European Banking Authority  
Tower 42  
25 Old Broad Street  
London EC2N 1HQ  

Dear Sir or Madam,

Re: Draft Regulatory Technical Standards (RTS) on credit valuation adjustment risk for the determination of a proxy spread and the specification of a limited number of smaller portfolios under Article 383 of Regulation (EU) 575/2013 (Capital Requirements Regulation - CRR) (EBA/CP/2013/24)

This letter contains the response of the International Swaps and Derivatives Association, Inc. (“ISDA”) and the Association for Financial Markets in Europe (“AFME”) to the European Banking Authority’s (“EBA”) Consultation Paper Draft Regulatory Technical Standards (“RTS”) on credit valuation adjustment risk for the determination of a proxy spread and the specification of a limited number of smaller portfolios under Article 383 of Regulation (EU) 575/2013 (Capital Requirements Regulation - CRR). The accompanying response is the result of a thorough industry consultation process involving a wide range of industry representatives. It is reflective of the industry consensus on this topic and aims at being as constructive as possible in seeking a proportionate outcome and additional flexibility.

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association’s web site: www.isda.org.

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76. For more information, visit www.afme.eu.

We look forward to working with the EBA to continue developing an approach that will result in a proportionate outcome and additional flexibility across the industry.

Yours faithfully,

Olivier Miart  
Assistant Director, Risk & Capital  
ISDA

Jouni Aaltonen  
Director, Prudential Regulation  
AFME
EBA Consultation Paper

On

Draft Regulatory Technical Standards (RTS) on credit valuation adjustment risk for the determination of a proxy spread and the specification of a limited number of smaller portfolios under Article 383 of Regulation (EU) 575/2013 (Capital Requirements Regulation - CRR)
(EBA/CP/2013/24)

Dated July 2013

Response of the International Swaps and Derivatives Association, Inc. (ISDA), and the Association for Financial Markets in Europe (AFME)

25 September 2013
A. Introduction

ISDA and AFME ("the industry") welcome the opportunity to comment on the above Consultation Paper ("the Paper") issued by the EBA. The industry highlights below a number of overarching issues regarding the consultation, followed by answers to individual questions raised.

**Overall Points:** The industry believes the proposals are unnecessarily prescriptive and do not reflect the diversity of industry practices and methods regarding CVA that are currently successfully in use at firms. As a result, many firms would need to create new processes with the sole function of dealing with regulatory CVA, which would come at a significant increase in cost and resource and which would be sub-optimal in terms of risk alignment.

Furthermore, we note that the EBA mandate has changed compared to the 2012 consultation in the sense that proxy spreads should now "be determined by the institution's approved internal VaR model for the specific interest rate risk" [Art. 383(7)]. In addition, when the institution’s approved internal VaR model for specific interest rate risk does not produce a proxy spread that is appropriate with respect to the criteria of the rating, industry and region of a given counterparty, the institution shall use the standard method [Art. 383(6)] to calculate the CVA own fund requirements on exposures to that counterparty.

Hence, a literal interpretation of EBA mandate could suggest that the term “proxy spread” refers indifferently to the proxy used in the regulatory CS01 formula in case no credit spread is available for the counterparty and to the generic credit spread curves that are used to determine spread shocks within internal VaR methodologies.

We believe this literal interpretation is inappropriate and would oblige banks to significantly revamp their VaR model.

More specifically, on one hand:
- We support the principle of replicating the market VaR methodology to define credit spread shocks in the CVA VaR.
- We also agree it is helpful to define the desirable level of granularity of proxy spreads in the absence of observable market data to ensure practices are consistent across industry.
- Finally, we understand the objective of ensuring consistency between the determinations of proxy spreads for the CVA charge and for the VaR-based market risk capital charge. We recall however that the recourse to proxies for spot spread levels is anecdotic in the case of market VaR as situations where no spread level is available in the market VaR occurs intrinsically very rarely since instruments covered by market VaR are in most cases tradable assets that are marked-to-market.

