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French Banking Federation Comments to BCBS d325 Consultative Document on review of the CVA risk framework

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

The French Banking Federation welcomes the opportunity to comment on the BCBS consultative document relative to review of the CVA risk framework.

We acknowledge the proposed framework addresses a number of shortcomings in the current CVA charge notably through the recognition of CVA market hedges as risk mitigants, the recognition of proxy credit spread hedges and more consistent capital charges under FRTB-CVA in line with the revised market risk framework. However we would like to express our concern with respect to two specific outstanding issues that in our view jeopardize the soundness of the revised framework:

1. We believe that capitalizing a hypothetical regulatory CVA distinct from the true accounting CVA distorts the essential link between economic risk and capital. We acknowledge that there is a need for more uniform and prudent CVA practices. However, we think that the Prudent Valuation is a more suitable framework to impose high quality standards on accounting CVA than the CVA risk charge.
2. The Basic approach “BA-CVA” should be appropriately calibrated, as risk weights are too conservative and not risk-sensitive enough. In particular, they don’t appropriately reflect the creditworthiness of counterparties.

We feel that subject to above-mentioned amendments, the objective of building a comprehensive CVA charge framework would be fulfilled.

I. Definition of Regulatory CVA (Accounting CVA VS Regulatory CVA)

Aligning regulatory CVA (for CVA capital charge) with accounting CVA is a prerequisite to build a sound and consistent capital framework. CVA capital charge was introduced in the Basel III framework as an answer from regulators to large accounting CVA losses banks experienced during the 2008 crisis¹: **the economic risk that needs to be capitalized arises from accounting CVA variability**. Capitalizing anything else than true accounting CVA would distort the essential link between the risk truly incurred and capital, leaving banks with a cornelian choice : either hedge true economic risk stemming from accounting CVA or hedge the CVA capital charge. This would not give the right incentive as hedging economic risk would not be appropriately reflected in own funds requirement. In addition, aligning regulatory CVA and accounting CVA would have the merit of further increasing the consistency of the overall market risk framework, narrowing the gap between the revised CVA framework and the market risk framework (FRTB), where risk sensitivities merely hinge on the actual accounting fair value of those financial instruments that are in the trading book. **As a result we strongly recommend that regulatory CVA exactly matches true accounting CVA, irrespective of discrepancies in practices that may exist across industry.**

We note that since 2010 accounting standard setters have worked hands-in-hands to refine the concept of fair-value, which has only been recently implemented (in 2014) via IFRS 13 and ASC 820 (formerly FAS 157), both converging to the same concept of “exit price”, market-based measurement, not an entity-specific measurement. Despite this converging trend, we acknowledge that accounting CVA practices across industry are not fully uniform and recognize it is legitimate to define a minimum set of standards to ensure practices are harmonized and robust enough across banks.

In that respect, we do believe the Basel Committee has already suitable tools at his disposal to achieve a harmonized and sustainable definition of CVA, notably through the Prudent Value guidance². Concretely, we acknowledge the need for the Basel Committee to define a set of minimum requirements, a so-called prudent CVA should meet along the principles enclosed in paragraphs §13 to §24 of the consultative document. Any shortcomings of accounting CVA to the prudent CVA should come in deduction of own funds but should not serve as the metric to define banks risk sensitivities. The aforementioned direct impact in own funds would indeed help ensure the safety of the industry at or above a certain confidence level and/or in a period of stress. Such an approach has the virtue of allowing the Committee to set appropriate standards and incentivize adoption of best practices for CVA while preserving the indispensable link between economic risk (accounting CVA) and capital. It would also avoid distortions to banks' accounting CVA hedging behaviour that might result from a regulatory CVA framework that deviates from true accounting CVA. Another virtue of this approach is that future evolution in accounting standards would not jeopardize the soundness of the framework as the link between economic risk and capital would not be broken.

¹ BCBS 189 par. 14(b) refers to "*potential **mark-to-market** losses [...] associated with a deterioration in the creditworthiness of a counterparty*".

² BCBS 128, par. 690 and subsequent.

Definition of prudent CVA

The industry is committed to supporting the BCBS to design a comprehensive framework for prudent CVA but is concerned that time constraints could jeopardize the building of a sound and consistent framework. In that respect, we acknowledge that requirements enclosed in paragraphs §13 to §24 of the consultative document constitute a good starting point for the minimum standards to apply to a prudent CVA that would serve as reference under the Prudent Value framework mentioned above. However, we think that some requirements deserve adjustments. We list hereafter outstanding issues with respect to current requirements:

- **Model parameters.** We acknowledge there is a broad-based adoption of market-implied parameters in accounting CVA including PDs, recovery rates and diffusion parameters. We appreciate the Basel Committee's move regarding the definition of market-implied LGD in paragraph 13. It introduces the possibility to recognise different recovery rates for senior exposures, which is closer to the structure of the market. In that spirit, we recommend that the Basel Committee goes further by clarifying that banks should also be able to use different recovery rates for certain specific type of exposures, e.g. because they are secured (such as covered bonds or project finance vehicles) or because their nature does not permit the reliance on the credit market (whether CDS or bonds) as the best proxy to mark the CVA. Indeed, empirical observations show that the credit market is not reliable for those counterparties, for technical and/or political reasons, due to their absolute nature (e.g. sovereigns or supra), in particular when they get closer to default.
- **SFTs.** Securities Financing Transactions and other forms of collateralized borrowing should not be incorporated in the CVA regulatory framework. These instruments are not captured in true accounting CVA. The credit valuation component of SFTs is embedded in the valuation base, much like a traded bond. Moreover, CVA is principally meaningful for longer term exposures whereas the vast majority of SFTs mature in (90) days or earlier.

II. Issues raised by the proposed Basic Approach

Firstly we consider that **the risk weights are too conservative** and their implementation by credit institutions applying the basic approach would result in a significant increase of own funds requirements and detrimental additional costs for derivatives' end users.

This concern had already been expressed at the time BCBS was designing the current CVA risk framework implemented in the EU through the Capital Requirement Regulation. However, in the aftermath of the 2008 financial crisis, BCBS initiative was seen as a relevant move forward in terms of prudential regulation. But in the course of this review, we don't see the rationale for increasing the capital charge in relation to CVA risk exposures.

In its CVA report of February 2015, the EBA underlined that *“the calibration of the CVA risk charge would be reviewed so as to effectively reflect actual CVA risk and ensure that the appropriate, conservative capture of CVA risks does not generate unintended market distortions or wrong incentives for institutions.”* A very conservative calibration of the CVA risk charge, as observed in the QIS, could generate a significant increase in trading costs charged to clients (notably corporates), with a risk that clients stop hedging their commercial/financial risks using derivatives. This situation is likely to raise systemic risk.

Secondly we think the definition of risk buckets under the Basic Approach lacks granularity. As a matter of fact, the granularity in the Basic Approach has decreased compared to the current standardised CVA making the contemplated approach less risk sensitive. If the Committee decides to move forward with this approach, we would like to draw its attention on the need to match business sectors with commonly used classifications. For instance, according to the Industry Classification Benchmark (ICB):

- Mining activities are included in the Basic Materials Industry ;
- Oil & Gas activities constitute a specific industry and are not mentioned in the table.

In any case, French banks would appreciate that a broad, uniform and worldwide definition and sectorial classification be chosen.