

EBA/CP/2016/04

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## Consultation Paper

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Draft Regulatory Technical Standards

for determining proxy spread and limited smaller portfolios for  
credit valuation adjustment under Article 383(7) of Regulation (EU)  
No 575/2013 (the Capital Requirements Regulation — CRR)

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# 1. Responding to this consultation

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The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

## Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 06.07.2016. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

## Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

## Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EC) N° 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the EBA in its implementing rules adopted by its Management Board. Further information on data protection can be found under the Legal notice section of the EBA website.

## 2. Executive Summary

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The EBA published on 20 December 2013 the RTS on CVA risk for the determination of a proxy spread and the specification of a limited number of smaller portfolios under Article 383(7) of Regulation (EU) No 575/2013 ('Capital Requirements Regulation' – CRR).

In the CVA report published on 25 February 2015, the EBA re-assessed the relevance of the RTS provisions, in particular based on a CVA data collection exercise involving 32 banks from 11 jurisdictions. The CVA report showed persistent difficulties for determining appropriate proxy spreads and  $LGD_{MKT}$  for a large number of counterparties.

Policy recommendations 7 and 8 of the CVA report concluded that the RTS should be amended to address the difficulties associated with the determination of proxy spreads for large numbers of counterparties, for which spreads may never be observed on markets, as well as issues linked with  $LGD_{MKT}$ .

Therefore, the present amending RTS propose limited amendments to Delegated Regulation (EU) No 526/2014 that aim at addressing those issues by further specifying cases where alternative approaches can be used for the purposes of identifying an appropriate proxy spread and  $LGD_{MKT}$ .

The proposed amendments are expected to lead to a more adequate calculation of own funds requirements for CVA risk and, in several cases, a reduction of own funds requirements for CVA risk, thus partially remedying the over-estimation of current own funds requirements for counterparties in the scope of the CVA risk charge in the EU.

As part of the consultation, institutions are also invited to comment on whether other amendments may be needed. Only amendments to Delegated Regulation (EU) No 526/2014, which fall within the scope of the mandate of Article 383(7), should be considered, as amendments to other provisions of the CVA risk framework (i.e. Articles 381 to 386) would require the Commission to adopt the delegated act foreseen in Article 456(2), with the specific case of exemptions of Article 382(4), which can be addressed via legislative amendments to the CRR only.

## 3. Background and rationale

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The EBA published on 20 December 2013<sup>1</sup> the RTS on CVA risk for the determination of a proxy spread and the specification of a limited number of smaller portfolios under Article 383(7) of Regulation (EU) No 575/2013 ('Capital Requirements Regulation' – CRR). The final RTS were published in the Official Journal of the EU on 20 May 2014<sup>2</sup>.

Article 456(2) of the CRR mandates the EBA to monitor the own funds requirements for CVA risk and submit a report to the Commission, assessing in particular the calculation of capital requirements of CVA risk. The EBA published the Report on CVA on 25 February 2015<sup>3</sup>.

Policy recommendations 7 and 8 of the CVA report recommend addressing difficulties associated with the determination of proxy spreads for large numbers of counterparties, for which spreads may never be observed on markets, as well as issues linked LGD<sub>MKT</sub>.

In addition, since the draft CP Guidelines on the treatment of CVA risk under SREP institutions under the advanced approach allow for the application of PR7 and PR8 for the purposes of the Pillar 2 approach, the amendment of the RTS on proxy spread is intended to reduce discrepancy between Pillar 1 and Pillar 2 CVA calculations.

### CVA report

As showed by the CVA report, the proxy spread methodology applies to the vast majority of counterparties subject to the advanced method: it generally concerns more than 75% of counterparties (Figure 28 p.69). This is an intrinsic feature of the prudential CVA risk charge – stemming from the accounting CVA -, which relies on a majority of proxies for the computation of own funds requirements.

Delegated Regulation (EU) No 526/2014 provides for a general approach for determining a proxy spread by considering the broad categories of rating, industry and region. It already allows for some flexibility to determine the most appropriate proxy spread based on institutions' expert judgment. However, despite efforts to increase the liquidity of the CDS market, including standardisation of CDS contracts, the liquidity and depth of the CDS market, which are a prerequisite to the well-functioning of both accounting and regulatory CVA frameworks, remain a concern.

