FÉDÉRATION BANCAIRE FRANÇAISE

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FBF RESPONSE TO EBA CONSULTATION PAPER ON THE TREATMENT OF CVA UNDER SREP (EBA/CP/2015/21)

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

The FBF welcomes the opportunity to comment on the EBA's Consultation on the treatment of CVA under SREP. The overall purpose of the proposed guidelines is to promote consistent and uniform supervisory review practices with respect to Credit Value Adjustment (CVA) risk in a Pillar 2 framework. If we support such an objective, we do strongly challenge the EBA approach both in the form and substance.

- First, the proposed guidelines factually alter, for banks above materiality thresholds, the exemptions of corporates and sovereign entities from the CVA capital charge intentionally granted by the European legislator within Regulation 575/2013 on Capital Requirements (CRR) at the time Basel 3 rules were implemented in Europe. In that respect, the adverse effects of the EBA guidelines on damaging the EU real economy have been stressed by the European Association of Corporate Treasurers in a press release[1] published on December 7th 2015.
- Second, the legal consistency of the proposed guidelines is rather questionable. Most of the provisions of the draft guidelines go far beyond the objective of supervision harmonization. As a matter of fact, the quantitative approach envisaged to determinate the appropriate coverage of CVA risk – the so-called supervisory benchmark – makes the determination of a potential capital add-on quite automatic and confers it a quasi-Pillar 1 status, pre-empting Pillar 1 rules.
- Third, the proposed supervisory benchmark is largely inherited from Basel 3 rules whose weaknesses and limitations are yet formally acknowledged by the EBA in its 25th February 2015 report on CVA risk[2].
- Lastly, the timing of the EBA initiative seems to be at odd as Basel 3 rules are currently under review and expected to change quite materially in the near future (the Basel review of the CVA risk framework should be finalised by year end 2016).

[1] http://www.eact.eu/docs/EACT-Press-Release-on-Letter-to-EBA-re-CVA-Dec15.pdf
[2] https://www.eba.europa.eu/documents/10180/950548/EBA+Report+on+CVA.pdf

1. General considerations

1.1. The proposed EBA guidelines are likely to erode benefits granted to exempted derivatives end-users, namely corporates and sovereigns

When, in the transposition of Basel III into the CRD IV package, capital charges on the counterparty risk arising from derivative transactions were massively increased, the European legislator decided to exclude from this charge the transactions concluded with “end-users”, i.e. corporates and sovereign entities, who use derivatives to protect them against potential adverse moves in currencies, interest rates or other financial variables (cf. art. 382 §4 CRR).

It was also the recognition that, although banks dealing with financial institutions should have a strong incentive to apply strict collateral guidelines, and/or clear through CCPs, these constraints should not be imposed on end-users, given that the limited scale of their derivative business does not justify these heavy infrastructure costs. This exemption was strongly supported by corporates and sovereign debt management agencies.

Nevertheless the proposed guidelines circumvent the explicit decision made in the Level 1 text and validated by the European Commission, Parliament and Council. The three of them jointly, during the democratic legislative process, decided to exempt from any CVA capital charge transactions with non-financial counterparties which are not subject to the central clearing obligation under EMIR. They did so consistently in CRD4 and EMIR in order to protect end-users' ability to mitigate their risks with OTC derivatives, promoting sound risk management, and in fact, making them more solid for the real economy.

It is now put into question by the EBA since the proposed guidelines define the appropriate CVA risk coverage as being proportional to the hypothetical CVA risk capital reincluding exempted names.

1.2. The legal background of the EBA draft guidelines is questionable

The EBA proposed Guidelines are issued on the basis of Article 456(2) of the CRR. This provision foresees the possibility to amend the CVA risk framework via a delegated act adopted by the European Commission, with the exception of the provisions excluding certain transactions from the own funds requirements for CVA risk under Article 382(4).

Article 456 (2) of the CRR entrusts the EBA with a precise mandate consisting in monitoring the own funds requirements for CVA risk and in submitting a report to the European Commission by 1 January 2015. The European Commission, where appropriate, will adopt the above-mentioned delegated act on the basis of this EBA report.

