

EBA/Op/2015/02

25 February 2015

Opinion of the European Banking Authority on Credit Valuation Adjustment (CVA)

Introduction and legal basis

Article 456(2) of Regulation (EU) No 575/2013 ('Capital Requirements Regulation' – CRR), relating to the delegated acts that the Commission is empowered to adopt, mandates the EBA to monitor the own funds requirements for CVA risk and submit a report to the Commission. In particular, the report shall assess: the treatment of CVA risk as a stand-alone charge versus an integrated component of the market risk framework; the scope of the CVA risk charge including the exemption in Article 482; eligible hedges; and the calculation of capital requirements of CVA risk. On the basis of that report and where the findings are that such action is necessary the Commission shall also be empowered to adopt a delegated act in accordance with Article 462 to amend Article 381, Article 382(1) to (3) and Articles 383 to 386 concerning those items.

In addition, Article 382(5) of the CRR mandates the EBA to produce a review on the application of CVA charges to non-financial counterparties established in a third country.

The EBA competence to deliver an opinion is based on Article 34(1) of Regulation (EU) No 1093/2010¹, as CVA is covered under Regulation (EU) No 575/2013 and relates to the EBA's area of competence.

In accordance with Article 14(5) of the Rules of Procedure of the Board of Supervisors², the Board of Supervisors has adopted this opinion.

Proposals of the Opinion

The Opinion constitutes the advice of the EBA on several aspects related to the own funds requirements for CVA risk.

¹ 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).

² Decision adopting the Rules of Procedure of the European Banking Authority Board of Supervisors of 11 December 2013 (Decision EBA DC 001 (Rev3)).

The 'EBA Report on Credit valuation adjustment' and the 'EBA Review on the application of CVA charges to non-financial counterparties established in a third country' (both henceforth referred as 'the Report'), accompanying this Opinion, develop the analysis, which was performed to support the different policy recommendations.

The advice takes the form of:

- Six policy recommendations on the scope of the CVA risk charge

Policy recommendation 1: The EBA recommends clarifying via amendment of CRR Article 382 that exchange-traded derivatives are included in the scope of the CVA risk charge.

Policy recommendation 2: The EBA recommends harmonising the treatment of securities financing transactions in the EU, upon completion of a review of the CVA risk charge in Basel as part of the Fundamental Review of the Trading Book.

Policy recommendation 3: The EBA considers that the CVA risk generated by EU exempted counterparties can be substantial and should be captured prudentially. Acknowledging the legal impossibility to amend EU exemptions via the delegated act foreseen in CRR Article 456(2) and bearing in mind ongoing discussions in Basel, the EBA recommends that all EU exemptions should be reconsidered and possibly removed in the context of legislative amendments to the CRR, upon completion of a review of the CVA risk charge in Basel as part of the Fundamental Review of the Trading Book.

Policy recommendation 4: Considering that the CVA risk generated by EU exempted counterparties can be substantial and acknowledging the legal impossibility to amend EU exemptions via the delegated act foreseen in CRR Article 456(2), the EBA recommends defining an EBA coordinated approach for yearly monitoring of the impact of transactions exempted from the CVA risk charge and for defining situations constituting a presumption of excessive CVA risks to be considered under SREP.

This approach will be further specified in a guidance on assessing excessive CVA risks under SREP, which will be submitted for public consultation in the course of 2015.

Policy recommendation 5: The EBA recommends moving the definitions of ‘clearing member’ and ‘client’ from CRR Article 300 to Article 4, so that these definitions apply without ambiguity to the whole of the CRR and not only to the articles dedicated to the own funds requirements for exposures to a central counterparty.

Policy recommendation 6: The EBA views that, in the context of indirect clearing, CRR Article 382(3) currently exempts from the CVA risk charge centrally cleared clients’ trades from the perspective of both the clearing member and the client, when the client is subject to the CRR. The EBA, however, recommends reconsidering this treatment in the light of international regulatory developments and based on an appropriate review of the incentives structure ensuring that indirect clearing remains incentivised vis-à-vis bilateral trading.