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<sup>1</sup> <http://www.eba.europa.eu/documents/10180/535344/EBA-RTS-2013-17+%28Final+draft+RTS+on+CVA%29.pdf/f9c9da5d-0ef6-4ffd-8abb-c94775690121>

<sup>2</sup> [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:JOL\\_2014\\_148\\_R\\_0005](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:JOL_2014_148_R_0005)

<sup>3</sup> <http://www.eba.europa.eu/-/the-eba-advises-the-european-commission-on-credit-valuation-adjustment-cva-risk>

In this context, the CVA report recommends allowing for additional flexibility to further alleviate difficulties associated with the determination of proxy spreads for large numbers of counterparties, as well as issues linked  $LGD_{MKT}$ .

### Policy recommendation 7 - Proxy spread

- 'The current proxy spread methodology relies on credit spread data from peers of the counterparty for which a proxy spread has to be generated (considering the attributes of rating, region and industry). Acknowledging some limits of such methodology, the EBA recommends allowing institutions to use alternative approaches based on a more fundamental analysis of credit risk to proxy the spread of those counterparties for which no time series of credit spreads are available, nor for any of their peers, due to their very nature.
- The EBA recommends that institutions justify and document all the instances where proxy spreads are based on an alternative approach other than using the three attributes of rating, region and industry. The use of alternative approaches shall also be justified by the use of similar approaches to proxy the spreads of the same counterparty for accounting CVA purposes. The EBA should monitor the range of practices in this area and could issue guidelines on such practices.
- In addition, the EBA recommends extending the possibility of use of single name proxy spreads to the case of a parent and a subsidiary, which share at least either the same industry or the same region.'

### Policy recommendation 8 - $LGD_{MKT}$

- 'The EBA recommends amending the Regulatory formula for the Advanced method in order to allow institutions to reflect the seniority of the netting set in  $LGD_{MKT}^*$ .
- The EBA recommends that institutions justify and document all the instances when  $LGD_{MKT}^*$  differs from  $LGD_{MKT}$  or when  $LGD_{MKT}^*$  is based on an alternative approach where no CDS are available as proposed under policy recommendation 7.'

## Amendments to RTS on proxy spread

### Use of alternative credit quality assessments

According to the current approach, after considering the rating, industry and region of the counterparty, institutions assign a proxy based on other counterparties' available credit spread data for combinations of rating, industry and region.

The CVA report acknowledges that, in some cases, the counterparty may have no peers at all with observed credit spread data, thus leading to a proxy spread that is entirely assigned based on credit spread data of counterparties that may have in practice very different business activities.

The CVA report recommends allowing, in this case, for the possibility to consider the 'rating attribute' more specifically, including via an assessment of the credit quality of the counterparty (and its peers) not only linked to external or internal ratings.

The language of the CVA report has been incorporated in the revised Basel framework (CP version 1<sup>st</sup> July 2015):

*25. A bank should estimate the credit spread curves of illiquid counterparties from credit spreads observed in the markets of its liquid peers via an algorithm that discriminates on at least three variables: a measure of credit quality (e.g. rating), industry, and region.*

*27. When no time series of credit spreads is observed in the markets of any of the counterparty's peers due to its very nature (e.g. project finance, funds), a bank is allowed to use a more fundamental analysis of credit risk to proxy the spread of an illiquid counterparty. However, where historical PDs are used as part of this assessment, the resulting spread cannot be based on historical PD only – it must relate to credit markets.*

The proposed amendment in Article 1(1)(b) allows institutions, when considering the attribute of rating, to consider, in addition to external or internal ratings, alternative credit quality assessments, where relevant.

An explanatory box for consultation is included in order to receive additional information on the specific cases or types of counterparties, for which this provision would be particularly adequate. Based on the information received after consultation, as well as its level of detail, the EBA may assess that the flexibility allowed by the current RTS is sufficient and reconsider whether to keep or remove this amendment.

### Use of the spread of the parent company for the subsidiary

The spread of the parent company may be in many cases the most appropriate proxy spread for the subsidiary, in particular compared to a proxy spread obtained based on an average of credit spreads of counterparties that share fewer features with the subsidiary than the parent company. Previous versions of the EBA RTS on proxy spread already included this possibility (in particular second CP RTS).

