EUROPEAN COMMISSION
Internal Market and Services DG

FINANCIAL INSTITUTIONS
Banking and financial conglomerates

Consultation Document

Counterparty credit risk

Capitalisation of bank exposures to central counterparties

Treatment of incurred credit valuation adjustments

You are invited to comment on the views reflected in this paper. These views are only an indication of the approach the European Commission may take and are not its final policy position nor do they constitute a formal proposal by the European Commission.

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The financial crisis highlighted that banks massively underestimated the level of counterparty credit risk associated with over-the-counter (OTC) derivatives. This prompted the G20 Leaders, at their Pittsburgh summit in September 2009, to call for more OTC derivatives to be cleared through a Central Counterparty (CCP). Furthermore, they asked to subject those OTC derivatives that could not be cleared centrally to higher capital requirements in order to properly reflect the higher risks associated with them.[1]

Following the G20 Leaders' call, the Basel Committee on Banking Supervision (BCBS) started to review the regulatory capital treatment for counterparty credit risk. The BCBS identified that this treatment was insufficient in a number of areas[2] and that CCPs were not widely used to clear derivatives trades. As part of the Basel III reforms, the BCBS has materially changed the counterparty credit risk regime.[3] These changes significantly increase the capital charges associated with bank OTC derivatives and securities financing transactions (SFTs) and should thereby create important incentives for banks to use CCPs wherever practicable.[4] The Commission has actively contributed to the process and therefore supports the work of the Basel Committee on these and other related issues.

In the Communication of 4 March 2009,[5] the Commission committed to deliver, on the basis of a report on derivatives and other complex structured products, appropriate initiatives to increase transparency and to address financial stability concerns. The summary of the results of the analysis of the functioning of derivatives markets was presented in a Communication published in July 2009,[6] whereas the initiatives were presented in a Communication published in October of the same year.[7] Among the initiatives announced in the latter Communication, the Commission announced it would amend the CRD to put in place higher capital requirements for bilateral derivative contracts in order to reflect the higher risk that such contracts pose to the financial system.

Between February and April 2010, the Commission services conducted a public consultation[8] on possible further changes to the Capital Requirements Directive (CRD),[9] which broadly followed the preliminary proposals put forward by the BCBS published in December 2009. That consultation already included some preliminary proposals amending the treatment of counterparty credit risk.

The purpose of the measures proposed in this consultation, envisaged to be part of a comprehensive legislative proposal of the European Commission due before summer 2011, is to strengthen the capital requirements for counterparty credit exposures arising from credit institutions' and investment firms' derivatives, repo and securities financing activities. Specifically, their objective is to raise the amount of capital backing these exposures, reduce

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[1] See paragraph 13 of the "Leaders' Statement: The Pittsburgh Summit", which is available at www.pittsburghsummit.gov/mediacenter/129639.htm.

[2] See the Committee's December 2009 consultative document "Strengthening the resilience of the banking sector", from paragraph 113. The document is available at www.bis.org/publ/bcbs164.pdf.

[3] On 16 December 2010 the Committee published its reforms related to counterparty credit risk. See "Basel III: A global regulatory framework for more resilient banks and banking systems". The document is available at www.bis.org/publ/bcbs189.htm.

[4] It is widely expected that not all OTC derivatives will be suitable for CCPs. Please see the Financial Stability Board report issued on 25 October 2010 for a discussion of the standardisation of derivatives and other matters related to increasing the use of CCPs and giving effect to the G20 Pittsburgh statement concerning CCPs. The report is available at www.financialstabilityboard.org/publications/r_101025.pdf.

[5] "Driving European Recovery" - COM(2009) 114. The document is available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0114:FIN:EN:PDF.

[6] "Ensuring efficient, safe and sound derivatives markets" - COM(2009) 332. The document is available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0332:FIN:EN:PDF.

[7] "Ensuring efficient, safe and sound derivatives markets: Future policy actions" - COM(2009) 563. Available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0563:FIN:EN:PDF.

[8] See http://ec.europa.eu/internal_market/consultations/docs/2010/crd4/consultation_paper_en.pdf.