Additionally, pursuant to Article 382 (5) of the CRR, the EBA is in charge of conducting a review by 1 January 2015 and every two years thereafter, in the light of international regulatory developments. Pursuant to these provisions, the EBA is solely entrusted with monitoring and reporting tasks. As a consequence the legal grounds, namely Article 456 (2) and Article 382 (5) of the CRR, on which the EBA supports its proposed Guidelines, raise some doubt about the validity of the legal basis of the guidelines.

Furthermore, we consider that the EBA goes far beyond the tasks conferred upon it by Regulation n°1093/2010 establishing the EBA. As a matter of fact, the EBA shall contribute to the consistent, efficient and effective application of the acts referred to in Article 1 paragraph 2 of Regulation n°1093/2010 (including CRR and CRD IV) and to foster supervisory convergence. According to Article 16 of Regulation n°1093/2010, the EBA "*shall, with a view to establishing consistent, efficient and effective supervisory practices within the ESFS, and to ensuring the common, uniform and consistent application of Union law, issue guidelines and recommendations addressed to competent authorities or financial institutions*". However the proposed Guidelines, whereas they are not legally binding, would actually impose a uniform supervisory benchmark triggering automatic measures consisting in additional own funds requirements in case of excessive CVA risk. By doing so, the EBA is clearly exceeding its missions laid down in EU legislation and is actually acting as a supervisor. As a consequence, article 16 of Regulation n°1093/2010 is proving to be an unsuitable legal basis to adopt such measures.

Sharing the final goal of an enhanced supervisory convergence as the one of the primary tasks granted to the EBA according to Article 20 a of Regulation (EU) No 1022/2013 "*The Authority shall promote, within the scope of its powers, convergence of the supervisory review and evaluation process in accordance with Directive 2013/36/EU in order to bring about strong supervisory standards in the Union*", the approach proposed as based on a quantitative approach seems to go far beyond enhanced convergence. Indeed, it will vanish the judgement that the supervisor is expected to exercise as part of the Supervisory Review and Evaluation Process as stated in Article 104.3 of Directive (EU) No 2013/36. EBA instead of promoting the convergence would lead to automaticity in the supervisory judgement unsuitable for the use of the Pillar 2.

1.3. The guidelines timeline is controversial

As stated here above, the Basel Committee launched in July 2015 a comprehensive review of the CVA risk framework[3] with the aim of answering shortcoming of the Basel 3 framework. We understand that the EBA is actively contributing to the Basel taskforce reviewing current rules. We believe this work is crucial as more risk-sensitive measures (internal or standardized) are key to an efficient capital ratio.

In addition the European Commission published a statement[4] on December 5th 2014 on Basel Regulatory Consistency Assessment of Basel 3 implementation whereby it recommends addressing the exemption issue within the context of the Basel review: "*A second issue that materially affects the overall judgement is the result of certain exemptions from capital requirements for credit valuation adjustment (CVA) risk. <u>This issue should be considered in the light of recent, new discussions in the Basel Committee</u>. At its meeting on 22-23 September 2014, the Committee decided to introduce major changes to the requirements for CVA risk.*"

In this context, we question the relevance of the timing of the EBA initiative that will lead to banks dealing with potential excessive risk exposures on exemptions granted by a European Legislation and based on rules that are being reviewed because deemed unsatisfactory by the Basel Committee itself.

2. Identified flaws and expected consequences

We do acknowledge CVA on exempted names is not risk free, should be adequately assessed, monitored and risk-managed. We don't challenge this evidence. However we advocate that the EBA

[3] www.bis.org/bcbs/publ/d325.htm
[4] http://europa.eu/rapid/press-release_STATEMENT-14-2403_fr.htm

proposal fails this objective and is likely to have detrimental consequences. We finally propose few principles for building a sound CVA SREP framework.

2.1. A flawed supervisory benchmark

Notwithstanding our above-mentioned concern that defining a quantitative measure of "appropriate risk coverage" in a Pillar 2 framework is questionable, we consider that the proposed supervisory benchmark suffers a major weakness: it is based on a hypothetical risk measure disconnected from economic risk truly incurred and monitored. CRD IV Article 73 explicitly requires banks to ensure "*the risks to which they are or might be exposed"* are adequately covered by capital. The economic risk that needs to be monitored and adequately capitalized as part of ICAAP arises from accounting CVA variability. This is because the fair value adjustment accounting for the cost of counterparty risk embedded in the price of a derivative is accounting CVA not regulatory CVA.