On the other hand, if the methodologies used to determine credit spread shocks are subject to the rating/industry/region prescription laid in Article 3 of the RTS, then we would face the following issues:
- First, it would generate a gap between the way banks risk manage their credit risk positions in the trading book (that scarcely rely on the Article 3 prescribed segmentation, in particular with respect to the “rating” attribute) and the way capital requirement is computed on those positions. Moreover, the suggested link between the proxy spreads for the counterparty and market risk applications if interpreted strictly, since it is not based on statistical evidence, could endanger the backtesting performance of the VaR models.
- Second, a large majority of banks that use alternative segmentations would have to perform in-depth review of their internal VaR models even when the latter have received prior approval by their supervisors and exhibited strong back testing performance in the past.
- Third, this in-depth review is particularly unwelcome today since the Basel Committee has launched in 2012 a fundamental review of the trading book which will materially reshape the market risk framework in the medium term. We have a strong concern on the relevancy of launching significant model and IT developments to implement interim rules that were not called for in the Basel 3 framework.
We believe an interpretation that respect the “spirit” of the EBA mandate would be to require banks to derive the CVA proxy spreads from their specific risk VaR model by the way of some adaptation that fit the RTS criteria but not by imposing the application of those criteria to the VaR model itself.

More specifically, when proxying credit spread dynamics within the credit VaR framework, relying on credit spread levels may be more adequate than relying on ratings. This is because the rating as a credit quality assessment has an update frequency that is not suited for market risk applications in the VaR, which has a time horizon of ten days and in most cases is calculated with a daily horizon. Therefore the rating does not reflect the daily market information that can be captured via alternative credit quality assessments. In contrast, when proxying credit spread levels within the CVA charge framework, relying on the rating attribute may be the preferred option.

As a result, we advocate that banks should be required to consider the rating/industry/region attributes enclosed in Article 3 as a starting point for proxying spreads both within the credit VaR scope and CVA charge scope but could ultimately come up with different adaptations of these attributes depending on the nature of the proxy (proxy for the spread level or proxy for the spread dynamics) and provided those choices are duly justified.

The industry’s preferred option is for a set of minimum standards that support the existing VaR practices, existing accounting CVA practices, with a stronger support for prudent risk mitigation. The Industry believes that the EBA should set out minimum standards around the implementation, governance, validation and degree of challenge to which models should be subject, while allowing for flexibility in choosing the methodology to meet these standards.

**More Flexibility Required:** For the largest global firms, the number of counterparties with proxy spreads is between 50% and 90% of the CVA portfolio of names (by number, not by exposure or 'risk').

The industry considers that the minimum prescribed granularity for rating, industry and region would not necessarily be appropriate for CVA proxy spread specification as it would give the wrong level of granularity and would not necessarily lead to statistically meaningful results. Many buckets of the proposed segmentation are likely to be poorly populated which will translate into statistically non significant model parameters. On the other hand, applying proxy spreads based on one or two firms in the relevant “bucket” will introduce idiosyncratic risks into the computation of VaR as the population is too small for capturing generic spread levels but instead exposes the measure to the performance of a small subset of firms.

In this respect, we appreciate the wording retained by the EBA for the “industry” and “region” attributes that require to “consider” the proposed granularities which suggest that banks may depart the proposed lists provided industry and region choices are duly justified and documented.

However, we argue that the rating attribute is too prescriptive for at least two reasons:

- It does not benefit from the flexible wording granted to “industry” and “region” attributes (we refer here to the word “considering”)
- The RTS wording imposes the reliance of proxys on “rating” whereas other credit quality assessment as spread level may be better suited as explained in previous section.

As a result, should the prescribed segmentation also apply to credit spread shocks, we recommend the EBA to amend Article 3 (1a) and (1b) of the RTS as follows:
(a) The proxy spread has been determined by considering all of the attributes of rating, industry and region of the counterparty;

(b) The attribute of rating has been defined by considering the use of a predetermined hierarchy of sources of internal and external ratings and alternative credit quality assessments. Ratings shall be mapped to credit quality steps, as referred to in Article 384(2) of Regulation (EU) No 575/2013. In cases where multiple external ratings are available the mapping shall follow the approach for multiple credit assessments set out in Article 138 of that Regulation;

Implementation period: We would like to stress that no impact assessment has been performed so far on the potential consequences of the RTS on credit VaR while they could potentially be far reaching. Moreover, the methodological changes induced by the RTS on credit VaR are likely to be classified as “material changes that require permission from the relevant competent authorities” under EBA consultation paper EBA/CP/2013/02 on the conditions for assessing the materiality of extensions and changes of internal approaches. Should the final RTS remain unchanged, banks would need to engage in heavy developments to comply. We therefore urge the EBA to incorporate in the RTS a 6-month implementation period after entry into force of the RTS for banks to comply with it.

