Revised credit valuation adjustment risk framework

Basel Committee final standards released July 8, 2020

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Highlights

Postponed go-live date by one year to January 1, 2023 due to COVID-19[6]

Less conservative capital requirements for both SA-CVA and BA-CVA through multiple changes, including:

- Risk weight reduction
- Capital multiplier recalibration
- Cross-bucket aggregation formula adjustment

Better alignment to the revised market risk framework and counterparty credit risk framework

Operational relief through:

- Limitation of covered fair valued SFTs to material exposures
- Introduction of new index buckets, eliminating requirement to decompose

Industry proposals not addressed included:

- Increased granularity in counterparty credit risk weights
- Exclusion of all SFTs from CVA capital charge
- Clarifications regarding the treatment of guarantees and the flexibility to estimate the appropriate ELGD

[1] "BCBS "Basel III: Finalizing post-crisis reforms," *BIS website*, https://www.bis.org/bcbs/publ/d424.pdf, December 2017
[2] BCBS "Basel III Monitoring Report," *BIS website*, https://www.bis.org/bcbs/publ/d500.pdf, April 2020
[3] ISDA GFMA IIF "BCBS Consultation – Credit Valuation Adjustment risk: targeted final revisions Industry response," *ISDA website*, https://www.isda.org/a/72oTE/ISDA_GFMA_IIF_CVA_Consultation_Response.pdf, February 2020
[4] BCBS Consultative Document "Credit Valuation Adjustment Risk: targeted final revisions," BIS website, https://www.bis.org/bcbs/publ/d488.pdf, November 2019
[5] BCBS "Targeted revisions to the credit valuation adjustment risk framework," BIS website, https://www.bis.org/bcbs/publ/d507.pdf, July 2020
[6] BCBS "Governors and Heads of Supervision announce deferral of Basel III implementation to increase operational capacity of banks and supervisors to respond to Covid-19", BIS website, https://www.bis.org/press/p200327.htm, March 2020

Introduction

The revised credit valuation adjustment (CVA) risk framework aims to achieve enhanced risk sensitivity, improved hedge recognition and better consistency with accounting CVA and the Fundamental Review of the Trading Book (FRTB) market risk framework. The revised CVA standards, released on July 08, 2020 by the Basel Committee on Banking Supervision (BCBS), were first published five years ago and involved several industry consultations, frequently asked questions (FAQs) and impact studies.

December 2017 standards[1]

The December 2017 standards replaced the current Basel III counterparty exposure at default (EAD) and the value-at-risk (VaR) based framework with two alternative approaches to calculating CVA risks:

Basic approach (BA-CVA): An exposure-based calculation utilizing EADs from the Basel III counterparty credit risk (CCR) framework, prescribed risk weights and capital calculation formulas

Standardized approach (SA-CVA): A sensitivity-based calculation similar to the FRTB Standardized Approach (FRTB-SA) for capitalizing market risk, requiring supervisory approval

Industry participants provided feedback that these standards had overly conservative calibrations. The calibrations resulted in capital charges that were disproportionate to the economic risks. The latest Basel III monitoring report from BCBS showed a weighted average capital charge increase of 47% in Europe, 43% in the Americas and 45% for the rest of the world.[2] The Quantitative Impact Study (QIS) performed by the industry showed an even higher capital charge increase of 58%.[3]

November 2019 consultation[4]

In light of revisions to the FRTB market risk standards in January 2019 and industry feedback, BCBS proposed targeted and final revisions to the CVA standards. Published in November 2019, the consultation document comprised of two types of revisions:

Alignment with the FRTB-SA framework, including adjustment to risk weights, introduction of index buckets for credit and equity sensitivities, and a revised aggregation formula

Additional targeted revisions, including the treatment of client-cleared derivatives to better align with the CCR framework, exclusion of immaterial CVA exposures to secured financing transactions (SFTs), reducing the SA-CVA multiplier (m_{CVA}) and the implementation of a discount scalar for BA-CVA capital charges

While the proposal addressed some of the industry feedback on the overly conservative calibration of the CVA risk framework, certain items were not addressed, including the divergence between accounting CVA and regulatory CVA, and the appropriateness of using the same rules across both reference and counterparty credit spread risks (e.g., risk weights, bucketing structure).

July 2020 final standards[5]

The July 2020 final standards adopt all proposals from the November 2019 consultation. However, the final standards did not address some of the industry's additional recommendations (see page 3 for further details).

The table below highlights key updates within the final BCBS CVA requirements, compared to the previous December 2017 standards and the November 2019 consultation.

