EACT Statement on the EBA Review of CRR CVA exemption

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The European Association of Corporate Treasurers (EACT)

The EACT is a grouping of national associations representing treasury and finance professionals in 18 countries of the European Union. We bring together about 13,000 members representing 6,500 groups/companies located in the EU. We comment to the European authorities, national governments, regulators and standard-setters on issues faced by treasury and finance professionals across Europe.

We seek to encourage the profession of treasury, corporate finance and risk management, promoting the value of treasury skills through best practice and education.

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Introduction

At the end of February 2015, the European Banking Authority published its advice to the European Commission on the application of Credit Valuation Adjustment (CVA) risk capital charge exemptions in the Capital Requirements Regulation (CRR)[1]. In essence, in this opinion the EBA concludes that CVA risks not covered in CRR due to the exemption can be material. Therefore the EBA plans to impose supervisory measures that could oblige banks to offset the impact of the CVA exemption by imposing additional capital charges for exempted transactions. The EBA further considers that the exemption should eventually be eliminated by aligning CRR with the Basel framework.

In this paper we make the following points as a reaction to the EBA's opinion:

[1] http://www.eba.europa.eu/documents/10180/950548/EBA+Report+on+CVA.pdf

- Non-financial companies (NFCs) require fairly market-priced, tailor-made and widely offered OTC derivative products to protect their core business activities from financial risks. The use of OTC derivatives by NFCs is part of prudent company risk management which contributes to financial stability by making these NFCs less risky to their financial counterparties, suppliers, customers, employees and to economic stability in general. This was recognised by the EU legislator in the exemption granted from central clearing in the European Market Infrastructure Regulation (EMIR) and the read-across exemption for CVA risk capital charge in CRR.

- The analysis of CVA risks done by the EBA is only partially valid and does not take into account the specificity of banks' CVA risk exposures to NFCs, the fundamental policy objective underlying the exemption or the impact on the financial system as a whole resulting from deletion or modification of the exemption.

- Imposing higher capital charges through supervisory measures for currently exempted transactions would mean that the effect of the exemption would be largely eliminated. This would cause uncertainty on the market and therefore higher prices and reduced number of bank counterparties for NFC OTC derivative transactions. This in turn would lead to reduced hedging by NFCs and therefore higher levels of risk being left in the real economy.

- Furthermore, we strongly question the EBA's mandate to impose supervisory measures that will go against the level 1 text that has been democratically agreed upon by the EU legislator.

- The EACT therefore requests that the EBA does not oblige additional capital charges for any transactions subject to the CVA risk calculation exemptions in CRR. We furthermore advocate that the EU maintains the current exemptions in any future adaptation of the Basel rules, due to the particular needs of EU non-financial companies.

Background

CRR introduced in its Article Art. 382 (3) an exemption for CVA charges for OTC derivatives transactions that have been exempted from central clearing under EMIR Article 10. This exemption was adopted by the EU legislator in order to preserve the economic value of the EMIR central clearing exemption, as applying CVA charges on

these transactions would have substantially increased the cost of hedging, as well as probably reduced the amount of risk-mitigating hedging.

These two exemptions recognise the important role that non-cleared OTC derivatives play in companies' risk management.

Non-financial companies, as end-users, enter into OTC derivatives transactions to hedge the impact of movements in currencies, interest rates, commodity and other market prices. This allows them to focus on their core purpose of building strong businesses, which through their growth create employment and further investment.

The access of non-financial companies to OTC derivative products with no obligation to centrally clear must be maintained as it is beneficial to the economy and reduces systemic risk instead of increasing it. Non-financial companies use derivatives for reducing risks of underlying commercial and industrial operations. They do not enter such derivatives for speculative purposes and do not pose systemic risks by their derivative transactions. Furthermore, the use of derivatives for hedging does not simply reduce operational risks for non-financial companies themselves; it also reduces risks for the banks which lend to these companies and hence contributes to the global stability of the financial system.

EBA Report

On 25 February 2015 the European Banking Authority published its advice to the European Commission on CVA.

The main findings that the EBA report makes concerning the exemption for non-financial counterparties are the following:

- The EBA considers that CVA risks not covered by the legislation can be material and that after the Basel framework review, they should be reconsidered or removed from the EU legislation.

- Transactions exempted from the CVA risk charge should be monitored, and potential situations of excessive CVA risks should be addressed. To this end, the EBA will issue guidance specifying what may lead to a situation of excessive CVA risk; national supervisors will impose additional capital requirements based on these guidelines as part of banks' Supervisory Review and Evaluation Process (SREP). However the EBA recognises that supervisory measures cannot substantially reverse the impact of the exemption.

EACT Reaction to EBA Report

The EACT strongly contests the EBA criticism of the CVA exemption for non-cleared OTC derivatives entered into by non-financial counterparties, both on substance and on procedure:

1. The substance:

The EBA report shows a complete lack of understanding of NFCs' usage or needs of OTC derivatives and of the policy goals behind the CVA exemption.

In our view the Report takes a very limited approach in the analysis on CVA risks – we would in particular criticise the following aspects of the report:

- The EBA report first highlights the importance of exempted NFCs by counting the number of counterparties (Figure 16 on page 53). We see no value in this argument, as this is perfectly natural since NFCs represent the entire non-financial economy, with a far larger number of legal entities than financial counterparties.