[9] Directives 2006/48/EC and 2006/49/EC.

procyclicality and provide additional incentives to move OTC derivative contracts to central counterparties (by requiring more capital for OTC derivatives not cleared by a CCP than for those cleared by a CCP), thus helping reduce systemic risk across the financial system. The proposed measures would also provide further incentives to strengthen the risk management of counterparty credit exposures.

The review of the treatment of counterparty credit risk in the CRD forms an integral part of the Commission's efforts to ensure efficient, safe and sound derivatives markets. It complements other Commission's regulatory initiatives in this area, in particular the Regulation on OTC derivatives, central counterparties and trade repositories ("the Regulation"), adopted by the European Commission on 15 September 2010.[10]

The purpose of this consultation is to gather stakeholders' views on two specific issues in the area of counterparty credit risk, on which:

- Capitalisation of bank exposures to central counterparties (Section I) and
- Treatment of incurred credit valuation adjustments (Section II)

The Commission services consider it necessary to launch an additional consultation on these two issues due to the fact that the Commission's February 2010 Consultative document did not set out the necessary level of detail on the above two issues.

With respect to the first issue, the possible measures contained in this Consultative document broadly follow the preliminary proposals set out in a consultative document published by the Basel Committee on 20 December 2010[11]. The Basel Committee is currently preparing an impact assessment on its proposals. The Commission services will take due account of the outcome of its own consultation, the outcome of the Basel consultation and the Basel Committee's impact assessment results as well as any other progress made in discussions on the international stage when finalising the respective legislative proposal.

With respect to the second issue, the Basel Committee already specified the respective treatment (details in Section II) on 16 December 2010[12]. This treatment is however, subject to a final impact assessment by the Basel Committee, which should be completed in the first quarter of 2011. In order to finalise the policy line on this issue, the Commission services considers it important, in line with the Better Regulation Agenda, to give due consideration not only to the results of the impact assessment but also to the comments gathered from all relevant stakeholders on the most appropriate treatment.

The responses to this consultation will provide important guidance to the Commission when preparing a formal Commission's proposal and the impact assessment accompanying it. In order to assist us in evaluating your contributions, we would appreciate it if you could maintain the structure of this questionnaire in your replies and **indicate clearly the question you are responding to**.

In replying to these questions, please indicate the expected impact of the potential changes described in each section of this paper on your activities or the activities of firms in your jurisdiction.

[10] See http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm#proposals for more details.
[11] http://www.bis.org/publ/bcbs190.htm
[12] http://www.bis.org/publ/bcbs189.htm

You are invited to send your contributions until **9th of March 2011** to
markt-crd-consultation@ec.europa.eu

Responses will be published on the following website unless requested otherwise:
http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm

Data protection rules: **http://ec.europa.eu/geninfo/legal_notices_en.htm#personaldata**

I. Capitalisation of bank exposures to central counterparties

1. Introduction

One of the issues explored by the Basel III reforms is the possibility of introducing changes to the capitalisation of exposures to CCPs. In particular, they foresee a positive capital charge for exposures to CCPs. This represents a significant change from the approach taken in Basel II rules[13] and the CRD[14] which allow exposures to CCPs to be zero, provided certain conditions are met. The BCBS launched a consultation on this new approach on 20 December[15] and is currently conducting a comprehensive Quantitative Impact Study. The following section is based on the consultation paper prepared by the BCBS. The Commission services will take due account of the outcome of both the Basel consultation as well as the QIS results when finalising the respective legislative proposal.

2. General aspects

2.1. Material scope

For the purpose of this consultation paper, exposures to CCPs refer to exposures arising from transactions in derivatives (both exchange-traded and OTC) and SFTs. For transaction in securities, the current treatment of settlement risk applies.[16]

2.2. Qualifying vs non-qualifying CCPs

The BCBS consultation paper proposes to apply a two-tier system when determining the necessary level of capitalisation of a bank's exposure to a CCP. In short, the paper proposes to differentiate between "qualifying" and "non-qualifying" CCPs.[17] In order to be deemed qualifying, a CCP would need to simultaneously fulfil two conditions:

1. the CCP is compliant with the Committee on Payment and Settlement Systems (CPSS) and the Committee of the International Organization of Securities Commissions (IOSCO) Recommendations for Central Counterparties ("the CPSS-IOSCO Recommendations");

