00%
A+	0.01%	0.01%	0.02%	0.01%
A	0.02%	0.04%	0.10%	0.01%
A-	0.02%	0.04%	0.07%	0.01%
BBB+	0.02%	0.07%	0.34%	0.00%
BBB	0.13%	0.13%	0.29%	0.10%
BBB-	0.17%	0.25%	0.28%	0.17%
BB+	0.46%	0.63%	0.84%	0.75%
BB	1.00%	1.51%	2.13%	1.81%
BB-	1.70%	1.89%	3.08%	1.80%
B+	3.13%	3.98%	4.81%	4.34%
B	3.24%	4.29%	4.48%	5.36%
B-	2.48%	3.45%	3.21%	4.58%

Our proposal is to retain rounded numbers by notch

Rating	Market-based weight w_i	Rating-based weight w_i
AAA	0.7%	0.02%
AA	0.7%	0.02%
A	0.8%	0.10%
BBB	1.0%	0.30%
BB	2.0%	2.00%
B	3.0%	4.50%
CCC	18%	18.00%

Technical information

Using an average S&P transition matrix

rating	Average transition matrix on 1990-2009 period																	
	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-	CCC	D
AAA	90.4%	4.1%	2.7%	1.9%	0.2%	0.3%	0.4%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
AA+	0.9%	81.6%	10.6%	4.0%	0.9%	0.9%	0.5%	0.4%	0.1%	0.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
AA	0.2%	1.1%	84.4%	9.0%	2.7%	1.4%	0.5%	0.5%	0.2%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
AA-	0.0%	0.1%	1.7%	81.6%	11.8%	3.1%	1.0%	0.1%	0.3%	0.1%	0.0%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
A+	0.0%	0.1%	0.2%	2.1%	80.9%	12.1%	3.0%	0.7%	0.5%	0.1%	0.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%
A	0.1%	0.0%	0.0%	0.1%	3.5%	83.6%	8.4%	2.5%	1.1%	0.3%	0.2%	0.1%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%
A-	0.0%	0.0%	0.1%	0.0%	0.5%	5.7%	79.5%	9.7%	3.4%	0.5%	0.2%	0.1%	0.1%	0.0%	0.0%	0.0%	0.1%	0.0%
BBB+	0.0%	0.0%	0.0%	0.0%	0.1%	0.8%	5.8%	79.6%	10.3%	1.8%	0.4%	0.3%	0.2%	0.2%	0.1%	0.0%	0.0%	0.2%
BBB	0.0%	0.0%	0.1%	0.0%	0.1%	0.4%	1.4%	6.8%	80.8%	6.9%	1.6%	0.8%	0.5%	0.3%	0.1%	0.0%	0.1%	0.1%
BBB-	0.1%	0.0%	0.0%	0.0%	0.0%	0.2%	0.3%	1.2%	9.3%	77.7%	5.8%	3.1%	1.3%	0.4%	0.3%	0.1%	0.1%	0.2%
BB+	0.2%	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%	0.9%	2.6%	13.0%	67.9%	8.6%	4.0%	1.3%	0.8%	0.1%	0.2%	0.3%
BB	0.0%	0.0%	0.0%	0.0%	0.1%	0.0%	0.0%	0.4%	0.8%	3.1%	8.5%	72.2%	9.2%	3.0%	1.2%	0.5%	0.4%	0.8%
BB-	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.4%	0.6%	2.3%	8.9%	72.7%	9.3%	2.8%	1.0%	0.7%	1.1%
B+	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.0%	0.1%	0.2%	0.1%	0.4%	2.0%	7.6%	74.3%	8.2%	2.5%	2.0%	2.4%
B	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%	0.0%	0.1%	0.6%	1.9%	10.2%	67.5%	7.2%	5.7%	6.4%
B-	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%	0.1%	0.0%	0.2%	0.6%	0.7%	4.8%	9.0%	60.6%	12.0%	11.6%
CCC/C	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.4%	0.3%	0.2%	0.0%	0.0%	0.7%	1.0%	1.9%	3.7%	9.7%	56.7%	25.4%

We compute cumulative migration probabilities excluding default event and the worst downgrading under the 1% probability.

