

Basel Committee on Banking Supervision – Consultative Document: Application of own credit risk adjustments to derivatives

Contact:

Dr Olaf Achteik

Telephone: +49 30 2021-2323

Email: o.achelik@bvr.de

Berlin, 17 February 2012

Federführer:

Bundesverband der Deutschen
Volksbanken und Raiffeisenbanken e. V.
Schellingstraße 4 | 10785 Berlin
Telefon: +49 30 2021-0
Telefax: +49 30 2021-1900
www.die-deutsche-kreditwirtschaft.de

Consultative Document: Application of own credit risk adjustments to derivatives

Dear Sir or Madam,

In December 2011, the Basel Committee on Banking Supervision started a public consultation on the application of own credit risk adjustments to derivatives. On behalf of the German Banking Industry Committee we welcome the opportunity to comment on this consultation paper.

We basically understand the rationale of an extension of paragraph 75 of the Basel III rules text to include fair valued derivatives, as considered by the Basel Committee, in view of the fact that the CVA can be calculated as bilateral CVA from a prudential point of view. Notwithstanding the foregoing, however, the implementation of the proposal would clearly reduce market efficiency so that it is not entirely possible to rule out negative macroeconomic consequences. Below, please find the reasons why we have strong reservations over the proposal and, on principle, reject the latter.

First, the wording "*derivatives liabilities*" leaves the regulatory scope of the proposal unclear. For instance, this expression might also refer to only those derivatives that are reflected in the liabilities section of the balance sheet. However, it will hardly be possible to predicate the calculation logic on only one part of the transactions: Firstly, because transactions may change the balance sheet side and secondly, because other scenarios, such as netting, have to be taken into account. Hence, it is our understanding that, as far derivatives are concerned, this term will generally refer to the payer side regardless of the value shown in the balance sheet.

As far as derivatives are concerned, the DVA is a *conditio sine qua non* for facilitating trade close to the mid-price i.e. for keeping the bid-ask spreads low. Should, however, both counterparties calculate their derivatives in a way as if they themselves were risk-free, then both of them would have to fully recognise the credit risk component (CVA and risk on CVA) during such pricing exercise - even in the absence of any economic justification for this. This would result in a significant widening of the bid-ask spreads in interbanking trade, in effect driving up the hedging costs. In the final analysis, such an approach would also have a negative impact on the end consumer. In our view, it would lead to considerable macroeconomic damage.

On the whole, the proposed regulatory approach of a "full deduction of DVA" overestimates the risk. Hence, it can be regarded as an overly conservative approach as it leads to a full deduction equal to the net present value of the bank's credit risk premium from Common Equity Tier 1 on the closing data (or, moreover at trade inception), rather than a mere neutralisation of the equity increasing effects resulting from a deterioration of the credit spread. This is also confirmed by the Basel Committee itself ("*...this option is generally more conservative*"). In the final analysis, this would lead to an *ad hoc* assumption of a hidden burden or capital consumption. Furthermore, since the regulatory scope of the present proposal is not merely confined to the trading book, it would also significantly curtail the potential use of derivatives for risk management purposes.

Whilst we understand that there are practical implementation difficulties when it comes to the discarded alternative approaches set out in the annex, in view of the general scarcity of Common Equity Tier 1 and the host of increasingly stringent regulatory provisions, we still perceive the need for contemplating further alternative options. *In lieu* of the proposals which have been outlined in the consultation paper, we feel that other, more pragmatic solutions, would be more appropriate. For instance, one alternative solution might read as follows: The delta between the DVA on the basis of the current own credit spread and a DVA on the basis of a long-term average value of the own credit risk shall be deducted from

Consultative Document: Application of own credit risk adjustments to derivatives

Common Equity Tier 1. At this juncture, by means of a haircut, there could still be a conservative adjustment or, moreover, reduction of the average credit spread. Another regulatory choice might be that only a potential OCS overhang per counterparty be deducted, i.e. that the prudential filter be adjusted to accommodate said delta. Due to the fact that OTC derivatives constitute bilateral transactions, both the parameters for valuation of counterparty risk and also for own credit risk might feature general market risk premiums/liquidity premiums with a very high negative correlation. Any unilateral consideration of these premiums would not be fit for purpose.

As a minimum, in order to spread the effect of first-time-application over a period of preferably four years, an incremental phase-in should apply or a transitional regime should be created.

Furthermore, it is our understanding that, essentially, a deduction from Common Equity Tier 1 should only apply if the deduction has not already been reflected in own funds by profit and loss statement. In order to reflect potentially forthcoming future developments in the accounting rules, we suggest including this clarification. Furthermore, we suggest clarifying that banks which refrain from valuation adjustments for their own credit risk during accounting for derivatives shall not have to calculate DVAs for the purposes of prudential supervision.

We would appreciate it if our views were taken into account in the ongoing consultation process. We would be happy to provide further information about any of the issues raised.

Yours sincerely,
On behalf of the German Banking Industry Committee
Federal Association of German Cooperative Banks



Dr. Holger Mielk



Peter Langweg