2. the CCP is able to assist clearing member banks in properly capitalising for CCP exposures by either undertaking the calculations and/or by making available sufficient information to its clearing members, or others, to enable the completion of capital calculations; and

Bank exposures to a qualifying CCP would receive a more favourable treatment than those to a non-qualifying CCP, i.e. the risk weights applicable to the former would be lower than those applicable to the latter. However, the paper also clarifies that in spite of the fact that a CCP may be considered as qualifying by its supervisor, a bank supervisor has the ultimate discretion to determine whether banks subject to its supervision should hold more than the minimum capital requirements arising from dealing with that CCP. Furthermore, the paper states that even in case a CCP supervisor (or a bank supervisor) considers a CCP to be

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[13] See Annex 4, paragraph 6, of "International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version", June 2006, which is available at www.bis.org/publ/bcbs128.htm.
[14] Point 6 of Annex III, Part 2 of Directive 2006/48/EC.
[15] See http://www.bis.org/press/p101220.htm. The consultative document also provides details about the process and timelines.
[16] Annex II of Directive 2006/49/EC.
[17] The main reason behind this differentiation is the desire to provide incentives to use "qualifying" CCPs, which are deemed to be safer.

qualifying, a bank retains the responsibility to ensure that the bank maintains adequate capital for exposures to such a CCP.

In view of the fact that the European Commission has recently put forward a legislative proposal that includes a common EU regulatory framework for CCPs,[18] the appropriate and logical starting point for defining the conditions for qualifying CCPs is compliance with EU law (i.e. the abovementioned Regulation and all the implementing and delegated acts that would accompany it).

Such approach would not have a negative impact on the quality of the test since the proposed draft Regulation is based on the CPSS-IOSCO Recommendations (it actually contains requirements which are, in many cases, significantly stricter than the CPSS-IOSCO Recommendations).[19] Furthermore, the Regulation would introduce a single set of rules that would apply across the EU, and crucially, both to CCPs located in the EU as well as third-country CCPs wanting to offer their services to EU market participants. Second, it would simplify the process of determining whether or not a CCP complies with the first condition: only an authorised CCP (or, in case of third-country CCPs, a recognised CCP) would meet it.[20]

In this context, an additional possibility that should be explored would be to make the condition 2 a binding legal requirement. This would have the advantage of simplifying the above test, as only authorised or recognised CCPs would be qualifying.

Questions:

1. **Are the two conditions and the approach outlined above broadly appropriate? If not, please explain why and how they should be modified?**
2. **Would the two-tier system ensure the right incentive structure for banks (and, indirectly, for CCPs)? If not, why?**
3. **Would a single-tier system, i.e. one where only qualifying CCPs would be allowed to exist, be preferable? If so, could making condition 2 a legal requirement for CCPs be considered as a way of doing that? Are there any other ways in which this could be done?**
4. **Are there any legal, confidentiality or other obstacles that would prevent CCPs to fulfil condition 2?**

2.3. Qualifying vs. non-qualifying transactions

In addition to distinguishing between qualifying and non-qualifying CCPs, the BCBS consultation paper also (implicitly) distinguishes between qualifying and non-qualifying transactions. To be deemed qualifying, a transaction would need to fulfil two conditions:[21]

1. the CCP counterparty credit risk exposures with all its clearing members in its arrangements are fully collateralised on a daily basis; and

2. the transaction must not have been rejected by the CCP.

[18] See footnote 10.
[19] CPSS and IOSCO are currently in the process of reviewing the existing Recommendations for CCPs with a view to make them stricter. For more details see www.iosco.org/news/pdf/IOSCONEWS177.pdf.
[20] A direct consequence of this is that an EU bank could never have an exposure to a CCP that would fail to meet the first condition, as it could not do business with such a CCP in the first place.
[21] Please note that these conditions are already contained in Directive 2006/48/EC (point 6 of Annex III, Part 2).

The capital treatment of the exposures related to a qualifying transaction should depend on the type of CCP used, i.e. if the transaction would be cleared by a qualifying CCP, then the treatment should be the one specified for exposures to qualifying CCPs (and vice versa). The capital treatment of the exposures related to a non-qualifying transaction should be the one specified for exposures to non-qualifying CCPs, irrespective of the type of CCP used.