The proposed amendment in Article 1(3) allows institutions, when considering the attributes of rating, industry and region of the counterparty, to assign as proxy spread for a subsidiary the spread of the parent, when this is more appropriate, provided that the parent and subsidiary share either the same industry or region attribute.

The revised Basel framework (CP version 1<sup>st</sup> July 2015) also includes the possibility in certain cases of 'mapping an illiquid counterparty to a single liquid reference name'.

### LGD<sub>MKT</sub>

Whereas Article 2(1) of the RTS recognises that an institution should generally use for LGD<sub>MKT</sub> a value for LGD<sub>MKT</sub> that is consistent with the fixed LGD commonly used by market participants for determining implied PDs from observed credit spreads (market convention of 60% for senior unsecured debt), a new Article 2(2) allows, where an institution is able to demonstrate that the seniority of its transactions with a counterparty differs from the seniority of senior unsecured bonds (i.e. the one reflected in the market convention), that the institution reflects this difference in seniority in the first LGD<sub>MKT</sub> term of the formula provided for in Article 383(1) third subparagraph.



The proposed amendment acknowledges the fact that the first term  $LGD_{MKT}$  in the regulatory formula reflects the recovery term of the general CVA definition, whereas the other  $LGD_{MKT}$  parameters appearing in the denominators of the exponential terms correspond to the standard market recovery used to imply probabilities of default.

As it may be easier in terms of legal drafting to allow for an adjustment of all  $LGD_{MKT}$  terms of the regulatory formula, rather than an adjustment of 'the first occurrence of  $LGD_{MKT}$ ' only, although this would be less justified from a theoretical point of view, two options are presented for consultation.

The language in Article 2(1), which is based on a Basel FAQ<sup>4</sup>, is also now reflected in the revised Basel framework (CP version 1<sup>st</sup> July 2015):

*The market-implied ELGD value used for regulatory CVA calculation must be the same as the one used to calculate the risk-neutral PD from credit spreads unless it can be demonstrated that the seniority of the derivative exposure differs from the seniority of senior unsecured bonds.*

### Other amendments

As part of the consultation, institutions are invited to comment on whether other amendments may be needed.

Only amendments to Delegated Regulation (EU) No 526/2014, which fall within the scope of the EBA mandate of Article 383(7) of the CRR should be proposed, as amendments to other provisions of the CVA risk framework (i.e. Articles 381 to 386 of the CRR) require the Commission to adopt the delegated act foreseen in Article 456(2), except for the specific case of exemptions of Article 382(4), where legislative amendments to the CRR are needed.

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<sup>4</sup> 'In cases where a netting set of derivatives has a different seniority than those derivative instruments that trade in the market from which  $LGD_{MKT}$  is inferred, a bank may adjust  $LGD_{MKT}$  to reflect this difference in seniority'

## 4. Draft regulatory technical standards

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In between the text of the draft RTS/ITS/Guidelines/advice that follows, further explanations on specific aspects of the proposed text are occasionally provided, which either offer examples or provide the rationale behind a provision, or set out specific questions for the consultation process. Where this is the case, this explanatory text appears in a framed text box.

**COMMISSION DELEGATED REGULATION (EU) No .../..****of XXX****[...]****amending Delegated Regulation (EU) No 526/2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for determining proxy spread and limited smaller portfolios for CVA risk****(Text with EEA relevance)**

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 575/2013 of 26 June 2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012<sup>5</sup>, and in particular the third subparagraph of Article 383(7) thereof,

Whereas:

- (1) Commission Delegated Regulation (EU) No 526/2014 sets the criteria for determining a proxy spread and for identifying  $LGD_{MKT}$  for Credit Valuation Adjustment (CVA) risk referred to in Article 383(1) of Regulation (EU) No 575/2013. In the course of the application of that Regulation it has been observed that difficulties persist for determining appropriate proxy spreads and  $LGD_{MKT}$  for a large number of counterparties, for which spreads may never be observed in the markets. Further, certain issues have been observed that require improved consistency with how proxy spreads are determined for accounting purposes. These issues were also raised in an Opinion on CVA<sup>6</sup>, which the European Banking Authority (EBA) delivered jointly with its report referred to in Article 456(2) of Regulation (EU) No 575/2013. Therefore, rules for determining a proxy spread and identifying  $LGD_{MKT}$  for CVA risk should be revised to further alleviate the above-mentioned difficulties associated with the determination of proxy spreads.
- (2) More in particular, there are groups of counterparties sharing fundamental characteristics, none of which has sufficient observable time series of credit spreads available. In those cases, applying Article 1(1)(b) of Commission Delegated Regulation (EU) No 526/2014 would result in the assignment of those counterparties to incoherent rating categories, whereas alternative credit quality assessments could deliver more appropriate proxy spreads. Therefore, it should be possible to allow institutions to use, when considering the attribute of rating, such alternative credit quality assessments for the purposes of assigning proxy spreads to those counterparties.
- (3) Furthermore, when considering the attributes of rating, industry and region, where a proxy spread is to be determined for a subsidiary of a parent company, for which a credit spread is available, that credit spread may be the most appropriate proxy spread for the subsidiary, in

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<sup>5</sup> OJ...<sup>6</sup> EBA/Op/2015/02

particular compared to a proxy spread obtained based on credit spreads of counterparties that share fewer features with the subsidiary than the parent. Therefore, where a parent and a subsidiary are sufficiently homogenous having regard to the criteria of industry and region, it should be possible to allow for the determination of an appropriate proxy spread on the basis of the credit spread of the parent or the subsidiary.

- (4) Whereas an institution should use for  $LGD_{MKT}$  that appears at the denominators of the formulae referred to in Article 383(2) a value for  $LGD_{MKT}$  that is consistent with the fixed LGD commonly used by market participants for determining implied PDs from observed credit spreads, it should be possible, where an institution is able to demonstrate that the seniority of its transactions with a counterparty differs from the seniority of senior unsecured bonds reflected in the market convention, to allow that institution to reflect this difference in seniority by adjusting the value of the first occurrence of  $LGD_{MKT}$  that appears in the formula provided for in Article 383(1) third subparagraph.
- (5) This Regulation is based on the draft regulatory technical standards submitted by the European Supervisory Authority (European Banking Authority) (EBA) to the Commission.
- (6) EBA has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the opinion of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010<sup>7</sup>.
- (7) Delegated Regulation (EU) No 526/2014 should therefore be amended accordingly,

HAS ADOPTED THIS REGULATION:

### *Article 1*

#### **Amendments to Delegated Regulation (EU) No 526/2014**

Delegated Regulation (EU) No 526/2014 is amended as follows:

1. In Article 1 paragraph 1, point (b) is replaced by the following:

‘(b) the attribute of rating has been determined by considering the credit quality of the counterparty in either of the following ways:

- (i) based on the use of internal and external ratings, where ratings shall be mapped to credit quality steps, as referred to in Article 384(2) of Regulation (EU) No 575/2013. In cases where multiple external ratings are available their mapping to credit quality steps shall follow the approach for multiple credit assessments set out in Article 138 of that Regulation;
- (ii) based on analyses of credit risk, other than internal and external rating, where this is more relevant, in particular where insufficient or no time series of credit spreads are observed for any of the counterparties sharing fundamental characteristics with the concerned counterparty, and on the condition that the institution uses similar approaches to proxy the

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<sup>7</sup> Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

spread of the counterparty for the computation of the credit valuation adjustments included in the measurement of the fair value of derivative instruments in accordance with the applicable accounting framework.

### **Explanatory text for consultation purposes**

This amendment is intended to implement policy recommendation 7 of the CVA report on proxy spread.

According to the current approach, after considering the rating, industry and region of the counterparty, institutions assign a proxy based on other counterparties' available credit spread data for combinations of rating, industry and region.

The CVA report acknowledges that, in some cases, the counterparty may have no peers at all with observed credit spread data, thus leading to a proxy spread that is entirely assigned based on credit spread data – and the rating - of counterparties that may have business activities that are in practice very different from the concerned counterparty.

Therefore, the CVA report recommends allowing, in that case, for the possibility to consider the 'rating attribute' more specifically, including via an assessment of the credit quality of the counterparty (and its peers) not only linked to external or internal ratings. The language of the CVA report has been incorporated in the revised Basel framework (CP version 1st July 2015).

