

European Banking Authority
Via email: EBA-CP-2012-09@eba.europa.eu

Date 15 September 2012
Reference BR1743

Regards: NVB reaction to EBA CP 2012/09 regarding draft RTS for CVA risk on the determination of a proxy spread and the specification of a limited number of smaller portfolios

Dear Sir, Madam,

On behalf of the Dutch Banking Association¹ (NVB) I would like to thank you for giving us the opportunity to react to Consultation Paper 2012/09 regarding draft RTS for CVA risk on the determination of a proxy spread and the specification of a limited number of smaller portfolios. In this letter, we will address our main points regarding the two subjects. The annex will provide you with our answers to the questions asked in the paper.

Proxy spreads:

For the determination of proxy spreads, the proposals put forward by EBA are very granular. The required granularity being such that, if not properly addressed, the quality of risk management might deteriorate as a consequence of the elevated use of non-IMM methods to calculate CVA. This fall back has to be used whenever insufficient data is available in a particular “rating, region, industry” bucket and the alternatives fail. The magnitude of the challenges faced by the industry was very well illustrated during the public hearing. It is our impression that the requirements are extremely challenging, if they can be met at all. We urge EBA to analyse the relevant market data and to make the results of this analysis public. In cases where insufficient data is found, banks should be allowed to estimate a reliable proxy of the implied market spread, instead of having to resort to a less sophisticated approach (which also has methodological shortcomings). Setting reliable proxies could be done by deriving it from another segment, by the scaling of another rating category or by mapping to a less granular bucket.

Smaller portfolios:

An institution can only acquire a license to use an IMM model if it is able to calculate a significant part of its portfolio using the IMM model. Given this limitation, we advocate linking the requirements in this RTS to current supervisory practice for IMM certification. Also, institutions that are certified should be allowed to calculate the CVA for non-IMM portfolios based on the advanced approach instead of SA. Imposing both the advanced approach and the standardized approach can create an option to arbitrage between both approaches. Requiring the advanced approach for the whole portfolio creates consistency and will neutralise any potential arbitrage incentive.

¹ The Dutch Banking Association (NVB) is the representative voice of the Dutch banking community with over 90 member firms, large and small, domestic and international, carrying out business in the Dutch market and overseas. The NVB strives towards a strong, healthy and internationally competitive banking industry in the Netherlands, whilst working towards wider single market aims in Europe.

If a split is made between IMM and CEM trades in the risk domain, this would create a discrepancy with legal netting sets; CSAs (including threshold and margin requirements) apply on the counterparty level. Such a disconnect would generate reconciliation and attribution challenges and the risk management process would become more complex, without generating any benefits. This situation is not desirable and should be avoided.

This concludes our main remarks. Our key messages will be elaborated in the answers to the questions raised in the consultation paper, which are included in the annex. In order to make the answers independently readable, some information from the letter will be reiterated.

In case you have question or remarks based on our reaction, or in case you would like to receive additional information, please do not hesitate to contact me via steins@nvb.nl.

Kind regards,



Onno Steins
Advisor Prudential Regulation

Annex 1: response to the questions asked in the consultation paper.

Q1: Please specify if the VaR proxy methodology always takes into account rating, region and industry when determining the proxy spread for the VaR model? Will the minimum prescribed granularity for rating, industry and region in Article 5, if made applicable to Article 4.1, impact institutions' current methodologies for proxy spread modelling of counterparties in the trading book? If yes, please specify and assess the overall effect on an institution.

A: As stated in the main response, the minimum prescribed granularity will definitely have an effect, as currently the curves are not available on the requested level of granularity. This will result in more, but less reliable curves being used. From our perspective the emphasis should be on the estimation of reliable proxies instead of granular ones. We invite EBA to analyse the relevant market data and publically share the results of this analysis.

Q2: Will the proposed use of the extended VaR proxy methodology and/or the minimum prescribed granularity for rating, industry and region when determining a proxy spread for CVA risk impact institutions' current methodologies for proxy spread modelling? If yes, please specify and assess the overall effect on an institution. Where possible please provide relevant data to support your response.

A: The minimum prescribed granularity will have an impact on methodologies and the requested approach will be very challenging in practice. We suggest focusing more attention on the estimation of reliable curves by using a less granular approach.

Q3: Please provide information and data concerning the availability of CDS data relevant to the intersection of sub-categories ("rating", "industry" and "region") and the application of the aggregation rules specified in Article 5.8.

A: The NVB does not have access to this data. However it is generally understood that the level of granularity is very challenging. Vendors, such as Markit, would be in a position to provide this information. Also, the definition provided for "industry" is not very clear to us. We request EBA to clarify the specification.

Q4: Please provide any information and the difference in own funds requirements for the portfolio of counterparties following the application of Article 5.8 and Article 5.9 and the policy options described in the explanatory box.

A: We do not have any information on this topic.

Q5: Do the proposed thresholds of [15]% for the number and [10]% for the size of smaller portfolios, together with the definitions, provide an incentive for institutions to limit their portfolio exposures not covered by the Internal Model Method (IMM)?

A: If an institution is allowed by the competent authority to use the IMM approach, the approach under this questions should be aligned to existing supervisory practices. We prefer to use option 2, as this is the easiest approach to align with IMM.

Q6: Will [15%] and/or [10] % cause any impact for your institution? If there will be an impact, please specify and assess the overall effect on the institution.

A: This is unlikely to have a large impact, as institutions using IMM already have to calculate a significant part of the total portfolio on the basis of IMM. For the non-IMM portfolio, IMM institutions should be allowed to calculate CVA based on the advanced approach instead of SA. Imposing both the advanced approach and the standardized approach can create an option to arbitrage between both approaches. Requiring the advanced approach for the whole portfolio creates consistency and will neutralise any potential arbitrage incentive.

If a split is made between IMM and CEM trades in the risk domain, this would create differences between the risk netting sets and the legal netting sets. CSAs apply (including thresholds and margin requirements) at the legal (i.e. counterparty) level. The proposed risk netting sets will be more granular. Splitting the risk netting set into subsets of the legal netting set would require the creation of an artificial allocation mechanism between the two views. As the added value of such a requirement will be limited, we request EBA not to create such a requirement.

Q7: Which of the three definitions of „size of portfolio“ as defined in Article 2(4) would you use to determine the [10] % size ratio? Please provide reasons for the selected definition and details of any alternative options you would propose. Where possible please provide relevant data to support your response.

A: We prefer to use option 2.

Q8: What would be the incremental costs and/or benefits were you to implement this proposal?

A: The incremental costs of the implementation of this proposal can be substantial. The misalignment of the legal and risk netting sets would create a significant administrative burden, which can and should be avoided. Also, as competent authorities have full discretion to approve IMM models, there is no reason to deviate from the approach used under IMM. If the portion of trades that are not calculated via the IMM model is too large, an institution will not be granted a license to use IMM in the first place.