Questions:

5. Are there any potential difficulties in applying this approach? If so, which?

2.4. Direct vs. indirect access to a CCP

A bank can access a CCP directly, i.e. by becoming a clearing member of that CCP, or through an intermediary (indirectly), i.e. by becoming a client of a clearing member of that CCP. Ideally, a bank accessing a CCP indirectly should not be penalised compared to a bank accessing a CCP directly. However, in order to allow equal treatment regardless of the type of access, the indirectly accessing bank would need not to be exposed to a potential insolvency of its clearing member. This would require the following two conditions to be fulfilled simultaneously:

(a) the positions and assets (provided as collateral) of the indirectly accessing bank are identified and segregated[22] from the positions and assets of both the clearing member and those of the clearing member's other clients (both at the clearing member and the CCP level), provided that the margins that the clearing member post to the CCP in correspondence of its clients' positions are calculated on a gross basis,[23] and such segregation results in these positions and assets to be bankruptcy remote should the clearing member become insolvent; and

(b) relevant laws, regulation, rules and contractual arrangements ensure that in case of the insolvency of the clearing member the bank using that clearing member will be able to transfer its positions and corresponding collateral to another clearing member.

If the above two conditions are met, and indirectly accessing bank would be able to enjoy the same capital treatment as a directly accessing one (see section 3 below for more details).[24] In the opposite case, the exposures of the indirectly accessing bank should be treated as bilateral exposures.

Questions:

6. Is the proposed treatment of exposures of banks accessing a CCP indirectly appropriate? If not, why?

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[22] The Regulation introduces important rules on segregation and portability of positions and corresponding collateral.

[23] This is a requirement for full segregation. An alternative could be to require segregation of the client's positions and assets only from those of the clearing member (again, both at clearing member and CCP level), but not the other clients ("partial (i.e. omnibus) segregation"), provided that the margins that the clearing member post to the CCP in correspondence of its clients' positions are calculated on a gross basis. However, this alternative would not completely rule out the possibility of loss for the client in case of the default of its clearing member. A further alternative, which is to ask for segregation of assets and positions of the bank from those of the clearing member and the CCP, without specifying the type of margining, is being suggested by the BCBS consultation paper.

[24] The section on the capitalisation of exposures due to default fund contributions only applies to banks that are clearing members, since banks accessing a CCP indirectly usually do not have to contribute to the CCP's default fund.

7. Could requiring just partial (i.e. omnibus) segregation with gross margining of client positions at CCP level qualify for the same treatment as full segregation? Why?

3. Capitalisation of exposures

3.1. Trade exposures

For the purpose of this consultation paper, trade exposures include posted collateral, mark-to-market exposures and potential future exposures.

a) Qualifying CCPs

Trade exposures to qualifying CCPs benefit from the multilateral netting and loss mutualisation mechanism provided by such CCPs. As a consequence, they involve a very low counterparty credit risk and should therefore be subject to a very low capital charge. At the same time, this capital charge should be positive in order to ensure that banks track and monitor their exposures to CCPs as part of good risk management and to reflect that even trade exposures to qualifying CCPs are not risk-free. In view of this, trade exposures to qualifying CCPs should be subject to a capital charge equal to the product of the exposure at default (EAD) of these trade exposures multiplied by a 2% risk weight. The EAD should be calculated in the way specified in Annex III of the CRD.

If settlement is legally enforceable on a net basis, the total replacement cost of all contracts could be calculated as a net replacement cost. Where the respective methodology allows for it, margining could be taken into account.

Treatment of bankruptcy-remote collateral

If the collateral held by a qualifying CCP on a bank's behalf would be identified, segregated and remote from the insolvency of the CCP, no counterparty credit risk would be linked to such collateral. Therefore, no counterparty credit risk capital charge should be required as a result of the bank posting such collateral.[25]

b) Non-qualifying CCPs

Exposures to non-qualifying CCPs involve a higher level of counterparty credit risk than exposures to qualifying CCPs. Therefore, trade exposures to a non-qualifying CCP should be capitalised more strictly, namely as bilateral exposures. More specifically, banks should apply the Standardised Approach for credit risk in the main framework to their trade exposure to a non-qualifying CCP, according to the category of the counterparty. In determining the category of counterparty, the counterparty's status as a CCP should not be taken into account.

