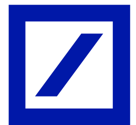

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***Guidelines on the treatment of credit value adjustment (CVA) risk under the Supervisory Review and Evaluation Process (SREP)***

Dear Mr Farkas,

Thank you for providing us with the opportunity to comment on the European Banking Authority (EBA) consultation covering Guidelines on the treatment of credit value adjustment (CVA) risk under the Supervisory Review and Evaluation Process (SREP).

We understand the desire of the EBA to provide additional guidance on assessing CVA risks under SREP guidelines and to focus on certain counterparties exempted from the capital charge. Nevertheless, we have a number of concerns with the current proposal:

- **The impact on pension funds and corporates counterparties exempt from the CVA risk charge:** the Capital Requirements Regulation (CRR) explicitly exempts non-financial corporations, pension funds and sovereigns from the CVA risk charge. Subjecting these counterparties to the CVA charge limits the ability of these counterparties to effectively manage their risks and raises the cost of hedging. Crucially, it also subjects these counterparties, although exempted through level 1 legislation, to a capital charge, which clearly runs counter to the objectives of the exemptions.

- **Assessing the relevance and the materiality of CVA risk:** the draft guidelines rely on the use of formulas which calculate hypothetical capital requirements, without these formulas providing specific factual information on the CVA risks which banks encounter on their counterparties. The guidelines should take a bank's risk management framework as a starting point for determining relevance, materiality and excessiveness, as this provides a more realistic insight of a banks' actual CVA risk, instead of using the proposed formulas.

- **Banks management of economic CVA risk:** we agree with the EBA that all CVA risks need to be managed appropriately. In this respect, banks manage economic CVA risk via market risk Value-at-Risk, Economic Capital and stress testing, regardless of the counterparty. Therefore risks stemming from exemptions are taken into account.

- **Considerations to wider policy developments:** the risk management framework on CVA is currently being revised and will most likely be finalised in 2016, while final standards on the Fundamental Review of the Trading Book (FRTB) was published in January 2016. Both CVA and

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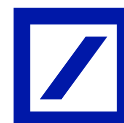


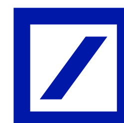
FRTB enhancements will come into effect in 2019. Most banks will start preparing for these developments long before the go-live date – thereby adjusting risk models, IT-systems and performing back testing and parallel runs. Supervisors will consequently also be involved at that stage to monitor progress which should provide insights on the new CVA risk management practices early on. Any future proposal to the existing regulatory framework should therefore be based on the newly calibrated regime, as the current rules are likely to be less relevant under the new CVA framework.

We would support further enhancement of the current SREP guidelines against this background, as well as the removal of the formula based benchmark. Enhancements of the guidelines could provide additional guidance to supervisors on modelling, methodologies and proper risk management practice of CVA. Monitoring CVA of the exempted counterparties via supervisory reporting, taking into account relevant risk mitigation in place, may provide supervisors with a better sense of the magnitude of the CVA exemptions within the banking sector. This should allow them to come to better assessments of CVA risk with the Pillar 2 framework.

In the annex we provide more elaborate views on the draft guidelines. Please do not hesitate to contact us if you have questions or wish to discuss these issues further.

Yours Sincerely,

Daniel Trinder
Global Head of Regulatory Policy



**Annex detailed comments on the draft guidelines**

These draft guidelines aim to establish a proportionate approach which, according to the EBA, should allow competent authorities to:

1) determine the relevance and materiality of CVA risk for an institution,
2) assess any material CVA risk under SREP,
3) assess the adequacy of own funds to cover material CVA risk, and
4) determine additional own funds requirements, where the risk is not adequately covered by the minimum own funds requirements, in particular due to the exemptions in the EU legislative framework.

This approach in essence is built around the inclusion of certain CRR exempted counterparties for the calculation of own funds requirements, as well as on the comparison of such hypothetical own funds requirements for CVA risk with actual minimum own funds requirements for CVA risk. We understand the desire of the EBA to provide additional guidance on assessing CVA risk under SREP guidelines also taking the exempted counterparties into account. The current proposals need to be reviewed when trying to properly assess CVA risks for the following reasons.

*1. Pension funds and corporates were exempted from the CVA capital charge for a reason*

The current Basel CVA framework has several features which would have had a negative impact on the ability of European counterparties to hedge their risks. This led to the decision within the EU to exclude these counterparties for the purpose of calculating regulatory capital charges under the CRR. This exclusion allowed European banks to keep providing the necessary hedging solutions for these counterparties. Applying capital charges for these exempted counterparties as proposed via these guidelines will raise hedging costs and goes against the objectives of the CRR exemption.

Banks already factor counterparty credit risk (CCR) and leverage exposure to exempt counterparties into trading decisions. A (partial) removal of the exemptions would add CVA Risk Weighted Assets (RWA), which would increase pricing and impact ability/willingness to trade, as it already does for eligible counterparties.