The Basel Committee, in its first consultative paper on the review of the CVA risk framework[5], acknowledges the current Basel 3 regulatory CVA is ill-defined and outdated since one of the objective of the on-going review is to better align regulatory CVA with accounting CVA: *"The current regulatory CVA formula used in the Advanced Approach does not incorporate many of the hedging strategies banks now employ under various accounting regimes, particularly with regard to the market risk drivers of CVA, and has thus become outdated."*

The consequence is that the current framework not only does not recognize some hedges (non eligible hedges) but also penalises sound risk management. It treats hedges of risk factors such as Interest Rates or FX rates as if they were naked market risk positions, leading to an increase of the Capital Charge when Banks reduce their real economic risks.

All in all, we firmly believe the proposed supervisory benchmark is flawed whatever the calibration of the "y" parameter because it solely relies on the theoretical concept of regulatory CVA, a concept that is outdated and disconnected from economic risk. The more the perimeter of this charge will be increased, the more Banks will feel the negative consequences of this ill-defined measure, disincentivising sound risk management.

We note that the proposed supervisory benchmark actually goes beyond Basel 3 requirements with the inclusion of intragroup transactions in the hypothetical own funds requirements for CVA risk. Indeed, the Basel Committee clarified in FAQ 2e.1 of the Frequently asked questions on Basel III counterparty credit risk[6] that intragroup transactions are not in the scope of the CVA capital charge: "*As per the group consolidated reporting, no regulatory capital charge (including a CVA charge) applies to intercompany transactions"*. We are concerned that the EBA is taking an overly conservative stance with respect to the definition of the appropriate level of risk coverage.

2.2. Expected consequences

a. A disincentive for end user sound risk management practice:

The EBA guidelines will increase the cost of derivatives for end users (corporates and sovereigns counterparties) entering into these instruments for hedging purpose. Indeed the poor calibration of the Basel 3 CVA risk capital charge –that is used as the base for the EBA guidelines– leads to punitive

[5] http://www.bis.org/bcbs/publ/d325.htm
[6] www.bis.org/publ/bcbs237.pdf

capital cost for uncollateralized derivatives. Many end users of derivatives can't –for operational reasons or more fundamentally for lack of access to liquidity– collateralize their derivatives transactions. This was acknowledged by the European Market Infrastructure Regulation that exempts corporates using derivatives for hedging purpose from clearing obligation.

However by facing much higher costs for entering new hedging transactions due to the EBA guidelines end users will be left with an unpleasant dilemma:

- Keep using derivatives for hedging purpose thus increasing the cost of producing goods, impacting their competitiveness and ultimately passing this incremental cost to consumers; or
- Stop using derivatives and effectively keep the market risk on their balance sheet. This would make them riskier, leave them exposed to market movements and potentially hamper their operations.

This was clearly stated by European Corporate Treasurers in their December 7th 2015 press release.

b. An incentive for banks to use Credit Default Swap and the negative feedback loop it may create for bonds primary issuance by corporate / sovereign :

The Basel 3 CVA risk capital charge is fully calibrated on inputs coming from the Credit Default Swap market. The fully market driven nature of the charge gives a strong incentive to banks to use credit default swaps in order to mitigate its volatility that would not be sustainable in a stress period. Given the lack of depth of this market that has been shrinking over the last few years, there is a genuine risk that a surge of protection buyer -banks hedging the CVA risk capital charge- will push CDS levels higher and feed into the level at which corporates and sovereigns borrow money in the bond market. This negative feedback loop phenomenon would make it more expensive for end users to finance their operations and is of a particular concern in period of stress where raising money could become extremely difficult and costly.

c. A reliance on the Credit Default Swap market for sovereign exposures that is at odd with EU position.

