Credit Valuation Adjustment (CVA) - CVA Exemptions

The Issue

In creating a global regulatory framework to ensure a more resilient banking system it is imperative that appropriate consideration be given to the potential impact on the real economy. Basel III has proposed that banks should be subject to a capital charge for potential mark-to-market losses (i.e. credit valuation adjustment risk - CVA) associated with the deterioration in the credit worthiness of a counterparty; in other words an additional capital charge for bilateral OTC derivative arrangements.

In current industry practice, OTC derivatives are primarily used to manage or hedge certain business risks, normally by the corporate treasuries, which do not always post collateral. As a result, the newly introduced CVA charge will increase the hedging costs significantly for the corporate end-users. Due to economic/market pressures, the companies could be inclined to reduce hedging activities leaving them directly exposed to business risks and/or price volatility, resulting in potentially negative implications for the real economy.

EMIR contains several critical concessions for corporate end-users which will allow them to effectively and efficiently manage risks. Such concessions seemed to have been overlooked in CRD IV and in some cases the current proposals may even contradict EMIR. Article 10 of EMIR\(^1\) includes an exemption for non-financial counterparties that meet certain conditions from the obligation to centrally clear. This is extremely important for the corporate world because it allows the possibility of entering into an OTC derivatives transaction without the need to post collateral. If such transactions are now subject to the CVA charges, such exemptions are entirely worthless.

In addition, EMIR contains several critical concessions for pension scheme arrangements which will effectively exempt them from the clearing obligation for three years, extendable by another two years plus one year, subject to reports justifying the deferrals. This is extremely important for the pensions as it temporarily allows for the possibility to enter into an OTC derivatives transaction without the need to post collateral. At present it appears that such concessions have been overlooked in CRD IV.

The temporary exemption of the clearing obligation for pensions is now entirely worthless as pension funds will face higher swap costs regardless. Pressure on banks to comply with higher capital requirements will see banks price in the additional capital costs they face on non-cleared transactions under CRD IV. The application of CVA charges to pension transactions will substantially increase costs, having a detrimental impact on pension schemes.

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\(^1\) As at the 11 April 2012 version of EMIR. The Article references are subject to change until the final version of the text is published in the Official Journal.
Therefore it is justified to exempt banks from holding additional regulatory capital for CVA risks, if 1) the counterparty is a non-financial company and the derivative in question is used for hedging purposes; or 2) the transaction is for pension scheme arrangements.

Clearing exemptions granted to such counterparties in EMIR should not be undermined by higher and disproportionate capital charges under CRD IV. The application of this charge to non-financial counterparties contradicts exemptions granted in EMIR. CRD IV should be aligned with EMIR to ensure consistent application of the rules. We believe that Amendments to CRR Article 372 should reflect concessions granted in EMIR as per below:

- Non financial counterparties that fall below certain, to be determined, thresholds as stated in Article 10 should be exempt from the obligation to clear unless they exceed the thresholds as per Article 10 when they will be subject to the clearing obligation.

- Pension scheme arrangements are exempted from clearing obligations (Article 2 (10), subject to certain transitional provisions outlined in Article 89).

- In addition, central banks, multilateral developments etc have been exempted from clearing obligations under EMIR Articles 1 (4 and 5).