The proposed amendment allows institutions, when considering the attribute of rating, to consider, in addition to external or internal ratings, alternative credit quality assessments, where this is more appropriate.

With a view to making a final decision on this proposal amendment, the EBA is requesting the industry to provide more information on the specific cases or types of counterparties that may be subject to this provision. Based on the information received after consultation, as well as its level of detail, the EBA may assess that the flexibility allowed by the current RTS is sufficient and reconsider whether to keep or remove this amendment.

**Question 1:** Do stakeholders agree with the amendment?

**Question 2:** Could stakeholders elaborate on the type of alternative credit quality assessments to be performed and on the precise cases or type of counterparties, for which such alternative credit quality assessments would be absolutely necessary, in particular, where relevant, with reference to accounting CVA treatment?

2. In Article 1, a new paragraph 2a is inserted:

'2a. In the process of considering the attributes of rating, industry and region of the counterparty in accordance with paragraph 1, the estimation of the proxy spread shall be deemed appropriate for a subsidiary based on the credit spread of the parent undertaking, where at least one of the attributes of industry or region of the subsidiary is equivalent to that of the parent undertaking, on the basis of the minimum categories defined in paragraph 1.'

### **Explanatory text for consultation purposes**

This amendment is intended to implement policy recommendation 7 of the CVA report on proxy spread.

It acknowledges the fact that, when considering the attributes of rating, industry and region of the counterparty, the spread of the parent company may show as the most appropriate proxy spread for the subsidiary. Previous versions of the EBA RTS on proxy spread already included this possibility (in particular second CP RTS). The revised Basel framework (CP version 1st July 2015) also includes the possibility in certain cases of ‘mapping an illiquid counterparty to a single liquid reference name’. Please note that the current Recital 4 of Delegated Regulation (EU) No 526/2014 already mentions the possibility of a proxy spread determined ‘on the basis of the credit spread of a single issuer, where this leads to a more appropriate estimation’, even though the particular case of regional and local authorities is the only one to be given as an example.

The proposed new Article 1(2a) allows institutions, when considering the attributes of rating, industry and region of the counterparty, to assign as proxy spread for a subsidiary the spread of the parent, when this is more appropriate, provided that the parent and subsidiary share either the same industry or region attribute.

The proposed wording implicitly assumes that rating can generally be considered equivalent. Alternative wordings could include an additional condition on the rating attribute:

- (a) the subsidiary and the parent undertaking have the same rating;
- (b) or there is no rating for the subsidiary.

**Question 3:** Do stakeholders agree with the amendment? Do stakeholders consider that an additional condition is necessary on rating?

3. Article 2, a new paragraph 2 is added:

#### **Option A:**

‘2. Where the seniority of the transactions with the counterparty differs from the seniority of senior unsecured bonds that is implied by the value of  $LGD_{MKT}$  referred to in paragraph 1, institutions may reflect this difference in seniority by adjusting the value of the first occurrence of  $LGD_{MKT}$  that appears in the formula provided for in Article 383(1) third subparagraph.’

#### **Option B:**

‘2. Where the seniority of the transactions with the counterparty differs from the seniority of senior unsecured bonds that is implied by the value of  $LGD_{MKT}$  referred to in paragraph 1, institutions may reflect this difference in seniority by adjusting the value of  $LGD_{MKT}$  that appears in the formula provided for in Article 383(1) third subparagraph.’

### **Explanatory text for consultation purposes**

This amendment is intended to implement policy recommendation 8 of the CVA report on proxy spread.

Article 2(1) of the RTS recognises that an institution should generally use for  $LGD_{MKT}$  a value for  $LGD_{MKT}$  that is consistent with the fixed LGD commonly used by market participants for determining implied PDs from observed credit spreads (market convention of 60% for senior unsecured debt).

The new Article 2(2) allows, where an institution is able to demonstrate that the seniority of its transactions with a counterparty differs from the seniority of senior unsecured bonds (i.e. the one reflected in the market convention), that the institution reflects this difference in seniority in the first  $LGD_{MKT}$  term of the formula provided for in Article 383(1) third subparagraph.