- Seven policy recommendations on the calculation of capital requirements of CVA risk

Policy recommendation 7: 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: 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.

Policy recommendation 9: The EBA recommends the following amendment to CRR Article 383(6) in order to clarify that a unified proxy methodology for both market risk and CVA risk purposes does not constitute a CRR requirement:

'For exposures to a counterparty, for which the institution's ~~approved internal model for the specific risk of debt instruments~~ proxy spread methodology does not produce a proxy spread that is appropriate with respect to the criteria of rating, industry and region of the counterparty, the institution shall use the method set out in Article 384 to calculate the own funds requirement for CVA risk.'

Policy recommendation 10: Consistently with policy recommendations 8 and 9, the EBA recommends the following amendment to CRR Article 383(7):

'EBA shall develop draft regulatory technical standards to specify in greater detail:

(a) how a proxy spread is to be determined ~~by the institution's approved internal model for the specific risk of debt instruments~~ for the purposes of identifying S_i , LGD_{MKT}^* and LGD_{MKT} referred to in paragraph 1;

(b) the number and size of portfolios that fulfil the criterion of a limited number of smaller portfolios referred to in paragraph 4.

EBA shall submit those draft regulatory technical standards to the Commission by 1 January 2014.

Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulation (EU) No 1093/2010.'

Policy recommendation 11: The EBA recommends that, when the stress period used for the stressed CVA VaR does not contain any data from Q2 2008 to Q2 2009, competent authorities should assess the relevance of setting a multiplier higher than 3 for the Stressed Value-at-Risk input to the CVA risk charge in order to address potential underestimation of own funds requirements for CVA risk.

Policy recommendation 12: The EBA recommends clarifying the standardised method for CVA, in particular the way the term $M_i \times EAD_i^{\text{Total}}$ is to be computed.

Policy recommendation 13: The EBA recommends removing the alternative approach of CRR Article 385 (institutions using the Original Exposure Method) as the approach is applied by very few institutions across the EU and its outputs do not reflect CVA risks in a sufficiently risk-sensitive way. Institutions using the OEM for counterparty credit risk purposes should use the EAD computed under the OEM in the standardised method for CVA, as provided for under CRR Article 384(1). A transitional period could be set for institutions to move towards the standardised method.

- One policy recommendation on eligible hedges

Policy recommendation 14: The EBA recommends amending CRR Article 386 via EC delegated act to clarify, separately for the advanced and the standardised methods, which instruments can be considered as eligible hedges.

- One policy recommendation on the treatment of CVA risk as a stand-alone charge versus an integrated component of the market risk framework

Policy recommendation 15: The EBA recommends amending the Basel CVA framework along the following lines:

- CVA should be moved to the market risk framework and treated as a fair value adjustment subject to prudent valuation requirements
- CVA should constitute a desk as defined in the Fundamental Review of the Trading Book and remain a standalone risk-charge in the market risk framework
- CVA advanced and standardised methods should be adjusted to reflect outcome of Fundamental Review of the Trading Book, in particular the sum of the VaR and the stressed VaR should be removed
- Market risk hedges of CVA (interest rate, FX hedges...) should be recognised as eligible hedges
- Subject to definition of specific conditions (e.g. capture of basis risk), proxy hedging should be allowed
- Subject to conditions, advanced institutions should be allowed to use their internal CVA

pricing models (without reference to the regulatory formula) for the purposes of computing the own funds requirement for CVA risks

- **The CVA framework should be re-dimensioned for the regulatory CVA risk charge to better reflect institutions' internal practices.**

The EBA suggests that the European Commission should consider possible action in this respect upon completion of the Fundamental Review of the Trading Book in Basel.

- One policy recommendation on the application of CVA charges to non-financial counterparties established in a third country

Policy recommendation 16: In line with CRR provisions and until EU exemptions are reconsidered, the EBA recommends applying the same approach for exempting NFCs for CVA purposes, regardless of whether they are established in the EU or outside the EU.

This Opinion and the supporting Report will be published on the EBA's website.

Done at London, 25 February 2015

[signed]

Andrea Enria

Chairperson

For the Board of Supervisors