- Then the EBA report highlights that the total CVA charge of exempted counterparties represents a material amount (Figure 17 on page 54 and subsequent paragraphs). We point out that assessing the systemic risk by using that number is flawed. There is indeed a fundamental difference in the CVA risks posed by NFCs compared to financial counterparties: NFCs' business and default risks are much less correlated and therefore less systemically important than those of financial institutions; therefore the CVA risk due to non-financial counterparties cannot be treated in the same way as that of financial counterparties. The sector diversification of NFCs means that correlation is low and in consequence, the CVA risk of the diversified portfolio is far smaller than the arithmetic sum of the CVAs as presented in Figure 7. In addition, due to the high number of counterparties, the individual NFC risk is not a threat to the system. Also, hedging transactions are generally matched in the NFCs by equal and opposite business flows, which further reduces the riskiness of their transactions.

- The EBA ignores what is yet evident from its own figures: the fact that historically the CVA losses due to NFCs have been negligible, as pointed out in figure 7 (on page 25). Most CVA losses have occurred in CDOs linked to ABSs and mono-line Insurers - instruments and sectors totally unrelated to NFCs.

- The EBA ignores the underlying reasons and justification of the CVA exemption and the reasons for NFCs engaging on OTC derivative transactions. Therefore we do not accept the EBA statement (pages 58-59) that the exemption both from central clearing and CVA charges may be justified only for SMEs. The size of the company is irrelevant as to the ability to support liquidity risk or higher hedging costs. Large companies have larger derivatives portfolios due the scale of their business operations, and would suffer most from an amendment of the exemptions.

- The report does not take into account the fact that the reduction in risk mitigation by NFCs as a consequence of any deletion or amendment of the CVA exemption will make NFCs more risky as counterparties to financial institutions. Hedging improves the overall risk profile and credit worthiness of companies.

- Also pushing for cleared derivatives transactions (which the EBA seems to imply) where collateral is posted would not make the system overall safer, as risk would simply be moved from financial institutions –where this risk can be dealt with – to non-financial companies that are less equipped to deal with the liquidity risks involved. Furthermore, NFCs would have to have credit lines at banks in order to hope to face margin calls, which would add another layer of counterparty risk for banks also. In a worst case, it could create stress on the liquidity of companies and force them to stop hedging. This in turn would create volatility and business risk.

- As regard to the EBA suggestion to align the EU capital requirements framework with the Basel framework in the future, i.e. deleting the current CVA exemption for corporate end-users, it should be noted that it is in our view justified that the EU legislator adapts the Basel framework to better reflect the fundamental differences with companies in other jurisdictions. Indeed, EU companies have a greater need for hedging for structural reasons. For instance, compared to their US counterparts, EU companies have much higher FX exposures due to the importance of exports and the fact that the US dollar is a dominant currency in many markets; and EU companies have different funding patterns compared to US companies, which calls the need for hedging interest rate risk.

2. The procedure:

We believe that it is totally inappropriate for an ESA to interfere on the level 1 text and propose supervisory measures that will in effect go against what has been democratically decided at level 1. The EU legislator willingly – and based on solid arguments – decided to exempt from CVA charges the transactions of non-financial counterparties that are subject to the central clearing exemption on EMIR. This was the result of a democratic process and resulted from the legislator's willingness not to remove the economic effect of the EMIR central clearing exemption by imposing CVA charges under CRR.

The EBA itself recognises in its report that it has no legal mandate to challenge the CVA exemption itself at this stage. Indeed, CRR Article 382(5) only calls on the EBA to review the calibration and thresholds for application of CVA risk capital charges to non-financial counterparties established in a third country. Article 456 states that EBA shall monitor the own fund requirements for credit valuation adjustment risk and by 1 January 2015 submit a report to the Commission but that this report can only be used for amending Article 382 points (1) to (3), which therefore excludes any amendment of the exemptions granted under Article 382(4). However, in its report the EBA argues that it can use the SREP procedure to address situations of excessive CVA risks based on provisions of CRD Articles 102, 103 and 104 concerning supervisory measures and powers which target situations where the requirements of the CRD or the CRR are not met or where identified 'risks' or 'elements of risks' are not 'covered' by the CRR.

We however consider that there is no basis for using the provisions of these Articles as it cannot be considered that an exemption constitutes a situation of 'uncovered' risk. These situations have indeed been foreseen by the legislator who has decided to exempt them.

Conclusions

EU NFCs must have continued access to fairly-priced risk mitigation tools based on the exemptions granted both in EMIR and CRD IV.

EU NFCs are already seeing the effect of the uncertainty posed by the EBA work in the pricing and conditions of OTC derivatives by some banks, and also in some banks' willingness even to enter into OTC derivative contracts with NFCs. EU NFCs are for

structural reasons more dependent on risk mitigation tools than for instance their US counterparts, and putting at risk the continued availability of such tools will put EU companies at a competitive disadvantage.

We therefore strongly urge the EBA to reconsider its proposals concerning additional supervisory measures and to maintain in whole the CRR CVA exemption for corporate end-users.

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