rating	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-	CCC	Default
AAA	90.4%	94.5%	97.2%	99.1%	99.3%	99.6%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	0.00%
AA+	0.9%	82.5%	93.1%	97.1%	98.0%	98.9%	99.4%	99.8%	99.8%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	0.00%
AA	0.2%	1.2%	85.6%	94.6%	97.3%	98.7%	99.2%	99.7%	99.9%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	0.00%
AA-	0.0%	0.1%	1.8%	83.4%	95.2%	98.3%	99.3%	99.4%	99.7%	99.9%	99.9%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	0.00%
A+	0.0%	0.1%	0.3%	2.4%	83.3%	95.5%	98.5%	99.2%	99.7%	99.9%	99.9%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	0.07%
A	0.1%	0.1%	0.1%	0.3%	3.8%	87.3%	95.7%	98.2%	99.2%	99.5%	99.7%	99.8%	99.9%	100.0%	100.0%	100.0%	100.0%	0.01%
A-	0.0%	0.0%	0.1%	0.1%	0.6%	6.3%	85.8%	95.5%	99.0%	99.6%	99.7%	99.8%	99.9%	99.9%	99.9%	99.9%	100.0%	0.02%
BBB+	0.0%	0.0%	0.1%	0.1%	0.2%	1.0%	6.8%	86.5%	96.9%	98.7%	99.2%	99.5%	99.7%	99.9%	99.9%	99.9%	100.0%	0.15%
BBB	0.0%	0.0%	0.1%	0.1%	0.2%	0.6%	2.0%	8.7%	89.6%	96.6%	98.2%	99.0%	99.5%	99.8%	99.9%	99.9%	100.0%	0.12%
BBB-	0.1%	0.1%	0.1%	0.1%	0.1%	0.3%	0.6%	1.8%	11.1%	89.0%	94.8%	97.9%	99.2%	99.6%	99.8%	99.9%	100.0%	0.22%
BB+	0.2%	0.2%	0.2%	0.2%	0.2%	0.3%	0.4%	1.3%	3.9%	16.9%	85.0%	93.6%	97.7%	98.9%	99.7%	99.8%	100.0%	0.30%
BB	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.4%	1.2%	4.3%	12.9%	85.7%	94.9%	97.9%	99.1%	99.6%	100.0%	0.77%
BB-	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%	0.6%	1.2%	3.5%	12.6%	86.1%	95.5%	98.3%	99.3%	100.0%	1.13%
B+	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.2%	0.4%	0.5%	0.9%	3.0%	10.8%	86.9%	95.4%	98.0%	100.0%	2.40%
B	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.3%	0.4%	0.5%	1.2%	3.2%	14.1%	86.2%	93.9%	100.0%	6.38%
B-	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.3%	0.5%	0.5%	0.7%	1.4%	2.2%	7.7%	17.9%	86.4%	100.0%	11.56%
CCC/C	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.5%	0.9%	1.1%	1.2%	1.2%	2.1%	3.4%	6.0%	11.0%	23.9%	100.0%	25.42%

For example a counterpart rated BBB has less than 1% chance to be downgraded more than BB. So its PD during this historical period would increase for 12bp to 77bp, that is a 65bp shock.

Translation in term of w_t is done using the following definitions:

$$CVA_t = LGD_t * FD_t * M_t * EAD_t$$

It's deviation could be written

$$\Delta^{BBB} CVA_t = LGD_t * \Delta^{BBB} FD_t * M_t * EAD_t *$$

As the Basle III standardized formula states that

$$\Delta^{BBB} CVA_t = 2.33 * w_t * M_t * EAD_t$$

Calibration for the proposed rating based weighting will be given by

$$w_t = \frac{LGD_t * \Delta^{BBB} PD_t}{2.33}$$

In our example the 65bp would give a 13bp = 45% * 65 / 2.33 weight in standardized formula.

Annex II
Fall-back approach
Exempting certain counterparties from the capital charge on CVA

In Pittsburgh, the G20 stated that “All standardized OTC derivative contracts should be (...) cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.”

Both Europe and the US deemed that corporate and other entities which did not raise systemic risk and used derivatives for legitimate hedging purposes should be exempted from the central clearing requirement. The rationale for such a decision was that central clearing would generate material operational, legal and liquidity costs that were not justified with regard to the situation of these entities.

Accordingly, whereas all the entities subject to the central clearing requirement are subject to additional measures¹ when their OTC derivatives transactions cannot not be cleared², the exempted entities are not subject to these additional requirements, for the same rationale.

It is therefore understood that whereas additional capital requirement on CVA make sense on the large active counterparties, major swap participants and swap dealers, they should not apply to the “exempted entities”. Otherwise, these entities would be driven either to central clear or to post collateral in order to mitigate the CVA capital charge indirect effects.

A consistent regime would be to

- fully exempt transactions with the Members of the European System of Central Banks and other national bodies performing similar functions and other public bodies charged with or intervening in the management of the public debt; multilateral development banks, as listed under Section 4.2 of Part 1 of Annex VI to Directive 2006/48/EC, the Bank for International Settlements.
- exempt non financial counterparties who remain under the clearing thresholds, ie whose derivatives positions, net of derivative contracts that are objectively measurable as reducing risks directly related to the commercial activity of that non financial counterparty.

An alternative solution would be to only exempt transactions done with SMEs; this approach would create thresholds effects that would not be linked to the derivatives activity of a firm but to its economic size. Whereas this solution is undoubtedly simpler to push forward, it raises many concerns if the rating based approach is not adopted. The main drawback is a fundamental change in the relationship between banks and large corporate, whereby banks would be pushed to hedge their CVA risk, i.e. transfer the counterparty risk to the markets, whereas European Corporates expect a long term / financing type relationship with their banks.

¹ timely confirmation, portfolio reconciliation and process to addressing disputes, collateralisation, segregation of initial margins and capital requirements.

² Non eligible derivatives.