This language, which is based on a Basel FAQ, is also now reflected in the revised Basel framework (CP version 1st July 2015): *‘The market-implied ELGD value used for regulatory CVA calculation must be the same as the one used to calculate the risk-neutral PD from credit spreads unless it can be demonstrated that the seniority of the derivative exposure differs from the seniority of senior unsecured bonds.’*

As it may, however, be easier in terms of legal drafting to allow for an adjustment of all  $LGD_{MKT}$  terms of the regulatory formula, rather than an adjustment of ‘the first occurrence of  $LGD_{MKT}$ ’ only, although this would be less justified from a theoretical point of view, two options are presented for consultation and stakeholders’ views are sought.

**Question 4:** Do stakeholders agree with the possibility provided by the amendment to adjust the value of the  $LGD_{MKT}$  term of the regulatory formula?

**Question 5:** Could stakeholders elaborate on cases (types of counterparties, business activities) where this adjustment would have a particularly significant impact and on the rationale for performing the adjustment in such cases?

**Question 6:** What are stakeholders’ views on proposed Options A and B?

## *Article 2*

### **Entry into force**

This Regulation shall enter into force on the twentieth day following that of its publication in the Official Journal of the European Union.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

*For the Commission  
The President*

*[For the Commission  
On behalf of the President*

*[Position]*

**Explanatory text for consultation purposes**

**Question 7:** Do stakeholders consider that other amendments to the RTS would need to be performed as part of this revision? Please provide rationale.

Only amendments to Delegated Regulation (EU) No 526/2014, which fall within the scope of the mandate of Article 383(7), should be considered, as amendments to other provisions of the CVA risk framework (i.e. Articles 381 to 386) would require the Commission to adopt the delegated act foreseen in Article 456(2), with the specific case of exemptions of Article 382(4), which can be addressed via legislative amendments to the CRR only.

## 5. Accompanying documents

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### 5.1 Draft cost-benefit analysis / impact assessment

Article 383(7) of the CRR requires the EBA to develop regulatory technical standards (RTS) to specify how a proxy spread is to be determined by the institutions' approved internal model for the specific risk of debt instruments for the purposes of identifying parameters  $s_i$  and  $LGD_{MKT}$  as referred in Article 383(1) under the formula to calculate the own funds requirements for CVA risk for each counterparty. Accordingly the EBA published its technical standards (EBA/RTS/2013/17) on 20 December 2013. The Commission Delegated Regulation (EU) No 526/2014 of 12 March 2014 was published in the Official Journal of the European Union on 20 May 2014. Current draft RTS intend to amend Delegated Regulation (EU) No 526/2014 in line with the findings of the EBA's report on CVA published on 25 February 2015.

As per Article 10(1) of the EBA regulation (Regulation (EU) No 1093/2010 of the European Parliament and of the Council), any regulatory technical standards developed by the EBA – when submitted to the EU Commission for adoption – shall be accompanied by an Impact Assessment (IA) annex which analyses 'the potential related costs and benefits'. Such annex shall provide the reader with an overview of the findings as regards the problem identification, the options identified to remove the problems and their potential impacts.

#### A. Problem identification

According to Article 1(1b) of Delegated Regulation (EU) No 526/2014, one of the conditions for the appropriateness of the proxy spread is that the attribute of rating should be determined by considering the use of a predetermined hierarchy of sources of internal and external ratings. Therefore, the current regulatory framework does not account for cases where internal and external ratings may not provide, for some types of counterparties, the most appropriate credit quality analysis for CVA risk purposes. In other words, institutions may have counterparties, which have no peers at all with observed credit spread data, thus leading to a proxy spread that is entirely assigned based on the credit spread data - and the rating - of counterparties that may have in practice very different business activities.

Additionally, Recital 4 and Article 1(2) of Delegated Regulation (EU) No 526/2014 allow for single-name proxying, where a link, such as between a regional government or local authority and the sovereign, exists. However, single-name proxying may also be more appropriate in other cases, for example when assigning a proxy spread to a subsidiary of a parent company, for which spreads are observed in the markets.



Similarly, Article 2 of Delegated Regulation (EU) No 526/2014 recognises that an institution should use a value for  $LGD_{MKT}$  that is consistent with the fixed LGDs commonly used by market participants for determining implied PDs. However, the current regulatory framework does not address cases where the seniority of transactions with a counterparty may differ from the market convention (i.e. 60% for senior unsecured debt), thus requiring adjustment of the value of the first occurrence of  $LGD_{MKT}$  in the regulatory formula.