Numerous sovereigns, especially in Europe, have been and keep on using derivatives to actively managed public debt and in most cases these derivatives exposures are not collateralized (or collateralised under "1 way" arrangements where the sovereign is receiving collateral but never posts, or sometimes posts non-eligible own asset collateral) thus creating potentially large exposures for banks. The incentive for banks to use credit default swaps to limit the volatility of the VaR on CVA capital charge will be particularly acute on these derivatives exposures. Indeed given the procyclicality nature of the VaR on CVA capital charge, exposure to sovereign counterparties will clearly be more prone at creating large volatility of banks capital base and so are likely to be a priority in terms of hedging and risk management with Credit Default Swaps.

The European sovereign crisis highlighted the contamination risk towards other sovereigns and banks that an unbalanced risk appetite in the credit default swap market may create. This was the very reason the European Union decided to curb their use and introduced rules to ban "naked" credit default swap end of 2011. We believe that the removal of sovereign exemptions from a VaR on CVA risk solely calibrated on the Credit Default Swap market will send the wrong signal and will be at odd with the position of the European Union vis-à-vis the use of these instruments to manage sovereign risk.

d. **Some banks exiting the derivatives business with corporates/sovereigns leading to a less competitive offer:**

As mentioned previously the EBA guidelines will push banks to use more credit default swaps in order to limit the volatility of their capital base. However many corporates – in particular SMEs – do not have active CDS and so the variability of the related CVA capital charge can't be hedged properly by banks. This will surely encourage some banks to limit or even suppress their offer of derivatives products to this client category. As such SMEs would be left with less bank counterparties willing to enter hedging derivatives transactions and a less competitive market that will ultimately lead to less favourable economic terms

Due to heavy wave of regulation in Europe, we notice that banks are announcing their willingness to reduce their derivatives activity in particular with counterparties not traded under a collateralization agreement. Imposing an additional CVA risk capital charge ill-calibrated is likely to accelerate this trend and leave end users with limited options.

3. Principles to be put forward

As a preliminary remark, we would deem essential to recall that supervisors in Europe, including the ECB, have broad powers under respectively Article 104 of CRD IV and Article 16 of Council Regulation No 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, to impose on institutions to hold additional own funds if a risk is not sufficiently covered by prudential requirements under CRR. Therefore we do question if EBA would act within its powers in designing a supervisory pattern which would vanish the correct supervisory assessment of each business model in order to define the right level of capital add-ons to address an excessive CVA risk.

Now, should the EBA still deems necessary to introduce quantitative benchmark in its CVA SREP guidelines, we argue that any proposal should not aim at substantially eroding the exemptions granted by the CRR but rather at putting forward common principles for a sound evaluation of internal capital adequacy assessments.

- As stated before, on the one hand, we agree that CVA on exempted names is not risk free but on the other hand we consider that regulatory CVA fails to adequately reflect the risk incurred. In other words, we agree the importance of making sure no excessive risk is held for CVA risk. In that respect, the ICAAP framework of each bank should provide an integrated view of all risks, and as such should be assessed on the full OTC derivatives perimeter (including on exempted names). We disagree to use a portion of the Basel 3 capital measure as the reference point since it removes the opportunity of institutions under Pillar 2 to use appropriate models to measure CVA risk and in particular within ICAAP, and think the EBA should promote a more individual analysis of CVA risk management and its essential risks (including concentration).

  As an example, CVA risk on SME is not necessarily measured using a Market VaR model, and a pillar 2 process will most likely use a more appropriate model.

  One key objective of the CVA SREP should be to assess whether a bank's ICAAP for CVA risk is sound, reliable and exhaustive. We deplore the lack of consistency between the supervisory benchmark (based on regulatory CVA) and what should be the outcome of a sound ICAAP (i.e. based on accounting CVA).