Questions:

8. Do you agree with the outlined approach to the capitalisation of trade exposures? If not, why?

9. Should the exception for bankruptcy-remote collateral in case of use of a qualifying CCP be extended also to collateral posted to non-qualifying CCPs, provided that the latter collateral complies with the same conditions? Why?

[25] However, where a bank posts collateral with a CCP, the bank continues to bear the risk associated with such collateral and must continue to capitalise its exposure to such collateral.

3.2. Exposures from default fund contributions

Margins posted by a bank to the CCP are used only if the bank that provided these margins would default on its obligations towards the CCP. They are used to cover any losses the CCP may incur with respect to the positions it had with the defaulting bank; they are not used to cover losses due to the default of other banks that are clearing members with the same CCP.

From this perspective, default fund contributions are different. By definition, the purpose of a CCP's default fund is to mutualise the losses among the CCP's clearing members, in case the losses incurred by the CCP are greater than the margin and default fund contribution provided by the defaulted clearing member (and any other defence the CCP may use before recurring to the default fund), the remaining loss gets covered, on a proportional basis, by the default fund contributions of the remaining clearing members.

In view of the above, the risk of loss associated with exposures from default fund contributions is higher than the one associated with trade exposures. Therefore, this type of exposures requires a higher capital charge.

The BCBS consultation paper outlines a risk-sensitive approach for identifying the amount of the capital charge. This approach takes into account the various defences (i.e. the "risk waterfall") that the CCP employs to manage the default of one or more of its clearing members. This section presents only the broad functioning of the approach proposed in the BCBS paper (for the details on the calculations, see Annex A of the BCBS consultation paper).

a) Qualifying CCPs

The proposed BCBS methodology is based on the concept of a CCP's "hypothetical capital"[26] (not to be mistaken with regulatory capital that CCPs are required to hold). This hypothetical capital is a quantity that estimates a CCP's exposure to its clearing members on a bilateral basis. It should be calculated using the current exposure method (CEM), and the standard credit risk mitigation techniques, in combination with a 20% risk weight from the standardised approach for credit risk. In order to obtain the hypothetical capital, the amount resulting from the above calculation should then be reduced by the initial margin held by the CCP, using the comprehensive approach with standard supervisory haircuts.

This hypothetical capital should then be used to establish the overall capital charge for all default fund contribution exposures to a CCP:

1. If a CCP's own pre-funded financial resources[27] exceed or match the CCP's hypothetical capital, the risk of a bank's default fund contribution being used in the event of the default of one or more clearing members is very low. Consequently, pre-funded default fund contributions should be capitalised at a rate of 1.6% (i.e. based on a 20% risk weight and the assumption of 8% total capital).
2. If a CCP's own pre-funded financial resources are less than the CCP's hypothetical capital, but the CCP's total (i.e. own plus those provided by clearing members[28]) pre-funded financial resources[29] exceed or match this capital, then clearing members would lose part of their default fund contributions (in aggregate, this loss would be equal to the amount by which the hypothetical capital exceeds the CCP's own pre-funded financial resources) in the event of the default of one or more clearing members. Consequently, the part of the default fund contributions

[26] Labelled as K_{CCP} in the BCBS consultation paper.
[27] Labelled as DF_{CCP} in the BCBS consultation paper.
[28] Labelled as ΣDF_{CM} in the BCBS consultation paper.
[29] Labelled as DF in the BCBS consultation paper.

that would be lost should be capitalised at a rate of 100% (i.e. based on a 1250% risk weight and the assumption of 8% total capital), while the remaining part of the default fund contributions should be capitalised at the rate specified under point (1) above.

3. If a CCP's total pre-funded financial resources are less then the hypothetical capital, then clearing members would lose all their default fund contributions. Consequently, all the default fund contributions should be capitalised at the rate specified under point 2. In addition, due to the fact that, in this scenario, a bank would effectively use a CCP with insufficient pre-funded financial resources to cope with a default of one or more of its clearing members,[30] a capital "surcharge" should be levied on clearing members. In particular, the amount by which the hypothetical capital exceeds the CCP's total pre-funded resources should be capitalised at the rate specified under point (2) multiplied by a scalar of 1.2. In this situation the CCP may also call on additional unfunded financial resources that clearing members had previously contractually committed to provide in such situations. These additional financial resources should also be subject to the surcharge mentioned above.[31]

The capital charge applicable to each clearing member[32] should be a pro-rata amount resulting from the above calculation (the share of each clearing member should be equal to the clearing member's share in the default fund).