As a result, especially where those adjustments are performed for accounting CVA purposes, the methodology may not accurately reflect the CVA risk associated with these counterparties and hence under/over-estimate corresponding own funds requirements.

### B. Policy objectives

The main objective of the draft RTS is first to allow institutions using the advanced method for CVA risk to adjust their internal calculations to accommodate cases where the current regulatory framework may potentially lead to less accurate calculations of CVA risk, i.e. in relation to the identification of the parameters  $s_i$  and  $LGD_{MKT}$ , and secondly to ensure a more appropriate calculation of own funds requirements for CVA risk.

The amendment to the current regulatory framework is expected to give institutions more flexibility to adjust their CVA risk calculations given specific circumstances and therefore avoid potential under/over-estimation of the associated own funds requirements.

### C. Baseline scenario

The baseline section aims to show the magnitude of the current draft amending RTS. Data in COREP (as of December 2015<sup>8</sup>) show that approximately 37% of the CVA-related total exposure values are based on the advanced method. In the EU there are approximately 20 institutions in 10 Member States (as identified in COREP templates) using the advanced method for the calculation of own funds requirements for CVA risk.

The aggregate total assets and RWA of these institutions are approximately EUR 15,823 billion and EUR 5,779 billion, respectively. These figures correspond to 50% and 45% of the total EU/COREP sample.<sup>9</sup> The aggregate own funds requirements for these 20 institutions corresponding to CVA risk is just over EUR 7 billion (or 30% of the total own funds requirements associated with CVA risk).

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<sup>8</sup> Due to data unavailability September 2015 figures have been used for two institutions.

<sup>9</sup> COREP database includes 178 institutions that submitted complete data for the CVA template and FINREP database for the total assets figures has 146 institutions. Therefore, the assets share of institutions using the advanced method is overestimated.



Also, country-level analysis shows that given the number of institutions using the advanced method, the current draft regulation is expected to have the greatest impact on the relevant institutions in the UK. Seven institutions in the UK are using the advanced method for CVA risk. This is followed by France with three institutions and, Germany and Italy where two banks in each jurisdiction fall under the remit of the draft standards. Similarly, other Member States [AT, BE, DK, FI, NL and SE] have one institution that may be impacted by the draft technical standards.

In this sample, 17 institutions report counterparties for which proxy is used to determine credit spread.<sup>10</sup> Of the total number of 67,075 counterparties under advanced models, on average for 77% of the cases (or 51,606 counterparties) a proxy spread is applied. Therefore, these cases may be subject to imprecise estimates for the calculation of CVA risk own funds requirements.

#### D. Assessment of the options considered and the preferred option(s)

##### a. Status quo

In case of no further amendments to the current provisions, the identified problems, i.e. the lack of accuracy and/or potential overestimation of the own funds requirements for CVA risk will prevail. This option is therefore not selected.

##### b. Alternative credit quality assessments and spread of the parent company for the subsidiary

The draft technical standards aim to provide institutions flexibility in their determination of appropriate proxy spreads where applicable. In order to do so, institutions may be able to rely on circumstances specific to counterparties in question. This is expected to give more accurate estimates in the calculation of own funds requirements. It is therefore not reasonable to set an exhaustive list of criteria for institutions (and competent authorities) to account when assigning proxy spreads.

Similarly, institutions may also decide to use the spread of the parent company when its subsidiary shares either the same industry or region attribute. The spread of the parent company may be in many cases the most appropriate proxy spread for the subsidiary, in particular compared to a proxy spread obtained based on an average of credit spreads of counterparties that share fewer features with the subsidiary than the parent company.

Should the institutions decide to select alternative credit quality assessment criteria for proxy spread, they may need to identify such criteria and re-assess the proxy spreads of a significant number of counterparties based on those criteria. This may entail a cost for institutions however the analysis team believes that such cost will be acceptable for institutions if the decision is eventually beneficial in terms of better alignment with the methodology used for accounting CVA

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<sup>10</sup> As reported in COREP.



and more accurate own funds requirements for CVA risk. The source of the cost is expected to be further data analysis and regular but fairly infrequent monitoring of the criteria.

