Credit Valuation Adjustment (CVA) Capital Framework

- **Risk** ([www.risk.net](http://www.risk.net)): Banks shun internal models in CVA impact study. Accounting exposures win out as banks seek to align capital with front-office practice.

- Banks have picked a winner from the two exposure modelling choices offered in an overhaul of the credit valuation adjustment (CVA) capital framework, opting universally for an accounting-based approach that promises to make their hedges more effective.

- Risk reports that currently, most big dealers use what is known as the internal model method (IMM) to calculate their exposure for CVA, which can be very different from the numbers they report for accounting purposes. They then face the choice of which figures to hedge. Mitigating the regulatory capital requirement can result in an accounting loss – Deutsche Bank, for example, racked up losses of more than EUR 400mn in the space of about 18 months as a result of its decision to seek CVA capital relief.

- "The CVA hedges are going to be a better match for the accounting rather than the IMM model. We hedge the accounting model because that represents our economic risk," says the head of CVA trading at a major Swiss bank in London.

- Four banks told Risk they will only be submitting results based on accounting exposure – known as option A – for a quantitative impact study (QIS) being run by the Basel Committee on Banking Supervision. A fifth bank said it is keen on switching to option A as soon as possible, even though it went for option B – the IMM approach – in the impact study.

- IMM exposure models are typically based on historical data, whereas accounting models rely on fair value or values implied from market prices. The latter is most in line with industry practice, feeding into the pricing for new trades and the hedging of existing ones.

- Risk reports that allowing banks to apply the accounting exposure approach could have significant capital benefits. Under the current regulatory framework, CVA capital requirements can be reduced by hedging, but under strict conditions – only credit derivatives can be used and no recognition is allowed of the market risk hedges that might limit real-world exposure amounts.

- Crucially, the CVA numbers themselves are also different from those calculated under accounting rules. Closing the gap between regulatory and accounting CVA should mean banks no longer face a choice of which numbers to use when running their business, says Jon Gregory, an independent XVA consultant based in London.

- To read the full Risk article, please [click here](http://www.risk.net).

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■ "Naturally, I would want my risk sensitivities to be driven from my front-office analytics. It might be less advantageous to use an IMM-approved methodology because this will create misalignment. The CVA desk may have put in a lot of effort building their analytics – in particular with respect to calculating sensitivities – and this would most obviously feed the capital numbers, so they get the right amount of capital relief."

■ Risk reports that this thinking is behind one regional European bank's plan to adopt the accounting approach to exposure calculation: "For the short term we are with option B, but we are rapidly converging our CVA front office and CVA capital setups, effectively switching to option A," says one of the bank's traders.

■ As well as these philosophical considerations, some banks' decisions about what to use for the QIS were based on more practical issues, such as the timeline and existing data. Banks were required to carry out the QIS for both the revised CVA framework and the latest amendments to the Basel Committee's Fundamental review of the trading book (FRTB) in a matter of two months. The deadline for both falls on October 18.

■ "Timewise, it was impossible. We only calculated option A because we were able to produce the sensitivities, and we don't have the data for the other one so we didn't try," says a senior manager responsible for risk measurement and analysis at a regional European bank.

■ Risk reports that a major US bank made the same choice. "I think regulators have let it be known that if we are going to struggle with option B in the allotted timeframe for the QIS, they would want us to focus on option A – so we are just focusing on that," says a senior adviser on regulatory reform and risk at the bank in London.

■ The revised CVA framework offers banks two wider modelling choices – the basic approach for banks that do not have a well-developed CVA function and a modelling approach that is known as FRTB-CVA. FRTB-CVA is further split into standardized and advanced methods, both of which allow banks the two options for the calculation of exposures. Combining the various options, banks have five different paths to follow: basic; standardized with accounting exposure; standardized with IMM exposure; advanced with accounting exposure; and advanced with IMM exposure.

■ Risk reports that the latest consultation paper, published in July, asks banks whether capital-modelling approval should be an additional requirement for a bank to be eligible to use option A in conjunction with FRTB-CVA.

■ "Personally, we would expect that banks would probably answer no to this question. The IMM approval process is aligned most closely with option B rather than risk-neutral accounting CVA models. It is not clear what benefit having an additional IMM approval requirement in the context of option A would bring to either market participants or regulators," says the head of the quantitative research team for CVA and funding valuation adjustment at a UK bank in London.

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■ Risk: Banks shun internal models in CVA impact study.

■ (Source: Risk www.risk.net).

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