If a default fund is shared between financial instruments with settlement risk only (securities) and financial instruments giving rise to counterparty credit risk (derivatives and SFTs) then all of the default fund contributions should receive the risk weight determined according to the approach outlined above, without apportioning to different classes or types of business or products.

Finally, it should be noted that the BCBS consultation paper makes an important simplifying assumption in case of scenario (3) above, namely that a CCP's clearing members have pre-committed to provide additional unfunded financial resources to be used in such situation and that these resources would be sufficient to cover the shortfall of pre-funded financial resources. This allowed the BCBS not to modify the assumption of low risk trade exposures (due to the existence of loss mutualisation).

b) Non-qualifying CCPs

A bank’s funded and unfunded, but contractually committed, default fund contributions to a non-qualifying CCP should be subject to the capital surcharge mentioned under point (3), or higher[33], in order to provide incentives to use "qualifying" CCPs, which are deemed to be safer.

Questions:

10. Do you agree with the approach to the capitalisation of default fund contribution exposures outlined above? If not, why?

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[30] The CCP may still be able to call upon unfunded financial resources that its clearing members have committed to provide in case the pre-funded financial resources run out.

[31] As the BCBS consultation paper explains, in such situation, the CCP is reliant on the solvency and liquidity of its clearing members in a stress period to provide additional resources to cover losses up to its hypothetical capital requirement. As it is plausible that some other clearing members will not answer the call, the risk of loss, or exposure of a solvent member bank, is greater.

[32] Labelled as K_{CM} in the BCBS consultation paper.

[33] The BCBS consultation paper suggests a capital charge based on the risk weight of 1250% for these exposures.

11. **Is it possible to improve the outlined approach by making adjustments to the Current Exposure Method? If so, how?**

12. **Could the outlined approach be used in a situation in which a CCP had multiple default funds covering different types of financial instruments, or would it need to be adjusted? If the latter, how?**

13. **Are there any other methods for calculating default fund contribution exposures or hypothetical capital that are both simple and easy to supervise? If so, which?**

14. **Is requiring bilateral capital treatment for trade exposures to a CCP whose total default fund is less than its hypothetical capital a more appropriate way to reflect the risk of being a member of such a CCP? If not, is there any alternative methodology that would allow achieving this goal? If yes, which?**

15. **Should CCPs be the ones calculating the hypothetical capital or could/should this calculation be performed by someone else? If the latter, who?**

16. **Do you agree with the proposed treatment of default fund contributions to non-qualifying CCPs and please explain why? In your view, what should be the risk weight associated with these exposures?**

3.3. Equity investment[34]

Where a bank has an investment in the capital of a CCP, such capital investment should be treated on an equivalent basis to an equity investment by a bank in a corresponding financial entity.

3.4. Other exposures[35]

Where a bank has a non-trade, non-default fund and non-equity exposure to a CCP (e.g. it provides a liquidity facility to a CCP), such exposure is a bilateral non-CCP related exposure and is to be capitalised under the regulatory capital framework in keeping with the capitalisation of any other such exposure.

[34] This is already covered by the general Basel II text provisions governing the capitalisation of equity investments in other entities.
[35] This result occurs due to the general Basel II text provisions governing the capitalisation of exposures.

II. Treatment of incurred credit valuation adjustments (CVA) - Recognition of CVA via reduced exposure or via provisions/increase of available capital

1. Introduction

In the February 2010 Consultative Document, the Commission services proposed that credit institutions should capitalise against the risk of future CVA losses. CVA is a fair value accounting concept by which a bank seeks to reflect the creditworthiness of its counterparty into the valuation of the OTC derivatives with that counterparty.

Several respondents to that consultation[36] expressed the view that capital requirements (including a capital charge for *future* CVA losses) based on the full exposure to derivatives would not be appropriate because they do not reflect the fact that some of that exposure has already been written down in the form of an *incurred* CVA (i.e. the CVA that has already been recognised by the bank against income). In essence, these comments indicated that the total capital charge should be based on the sum of expected and unexpected losses from counterparty credit quality deterioration and default minus incurred CVAs already recognised against income.