These current draft provisions amending the RTS under Article 383 of the CRR in overall are not expected to generate substantial costs for the institutions and the analysis team expects the benefits to exceed the costs of implementation.

**c. Adjusting the value of the first occurrence of  $LGD_{MKT}$  vs. Adjusting the value of  $LGD_{MKT}$**

In terms of the specification of the  $LGD_{MKT}$  to account for the difference between the seniority of the transactions with the counterparty and the seniority of senior unsecured bonds, the analysis team considered two options:

- i) Institutions to adjust the value of the first occurrence of  $LGD_{MKT}$  under Article 383(1) of the CRR, and
- ii) Institutions to adjust the value of  $LGD_{MKT}$  (as appear in three instances) under Article 383(1) of the CRR.

The regulatory formula referred to in Article 383 is derived from the general definition of the unilateral CVA:

$$CVA = E^Q \left[ 1_{\{\tau_B < \tau_A, \tau_B \leq T\}} DF(t, \tau_B) \cdot LGD_{\tau_B} (NPV_{\tau_B})^+ \right]$$

Where:

- Risk neutral expectation - A is the bank, B is the counterparty
- T longest maturity within netting set of transactions with counterparty B
- $\tau_A, \tau_B$  default times – Assumption: Only B defaults before T
- $DF(t, \tau_B)$  risk-free discount factor
- $LGD_{\tau_B}$  recovery at default date of counterparty B:  $LGD = 1 - R$
- $NPV_{\tau_B}$  value of the netting set of transactions at default date of counterparty B

The regulatory formula, however, is based on key approximations, in particular:

- the assumption of a constant recovery rate
- the independence of market and credit processes
- the use of expected exposures (EE) computed using the IMM instead of potentially different risk-neutral EE used for CVA pricing
- the discretisation of the time integral to reflect points in time  $t_i$  where the EE are computed

- the use of credit spreads to proxy marginal default probabilities.

This leads to the following formula:

$$CVA = LGD_{MKT} \cdot \sum_{i=1}^T \max \left\{ 0, \exp \left( - \frac{s_{i-1} \cdot t_{i-1}}{LGD_{MKT}} \right) - \exp \left( - \frac{s_i \cdot t_i}{LGD_{MKT}} \right) \right\} \cdot \frac{EE_{i-1} \cdot D_{i-1} + EE_i \cdot D_i}{2}$$

The first term  $LGD_{MKT}$  in the regulatory formula reflects the  $LGD_{\tau_B}$  term of the general CVA definition, considered constant here, whereas the other  $LGD_{MKT}$  parameters that appear in the denominators of the exponential terms correspond to the standard market recovery used to imply probabilities of default.

Rather than a discussion of the potential costs and benefits of the options, the discussion involves the analytical reasoning and legal implications of both options. While, option (i) seems to be the logical option given the theoretical background, option (ii) may be easier to implement from a legal point of view.

Both options are expected to at least partially remedy the overestimation of the own funds requirements for CVA risk for some counterparties, without generating much implementation costs for the institutions. Therefore, in overall the benefits of adjusting the parameter  $LGD_{MKT}$  are expected to exceed the costs.



## 5.2 Overview of questions for consultation

**Question 1:** Do stakeholders agree with the amendment?

**Question 2:** Could stakeholders elaborate on the type of alternative credit quality assessments to be performed and on the precise cases or type of counterparties, for which such alternative credit quality assessments would be absolutely necessary, in particular, where relevant, with reference to accounting CVA treatment?

**Question 3:** Do stakeholders agree with the amendment? Do stakeholders consider that an additional condition is necessary on rating?

**Question 4:** Do stakeholders agree with the possibility provided by the amendment to adjust the value of the LGDMKT term of the regulatory formula?

**Question 5:** Could stakeholders elaborate on cases (types of counterparties, business activities) where this adjustment would have a particularly significant impact and on the rationale for performing the adjustment in such cases?

**Question 6:** What are stakeholders' views on proposed Options A and B?

**Question 7:** Do stakeholders consider that other amendments to the RTS would need to be performed as part of this revision? Please provide rationale.