

# Opinion of the European Banking Authority on Credit Valuation Adjustment risk for the determination of a proxy spread

## Introduction and legal basis

1. Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms ('CRR') requires the EBA to draft regulatory technical standards ('RTS') for credit valuation adjustment risk ('CVA risk') on the determination of a proxy spread in Article 383(7) CRR. The mandate given to the EBA in Article 383(7) CRR requires the EBA to specify in greater detail how a proxy spread is to be determined by the institution's approved internal model for the specific risk of debt instruments ('market risk VaR') for the purposes of identifying  $s_i$  and  $LGD_{MKT}$ .
2. The methodology of the market risk VaR, which an institution has been granted permission to use according to Article 363 CRR for the calculation of its own funds requirements for market risk, specifies how a proxy should be determined where no credit spread is available. Article 383(7) CRR, relating to the CVA risk charge, requires that the proxy spreads used for the CVA Advanced method should be determined by the institution's approved market risk VaR. It however adds that these proxy spreads should be determined having regard to the rating, industry and region of counterparties and, furthermore, in accordance with the provisions of the EBA draft RTS for CVA risk on the determination of a proxy spread.
3. This opinion elaborates on how the combined reading of Article 383(1) and 383(7) CRR, that links the determination of proxy spreads in the advanced CVA approach in Title VI with the approved market risk VaR in accordance with Title IV, will impact the approved market risk VaR with the potential of reducing its quality, thus providing a ground for the flexible approach adopted by the EBA in the draft RTS on the determination of a proxy spread. The EBA is very aware that the RTS, which are based on that flexible approach, may not achieve their goal of ensuring a fully harmonised application of the CVA risk framework. However, as the requirement of determining a proxy spread having regard to rating, industry and region of the counterparties may not always be suitable in the market risk VaR, a more prescriptive approach in the RTS would risk resulting in too severe an impact on the measurement of market risk.

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4. The EBA competence to deliver an opinion is based on Article 34(1) of Regulation 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 ('EBA Regulation'), as the CVA risk is an issue covered by the CRR, which itself falls within the EBA's scope of action according to Article 1(2) of the EBA Regulation.
  5. In accordance with Article 14(5) of the Rules of procedure of the EBA, the Board of Supervisors has adopted this opinion.

### Specific comments and proposals

6. Article 383(7) CRR requires the EBA to specify how proxy spreads should be determined by an institution's approved market risk VaR, for the purposes of the advanced CVA approach, for counterparties with no CDS spread available. At the same time, Article 383(1) CRR requires institutions to consider the rating, industry and region of these counterparties when determining proxy spreads, thus requiring substantial changes to be made to the proxy spread methodology of their already approved – and used for risk management - market risk VaR.
7. The EBA considers that the size of required changes to the institutions' approved market risk VaR should remain commensurate with the objective of Article 383(7) CRR, which cannot very convincingly be argued that it was to fundamentally alter the market risk VaR. A systematic interpretation of these articles would suggest that, if this had been the case, the changes would have been required for all institutions using a market risk VaR - and not only for the institutions using their market risk VaR also for CVA purposes - and an EBA mandate would, most probably, have been integrated directly in Title IV of the CRR, relating to market risk. Most importantly, as a result of that, the RTS will lead to differing practices between the institutions using the market risk VaR for CVA purposes and those which only use the market risk VaR for the specific risk of debt instruments.
8. The EBA recognises that institutions may have developed a more appropriate methodology for determining proxies in their market risk VaR than an approach based on the attributes of rating, industry and region and that, in particular, the attribute of rating, which is generally considered to be useful for determining the proxy spread of a counterparty in the CVA risk framework, may not be appropriate when determining proxy spreads in the market risk framework.
9. The EBA also acknowledges that the availability of reliable CDS data will be an issue for some combinations of rating, industry and region criteria, thus potentially leading to major uncertainty embedded in the proxy spread methodology, which has the potential to reduce the quality of the market risk VaR, as well as harm its close integration into the daily risk management process of institutions.
10. Consequently, insofar as permitted under the legal mandate for drafting the RTS under Article 383(7), the EBA has decided to allow for greater flexibility in the draft RTS on the determination of

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a proxy spread for CVA. However, the EBA is aware that the increased flexibility may not address all concerns and would like to emphasise that the EBA is mandated to produce a report under Article 456(2), whereby, in light of the issues raised by the implementation of the CVA risk charge, the relevance of some of the features of the CVA framework, together with the relevance of the provisions of these RTS, may be reconsidered.

11. The EBA will consider the appropriateness of a unified proxy methodology for both market risk and CVA purposes against an alternative approach that would require a proxy methodology to be used for CVA purposes only as part of its report under Article 456(2). The EBA recognises that this issue is part of a broader issue related to the entire CVA framework and that the consistency of a possible solution with the Basel framework or relevant changes thereof are to be further evaluated. If appropriate, the EBA will encourage the Commission, European Council and the European Parliament to contemplate an amendment of Article 383(7), when considering subsequent revisions of the CRR.

This opinion will be published on the EBA's website.

Done at London, 19 December 2013.

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For the Board of Supervisors