Those respondents argued that if a firm had opted to take a conservative CVA adjustment, this was equivalent to an upfront write down of some potential future losses, and accordingly it would be redundant to impose a capital charge on the corresponding amount of exposures. This issue is related to comments received on firms' individual CVA marking practices. It was furthermore argued that one advantage to an approach which took into account incurred CVA in the default risk capital charge is that it would reward firms with more conservative incurred CVA marking approaches while penalising those with lower incurred CVA.

2. Basel III treatment

In recognition of the fact that the amounts already written off by the firms cannot be lost again in case of default, the Basel Committee on Banking Supervision has agreed on the following treatment:[37]

In calculating the counterparty credit (default) risk capital charge (i.e. IMM, CEM or SM), the incurred CVA for a given counterparty (i.e. the CVA that has already been recognised by the bank against income) is subtracted from the sum of the Exposure At Defaults (EADs) across all netting sets with that counterparty. This CVA is calculated without taking into account any offsetting Debit Valuation Adjustments (DVA) [38] which have to be deducted from capital.[39] The new standard explicitly specifies that this reduction of EAD by incurred CVA losses does not apply to the determination of the CVA risk capital charge but only to the determination of the counterparty credit (default) risk capital charge.

[36] E.g. BNP Paribas or Goldman Sachs. Responses authorised for publication are accessible at: http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/requirements_directive_1&vm=detailed&sb=Title

[37] Paragraph 99 of the Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010: http://www.bis.org/publ/bcbs189.pdf

[38] DVA (debit valuation adjustment) is the reverse of CVA, as the bank reflects its own riskiness into the valuation of the OTC derivatives with its counterparty (and is generally not considered for capital purposes). The net of CVA and DVA results in unrealised accounting profit and loss.

[39] The incurred CVA loss deduced from exposures to determine outstanding EAD is the CVA loss gross of all Debit Valuation Adjustments (DVA) which have been separately deducted from capital. To the extent DVA has not been separately deducted from a bank's capital, the incurred CVA loss used to determine outstanding EAD will be net of such DVA.

When publishing this new rule in December 2010, the Basel Committee on Banking Supervision made it clear that the above treatment is subject to a final impact assessment, which is currently ongoing and targeted for completion in the first quarter of 2011. The impact assessment is assessing whether the reduction in the EAD could, without resulting in inadequate capitalisation, be a larger amount to reflect the offset to future loss represented by the incurred CVA (e.g. incurred CVA divided by LGD). The Commission services intend to give due consideration to the results of this impact assessment before finalising their proposal on this issue.

3. Existing treatment in the EU

The current treatment stipulated in the CRD[40] allows credit institutions that apply the IRB approach to treat incurred CVA as equivalent to a provision[41] and to add its excess over expected loss (EL) to own funds, up to 0.6% of risk weighted exposure amounts[42].

Such treatment effectively allows incurred CVA to be counted toward the eligible provisions[43] to offset EL and thus directly *increase available capital*, subject to the 0.6% cap. This concept, using the analogy to loan provisions, is different from approach set out in the new Basel III framework. The latter will, as described above, recognise incurred CVA by *reducing the exposure amount* to which the counterparty credit risk capital charge is applied and will, by consequence, typically result in a less favourable overall capital position.

4. Comparison of recognising incurred CVA via provisions/increase of available capital with recognising incurred CVA by reducing the exposure amount

Both treatments have their advantages and disadvantages:

i. ***Recognition of incurred CVA via provisions/increase of available capital***: It leverages an existing treatment for credit risk exposures, which, however could pose challenges in terms of the appropriate calibration: Treating the excess of incurred CVA above EL as Tier 2 capital may be unduly penal (with limited countercyclical effects); whilst treating it as Tier 1 capital may be excessively generous (with more countercyclical effects). In particular, the latter option could reverse out completely the fair value write-down made to value capital resources, if it is not possible to enforce a trade level cap on the quantum of incurred CVA written back to capital resources[44]. Alternatively, in order to address this trade-off, a combination of the two scenarios could be considered, i.e. that a part of the excess of incurred CVA above EL (e.g. 50%) is treated as Tier 1 capital, while the rest as Tier 2 capital. Such treatment, if appropriately calibrated, could possibly represent a more balanced approach how to recognise incurred CVA, both in terms of the overall impact on capital resources and counter-cyclicality.

ii. ***Recognition of incurred CVA via reduced exposure***: Treating incurred CVA as a risk-neutral price correction/value adjustment, rather than as a provision, would dispense from the need to dissect incurred CVA into impaired/performing cases or to separate 1-

[40] Article 17(1)(a) of Directive 2006/49/EC in conjunction with Article 63(3) of Directive 2006/48/EC.