Changes to Thresholds Proposed: Regarding the proposed thresholds of 15% for the number and 10% for the size of smaller portfolios, the industry thinks the proposal to define quantitative limits based on the number of smaller portfolios is not appropriate. We outline in our response that the metric should rather be a function of exposure and tenor, which are more relevant to the risk profile than the number of portfolios. It is frequent among large dealers to observe aggregated exposures where 80% to 90% of the portfolios make 10% to 20% of the exposure.
B. Responses to Discussion Paper Questions

Q1. Please provide information and data concerning the availability of CDS data with respect to the minimum categories for ‘rating’, ‘industry’ and ‘region’ defined in points (b), (c) and (d).

Some firms compute CVA/DVA values using counterparties’ credit curves, primarily utilizing traded CDS spreads as they are the best sources of such curves. In cases where a traded CDS for a specific counterparty does not exist, a proxy logic based on a combination of attributes rating, sector (industry), and region is applied.

The industry agrees with Point 5 of Article 3 which states that there is a trade-off between the granularity and reliability of proxy spread data, and that only meaningful data should be used as input in the determination of a proxy spread. However, we believe that the changes proposed in the draft RTS do not account for the consequences of a major slowdown in market activity, leading to the lack of single name data and compromising the above requirement. A detailed analysis of the availability of liquid CDS data by which to build proxy spreads is developed in appendix 1.

We recommend that the EBA revise the RTS to state that rating-industry-region sub-categories should be used where data permits without providing any minimum levels of granularity. This would allow firms to make the best use of the data that they possess without having to compromise the integrity of the spread time series in an effort to meet the minimum standards. Regulatory authorities could assess the granularity of firms’ time series as part of their ongoing reviews of firms’ models.

Q2. Please provide information concerning the usefulness, appropriateness and coherence with market practices of the approach to the use of single-named proxies described in Article 3.

As stated in the response to Q1, the main consideration when introducing these changes should be related to achieving a reasonable compromise between the granularity and reliability of proxy spread data. This should go hand in hand with a concern for the relevance and reasonability of the applied rules from both implementation and risk management perspectives. There is no market standard regarding the use of single-named proxies to derive proxy spreads within the scope of specific risk internal models as very few names have no market spread available. Our view is that the proposal with regards to granularity and usage of ratings is too detailed and prescriptive; firms should have more flexibility in applying those attributes in the proxy logic.

Although, in general, we support the proposal regarding the usage of single name proxies (see answers to questions Q3-Q5), our view is that when establishing generic spreads for proxied names, traded CDS indices rather than indices constructed from single name CDS may be used. Traded indices have observable credit spreads, making them reliable sources of information. We believe that the EBA RTS should give firms the flexibility to use traded indices, subject to regulatory approval.

If implemented as outlined, the standards set out in Article 5 would have an impact on our current methodologies for establishing proxy credit spreads. The RTS would require us to change the proxy spreads that we currently use for the regulatory CVA charge in order to mark the proxied counterparties for accounting purposes. This is inconsistent from a hedging perspective as the intention should be to align accounting and regulatory CVA. As such, we believe that the EBA RTS should be made less specific; it should allow for the use of traded indices, the use of more flexible single name proxy mappings (see below) and it should not prescribe particular levels of granularity.

We finally advocate that CDS on single-named proxies should be recognized as eligible CVA hedges with respect to exposures mapped to such proxies. It would consistently reflect the way incurred CVA is hedged by CVA desks.
Q3. Paragraph 3 allows for the proxying of the spread of the subsidiary by the spread of the parent company. Where no rating is available for the subsidiary or the parent undertaking or both, should the entities be considered equal in terms of the ratings attribute? Do you think that this treatment is appropriate? Please state the reason(s) in favour and/or against.

The industry view is that proxying of the spread of the subsidiary by the spread of the parent company is a reasonable approach in most cases, to the exception of certain holding companies. In the case of holding companies, subsidiaries often have very different characteristics and risk profiles from the parent company, a more granular assessment of the subsidiary’s rating would therefore be appropriate.

Differences in characteristics (e.g. rating) between the two counterparties may be reflected by applying a multiplier. In situations where ratings are not available, a case-by-case review and computation of the multiplier should be used. We believe that the EBA RTS should consider such an approach, subject to regulatory approval, as this could produce a more accurate proxy credit spread than using a generic spread based on rating, industry and region.

Q4. Paragraph 4 allows for the proxying of the spread for a regional government or local authority by the spread of the relevant sovereign. Where no rating is available for the regional government or local authority, should the entities be considered equal in terms of the ratings attribute? Do you think that this treatment is appropriate? Please state the reason(s) in favour and/or against.