Should the EBA finally retain the principle of a supervisory benchmark, <u>we recommend that such a benchmark relies on accounting CVA not regulatory CVA.</u>

- European banks are subject to a strict regime of prudent valuation including on CVA risk. Additional value adjustments are to be deducted from CET1. There is in theory no overlap between Additional Value Adjustments that aims at capturing the uncertainty of the CVA at a given point in time and the CVA risk charge that aims at capturing the uncertainty of the CVA variation. Both measures are defined at a high confidence level (respectively 90^{th} and 99^{th}) and directly affect the solvency ratio. In practise, we argue that there is a risk of overlapping between both measures if not implemented consistently with one another. It is well established that CVA is not observable in isolation in the market, and overlaps with many other fair value elements, which is at once the consequence and reason for the diversity of approaches highlighted in the February 2015 EBA report on CVA. This economic fact is the reason for which it is difficult to have fully distinct approach for CVA variability and its Prudent marking. In our view, a fully distinct approach mechanically leads to undue capital layers. If the aim of the guidelines is to ensure sound and harmonized supervisory approach to CVA risk, it must take into consideration the current ability of entities to observe the market, the exact models and the potential for overlap between the Prudent Value charge and the CVA capital charge.

- Finally, we are concerned that a strict application of the SREP guidelines could render SREP processes systematic and inappropriate. A "one-fit-all" process is likely to jeopardize the relevance of supervisory reviews because it will fail to capture special situations. We strongly believe that supervisors must keep the ability to appreciate specific cases and take customised remedial actions different from those enclosed in the guidelines if deemed necessary.

<u>Answer to questions related to the consultation</u>

Question 1: Do you agree with determining relevance of CVA risk by means of assessing the size of an institution's derivative business using the exposure value for non-QCCP cleared derivatives transactions?

We understand the EBA's objective to exclude from the step 3 small non-complex EU institutions which do not exhibit excessive CVA risk.

However, to meet this objective, we would recommend EBA to remove the Threshold 1 because (i) the size of an institution derivatives business is not in general a relevant criterion to assess CVA Risk, especially for those small non-complex EU institutions calculating EAD according to the non-risk based standard method (CVA risk depends more broadly on the credit quality of counterparties and on the portfolio risk factors), and (ii) the threshold seems to be useless as those small non-complex EU institutions are required to calculate Threshold 2 in all cases, this second threshold being a fairly better indicator to determine relevance of CVA risk, notwithstanding the limitations exposed in the answer to Question 3.

Question 2: What are your views on how Threshold 1 should be calibrated?

Consistently with the answer to Question 1, we would rather recommend to remove the Threshold 1.

If however the EBA decided to maintain Threshold 1, it would be more appropriate to consider that the CVA risk is relevant when both Threshold 1 **and** Threshold 2 are exceeded (instead of Threshold 1 **or** Threshold 2).

Question 3: Do you agree with determining relevance of CVA risk by means of assessing the share of own funds requirements for CVA risk to the total risk exposure amount?

Notwithstanding the arguments provided in the general comments, we are in the opinion that the share of own funds requirements for CVA risk to the total risk exposure amount is a better indicator to determine relevance of CVA risk compared to a volume based indicator.

However, we consider that the proposed ratio suffers a major weakness as it is based on a measure disconnected from true economic risk. The relevance of CVA risk that could be assessed as part of a SREP process should rely on the accounting CVA and not the regulatory CVA.

Question 4: Do you agree with the approach provided for the determination of materiality of CVA risk?

BCBS has designed and calibrated at the global level the CVA risk framework for the consolidated level. Notwithstanding the arguments provided in the general comments, we are in the opinion that the determination of materiality of CVA risk should be assessed exclusively at the consolidated group level. This recommendation is consistent with the answers provided to questions 7 regarding intragroup transactions.

Question 5: What are your views on how 'x%' (Thresholds 2 and 3) should be calibrated?

We believe the proposed threshold is flawed whatever the calibration of the "x" parameter because it rely on the regulatory CVA while the economic risk that needs to be monitored and adequately capitalized as part of ICAAP arises from accounting CVA variability instead.

Additionally, we are in the opinion that setting a unique x% value is inappropriate, moreover for both thresholds. A "one-fit-all" value is likely to jeopardize the relevance of supervisory reviews because it will fail to capture the specificities of the institution which should be part of the SREP process, as defined in Article 107(3) of EU Directive 2013/36, "*in a manner that is appropriate to the size, the structure and the internal organisation of institutions and the nature, scope and complexity of their activities*". We believe that supervisors must keep the ability to appreciate specific cases and take customized views different from those enclosed in the guidelines if deemed necessary.