[41] And include it in the sum of value adjustments and provisions made for loans/"classical" credit risk.

[42] For the sake of completeness, it has to be noted that Article 17(1)(b) of Directive 2006/49/EC also allows the credit institutions, which apply the IRB approach, subject to the approval of the competent authorities, to set the expected loss amount for the counterparty risk exposure to zero, if the credit risk of the counterparty is adequately taken into account in the valuation of a position included in the trading book. In the context of the Commission's efforts to create single rule book in banking and to remove options and national discretions from the Directive, the Commission will reflect on the appropriateness of this treatment (and in particular it coexistence with the approach set out in Article 17(1)(a) and will consider whether any changes are desirable).

[43] Any provisions, i.e. not only those related to counterparty credit risk.

[44] For example by leveraging the alternative to the EL less provisions approach, detailed in footnote 44.

year/lifetime expected future losses implicit in CVA. However, such approach would result in a situation where CVA is fully deducted from capital resources but only a fraction of it (8% times the applicable risk weight) is deducted from capital requirements. If firms had complete latitude as to the magnitude of incurred CVA this may possibly result in incentives to mark these as low as possible.

Questions:

17. How do you currently treat incurred CVA

a) in the regulatory capital for market and counterparty credit risk; and

b) in the internal capital adequacy assessment?

18. Do you separate 1-year and lifetime expected future losses implicit in CVA and if so, how do you do it and how do you treat each part? Could you please characterise how such separation could be carried out? What are the main challenges arising from this separation and the respective treatment?

19. What are the key pros and cons of recognising incurred CVA via provisions/increase of available capital and recognising incurred CVA by reducing the exposure amount?

20. What regulatory treatment for incurred CVA do you consider conceptually as the most appropriate and why?

21. If you suggest recognising incurred CVA by reducing the exposure amount when calculating the counterparty credit risk charge, could you please specify the appropriate amount (e.g. CVA only, CVA divided by LGD etc) by which the exposure amount should be reduced and why?

22. If you suggest treating incurred CVA as equivalent to a provision:

a) What treatment should be applied to credit institutions applying the IRB approach? Please justify and elaborate on both the effect on capital resources and counter-cyclicality.

b) Should incurred CVA be compared to total EL for counterparty credit risk only or to total EL arising also from credit risk, or against EL on the specific asset, or netting set against which it was taken?

c) Should the respective increase of available capital be limited and if so, please specify the appropriate limit.

d) What treatment should be applied to credit institutions applying the standardised approach?

23. If you suggest using the approach detailed in footnote 44, please explain why and indicate whether any changes to that treatment are necessary.

24. If you suggest a different alternative to the treatments mentioned in questions 21 - 23, please specify its details and why you consider that such treatment would be prudentially sound.

25. Why do you consider the other alternative(s) to your preferred approach to be unsuitable?

26. Please assess the likely consequences and impact (both qualitative and quantitative) of all the options considered above? To the extent possible, please cover both benign and stressed periods for such assessment.

27. Should incurred CVA losses also be recognised in calculation of the CVA capital charge? If so, why and how? Do you recognise incurred CVA when determining VaR of CVA or when calculating CVA sensitivities for hedging purposes? If so, how? Are you able to reflect the maximum loss at individual counterparty level when simulating changes in CVA? How material is the impact?

28. Please provide an estimate of the impact of the current CRD approach, the Basel III approach and your own suggested treatment for your own firm (differentiated by available own funds, exposure at default and capital requirement).

29. Please provide any further information (both of qualitative and quantitative nature) you consider relevant for the purposes of finalising the upcoming legislative proposal on this issue.