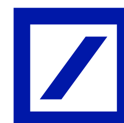
The European Parliament has recently reaffirmed their position on maintaining the exemptions in their report on stocktaking and challenges of the EU financial services regulation published in December 2015[1]. In their report the European Parliament calls on the European Commission to safeguard the exempted status of NFCs, which “were exempted for valid reasons”. As such, the proposed changes to the exemptions for the purpose of the own funds requirement are inconsistent with the Level 1 rules.

*2. The guidelines do not adequately assess relevance and materiality of CVA risk*

The EBA states that the purpose of this proposal is to assess relevance and materiality of CVA risks and following this assessment determine the level of potential capital add-ons. In order to assess the materiality and excessiveness, the guidelines provide basic formulas to calculate hypothetical own funds requirements. However, this should not be the starting point for the supervisory assessments.

Relevance, materiality and excessiveness of CVA risk can only adequately be assessed by taking the overall CVA risk management framework of each bank into account. The guidelines acknowledge that supervisors should take this overall framework into account to determine their final conclusion on potential additional Pillar 2 capital requirements. However, the focus in these guidelines on the

[1] Report of the European Parliament on stocktaking and challenges of the EU financial services regulation: impact and the way forward towards a more efficient and effective EU framework for Financial Regulation and a Capital Markets Union (2015/2106(INI)).



application of the formulas provides an imperfect benchmark which supervisors are obliged to use in their assessment of Pillar 2 capital. The EBA acknowledged the benchmark character of the supervisory formula at its public hearing. However, the guideline falls short of providing any explicit remedies for supposedly excessive CVA risk.

This proposal should be reviewed by taking the risk management framework into account, which should provide a more comprehensive picture of the materiality of CVA exposures and risks. We would support further enhancement of the current SREP guidelines against this background, removal of the formula based benchmark and instead provide additional guidance to supervisors on modelling, methodologies and proper CVA risk management.

*3. <u>We actively manage our economic CVA risk</u>*

We agree with the EBA that all CVA risks need to be managed appropriately, regardless of regulatory exemptions. The fact that exposure to certain counterparties are exempted from capital charges does not mean that banks do not manage the economic risk associated with these exposures. Generally, banks' risk management focuses on economic (accounting) CVA risk, which differs from the current regulatory definition (a shortcoming which is acknowledged in the Basel Committee FRTB CVA review).

Deutsche Bank has always managed our economic CVA risk via market risk Value-at-Risk, Economic Capital and stress testing, also prior to the introduction of Basel 3 and CRD4. Our approach to managing CVA risk consequently does not lead to excessive CVA risk exposure, which would therefore not justify an incremental Pillar 2 capital charge.

*4. <u>The proposals should be viewed in light of wider policy developments</u>*

The Basel Committee is working on finalising the calibration of the Fundamental Review of the Trading Book (FRTB) and its review of the current CVA framework. This will have an impact on banks' own funds requirements and on CVA risk management. Any future proposal to the existing regulatory framework should be based on the newly calibrated framework, as the current rules are likely to be less relevant under the new CVA framework.

The upcoming framework on CVA will most likely be finalised in 2016, while final standards on FRTB have already been published in January 2016, and both will come into effect in 2019. Most banks will start preparing long before this date, adjusting their risk models, IT-systems and performing back testing and parallel runs in conjunction with their supervisors. In the interim, implementing the proposed benchmark formula for calculating hypothetical CVA capital requirements will require incremental resources and will have little added value for banks and supervisors.

Furthermore, when transposing the new CVA framework of the Basel Committee into the European context, a proper impact assessment on the wider implications for the European economy should be undertaken. Attention should be given to the structural difference in FX risk exposure for the counterparties in Europe versus the US. European counterparties will always be operating in an unlevel playing field when hedging their FX risks, given that global markets are driven by the US dollar and consequently US counterparties are less confronted with FX risks. If the current CVA framework is applied in its existing form to European pension funds and corporates, it would raise their costs of entering into derivatives transactions and negatively impact their ability to hedge their risks.

*<u>Additional elements for comment</u>*

*1) EBA proposals on addressing shortcomings (i.e. including proxy spreads and LGD_MKT parameters)*

We welcome the proposals made by the EBA on addressing the shortcomings by including proxy spreads and LGD_MKT parameters into the European framework for CVA. These adjustments will assist banks in better risk management and measurement.

*2) Monitoring of exempted counterparties*

We understand the need from the supervisory perspective to get a better sense of the magnitude of the CVA exemptions within the banking sector. Deutsche Bank supports the proposal to monitor the CVA of exempted counterparties via supervisory reporting practices. However, the monitoring should also take into account relevant risk mitigation in place. This information should provide the supervisors with additional information to make a better informed decision on Pillar II CVA risks within the SREP process.

*3) Treatment of intragroup transactions.*

Intragroup transactions should be excluded from the scope of any calculation of CVA capital charges. Basel 3 FAQ's provided by the Basel Committee clearly state that intragroup transactions are not in scope of the CVA capital charge. Including these transactions would go against centralised risk management practices and would not be in line with consolidated accounting practice.