Question 6: Do you agree with the scope of derivative transactions to be included into the calculation of hypothetical own funds requirements for CVA risk?

As mentioned in our general response, we are not trying to challenge the evidence that the exempted CVA perimeter is not risk free. On the contrary, we think that CVA risk shall be measured adequately. But, we do not agree with the approach proposed in the guidelines, which is based on the Basel 3 framework.

If EBA continues imposing this automatic measure despite the negative consequences, we argue that

- The sovereign counterparties continue to be exempted until at least the Commission has reviewed the prudential treatment to sovereign counterparties as a whole.
- The NFC- counterparties continue to be exempted until the definition and thresholds have been reviewed by ESMA in the EMIR context.
- In both cases, a precise assessment of the impact of the removal of the exemption on the derivative market is an important prerequisite, as shortage of supply of derivative may impact badly the EU economy.

Question 7: Do you agree that intra-group derivatives transactions should be explicitly included into the scope of calculation? If not, what do you think could be a credible alternative treatment of the CVA risk of intragroup transactions?

No, we do not agree with this principle. We think that the intra-group transactions shall be exempted from the CVA charge at group level as soon as institutions are supervised on a consolidated basis. This exemption is consistent with the counterparty credit risk treatment for intra-group transactions on a consolidated basis.

Indeed, CVA losses can occur either because of an increase in the institution's counterparties credit spreads or because of an increase in the institution's exposure to its counterparties. But on a consolidation basis, in accordance with the IFRS principle, intra-group transactions are cancelled. Hence, there is no volatility to institutions' own funds neither CVA loss to institutions themselves.

Moreover, according to the CRR, changes in the value of own liabilities (DVA) shall be filtered from own funds. And, actually, the credit spreads of consolidated entities will be based on the CDS of its parent undertaking. Consequently, even if intra-groups transactions were included for the CVA charge purpose, this charge will be filtered in accordance with the DVA treatment.

From our point of view, intra-group transactions shall only cover transactions between entities in the same consolidation perimeter (as define in art. 382(4)(b)) for the prudential purpose. Similarly it is quite acceptable to include intra-group transactions these transactions do not fulfil the criteria listed in the article 382 (4)(b) of the CRR. Besides, transactions with structurally separated subsidiaries shall not be considered as intra-group transaction.
Reversely transactions with insurance subsidiaries or with entities recorded in accordance with the equity method shall not be considered as intra-group transactions. As a consequence, the CVA charge shall be computed as usual for these transactions.

Question 8: Do you agree with the approach provided for the determination of supervisory benchmark for material CVA risk?

As outlined in section 2.1, we believe that providing a quantitative measure of what should be the appropriate coverage of CVA risk as part of SREP is unsuitable.
Moreover, we consider the proposed supervisory benchmark is arbitrary and flawed.

Question 9: What are your views on how ‘y%’ (Threshold 4) should be calibrated?
Whatever the calibration of “y%”, we consider the proposed approach is inappropriate. No calibration can address the shortcoming of the contemplated approach.

Question 10: Do you agree with the approach provided monitoring of CVA risk by competent authorities and EBA and data to be provided to competent authorities for this monitoring?
We agree with the objective of enhanced supervision of CVA risk. However, as stated previously we consider the proposed approach will fail this objective (See sections 2 and 3 of the general comments). As a consequence, we believe the requested data will be of no use for the sake of monitoring CVA risk. As already mentioned above, the Pillar 2 process allows institutions to use appropriate models to measure CVA risk and in particular within ICAAP. By stating that the competent authorities should use the value of the hypothetical own funds requirements for CVA risk as specified in these Guidelines, the EBA removes this opportunity of using appropriate models, which is contrary to this fundamentally sound principle..

Question 11: What is your view regarding the potential burden of computing hypothetical own funds requirement for CVA risk at the same frequency as the regulatory CVA VaR and Stressed VaR figures?
If we are to invest resources on monitoring CVA risk arising from exempted counterparties, then we prefer to do so in the context of improving the soundness and reliability of the CVA ICAAP framework under supervisory scrutiny.