Framework component		July 2020 update
Timeline	Go-live date	Confirmed to be January 1, 2023
Scope	Adjusted population scope	Client cleared derivatives exposures transacted indirectly with qualified central clearing counterparties (CCPs) (i.e., through a clearing member) are also exempted from CVA capital requirements, in addition to direct transactions with qualified CCPs
		Fair-valued SFTs where the CVA risks are deemed immaterial can be excluded; in such cases, the bank must justify and provide documentation of a materiality assessment to its supervisors
SA-CVA	Margin Period of Risk (MPoR)	Reduced MPoR floor for SFTs and client-cleared transactions to 4+N business days (N is the re-margining period in the margin agreement), aligning to the CCR framework
	Risk weights	Reduced delta risk weights to better align with the FRTB market risk framework for the following risk classes: ► Interest rate: reduced by 30% (relative change) for all tenors and currencies ► Foreign exchange: reduced from 21% to 11% for all currencies ► Credit spread: high yield (HY) and non-rated (NR) sovereigns' risk weights lowered from 3% to 2% (for both counterparty credit risk and reference credit risk)
		Capped vega risk weights at 100% to be consistent with the FRTB market risk framework for the following risk classes: ► Interest rate: reduced from 135% for all currencies ► Foreign exchange: reduced from 110% for all currencies ► Reference credit spread: reduced from 191% ► Equity: reduced from 135% for non-large cap entities ► Commodity: reduced from 191%
	Index buckets	Introduced new "index level" buckets: Counterparty credit, reference credit and equity indices that meet the same liquidity and diversification eligibility criteria stated in the FRTB market risk rule can be assigned to a corresponding index bucket. Indices that are assigned to the new buckets do not require decomposition and looking through of underlying constituents
	Cross-bucket aggregation formula	Revised cross-bucket component of aggregation formula to use the sum of weighted sensitivities for each bucket instead of the capital for each bucket; this will improve the recognition of CVA hedges, particularly for index hedges
	SA-CVA Multiplier	Reduced value of the multiplier: The minimum multiplier m_{CVA} is reduced from 1.25 to 1. This multiplier may be raised at the discretion of a bank's supervisors if the model risk for CVA sensitivity calculation is deemed too high
BA-CVA	Discount scalar	Introduced new discount scalar: A discount scalar (DS_{BA-CVA} = 0.65) is applied to BA-CVA capital charges (both reduced and full approaches) in order to achieve an appropriate calibration relative to SA-CVA
	Risk weights	Reduced risk weights (RW_C) from 3% to 2% for HY and NR sovereign counterparties; this is the same adjustment made to HY and NR sovereign counterparties' risk weight used in SA-CVA

Items not addressed

The July 2020 final standards did not address some of the industry requests for further calibration or other revisions to better reflect underlying economic risks. Examples of public feedback[7] not addressed include:

Greater alignment between accounting and regulatory CVA

- Population scope: The request to exclude all client-cleared transactions and SFTs from CVA capital requirements was not adopted.
- Modeling parameters: The request to floor the MPoR according to the accounting CVA rules (e.g., at 4+N business days instead of 9+N business days) and allow more flexibility to estimate expected loss-given-default (ELGD) (e.g., based on accounting CVA practices) was not adopted.

Enhance risk sensitivity within the counterparty credit spread risk class

- Risk buckets and risk weights: The request to increase granularity of risk weights, especially for financial counterparties, to recognize the differentiation in counterparties' risk profiles was not adopted. This would have improved the mapping of exposures to industry sectors based on the underlying risk, which would lead to enhanced risk sensitivity.
- Index hedge recognition: The request to use a portfolio-level aggregation formula with a higher correlation between the index and portfolio-level risk instead of the existing cross-bucket aggregation formula was not adopted. This alternative approach would have better reflected the risk-reducing impact of portfolio hedges.

Items that may require further guidance

The final standards were silent on a few topics that remain open to interpretation, including eligibility of over-hedges, collateral modeling and collateral allocation for split SA/BA netting sets, and capitalization of other valuation adjustments, as well as jurisdiction-specific implementation considerations (e.g., capital floor applicability, capital stress testing).

The time to act is now

Notwithstanding the progress firms may have made to date on their regulatory CVA programs, there is a significant effort required to comply with new rules as a result of the complexity, the requirement for regulatory approval to use SA-CVA and the potential need for changes to CVA models and supporting technology infrastructure. While the go-live date is still more than two years away, firms should continue their preparation and make key decisions on their strategy.

Critical near-term activities

- Updating risk-weighted asset impact assessments to reflect the final requirements so that impacts to SA-CVA and BA-CVA calculation approach, strategy and portfolio coverage can be determined
- Updating gap analyses and project plans across framework components to facilitate appropriate budget allocation, resourcing, and governance and dependency management
- Assessing and prioritizing any enhancements to CVA models, technology/data infrastructure (e.g., capital calculators, population, risk factor bucketing, reporting) and business processes to support revised CVA risk framework
- Briefing senior management and driving broader firm awareness of the requirements and their business implications and engaging key stakeholders from the front office, risk, finance, technology and other functions in planning for full implementation

[7] ISDA GFMA IIF "BCBS Consultation – Credit Valuation Adjustment risk: targeted final revisions Industry response," *ISDA website*, https://www.isda.org/a/72oTE/ISDA_GFMA_IIF_CVA_Consultation_Response.pdf, February 2020

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