Similarly to answer to Q3, the industry view is that a state-owned enterprise, a regional government, or a local authority may be mapped to the relevant sovereign credit spread with a multiplier used to reflect different characteristics (rating in particular) of the enterprise compared with those of the sovereign (for example, the Republic of France traded CDS spread could be used as a proxy spread for the counterparty of France Telecom). In situations where rating is not available, it is still reasonable to apply the logic, by introducing a review and the computation of the multiplier on a case-by-case basis. We believe that the EBA RTS should consider such an approach, subject to regulatory approval, as this could produce a more accurate proxy credit spread than using a generic spreads based on.

Q5. Please indicate other particular cases in which single named proxies might be appropriate.

Although the majority of proxied counterparties are generally mapped to credit spreads derived using the rating, industry and region attributes, some proxied counterparties may instead be mapped to other single name counterparties (or combinations of single name counterparties) with which they share similar characteristics. We believe that this may produce a closer match to the credit spread which the counterparty would trade in the market than would be possible using generic spreads. The examples, proposed in paragraphs 3 and 4, are broadly used indeed. Additionally, proxying a counterparty with a proven interest may be considered, subject to regulatory approval: e.g. if company A is linked to company B via an explicit guarantee.

Q6. Do the proposed thresholds of [15] % for the number of non-IMM portfolios, of [1] % for each individual non-IMM portfolio, and [10] % for the total size non-IMM portfolios, together with the definitions, provide an incentive for institutions to limit their portfolio exposures not covered by the IMM? Will the defined thresholds of [15] %, [1] % and [10] % cause any impact for your institution?

The industry does not believe that the size of the thresholds will be a material consideration when firms assess whether portfolios should be covered by the IMM or standardized approach. The standardized approach is less sophisticated and risk-sensitive than the IMM approach, which means that it typically delivers much more conservative capital requirements. This provides an incentive for firms to use the IMM approach wherever possible. However, the main reasons that some firms use the IMM for the majority of their exposures and the
A standardized approach for a subset of portfolios, is driven by systems, modeling and data constraints. These issues may mean that certain portfolios remain on the standardized approach, even if there is a capital incentive to move them to the IMM approach.

Furthermore, although we understand the rationale for imposing maximum materiality (i.e. size) thresholds for non-IMM trades, we do not believe that a threshold on the number of transactions is needed. The capital charge that firms calculate is not driven by the number of transactions but rather by the size and type of transactions. Firms may have large volumes of small transactions in non-IMM portfolios that attract small capital charges. Firms should not be penalized by having to adopt the standard CVA approach for portfolios that do not attract large capital charges. We also believe that basing the threshold logic on EADs would be a sensible approach; however the exclusion of collateral from the calculation seems contradictory to the wider calculation of exposure for capital requirements purposes. If collateral is applied primarily against non-IMM exposures then collateral should be considered as part of the threshold calculation as it is a valid mechanism of exposure reduction.

We do not expect the thresholds to have a material impact on larger institutions.

In addition, we would like to clarify:
- the draft RTS require firms to calculate and report the arithmetic average of at least monthly observations of the ratio of ‘the individual size of each non-IMM portfolio to the total size of all portfolios’ to the local regulator. Does this mean that the arithmetic average for every non-IMM portfolio needs to be reported to the local regulator (this could result in thousands of lines of data from each firm)?

Q7. The EBA expects that only a limited number of counterparties/names will receive a proxy spread. Do you agree with this conclusion? If not, could you explain why and state how many of your names will require a proxy spread?

No. Our analysis indicates that due to the current slowdown in activity on the OTC market, there will be a significantly larger number of counterparties with no observable credit spread (and thus requiring a proxy spread) than there will be counterparties which would benefit from receiving a direct mapping. This is particularly true for smaller and/or non-financial counterparties, as well as for private banking clients. For larger institutions, more than two thirds of the names will require a proxy spread.

Q8. Do you agree with the above analysis of the costs and benefits of the proposals? If not, please provide any evidence or data that would further inform the analysis of the likely cost and benefit impacts of the proposals.

We believe that the cost-benefit ratio for this particular change is disproportional. The main reasons for this are:

- **Cost**: as stated in the response to previous RTS, new proxy logic leads to a misalignment between the accounting CVA and the regulatory CVA frameworks. This inconsistency could force firms to first build a strategic infrastructure to address new requirements and afterwards create new operational units having the sole function of dealing with regulatory CVA in addition to the existing units. This would lead to significant incremental costs to the industry for no risk management benefit.

- **Benefit**: although we do agree that imposing harmonised criteria for the calculation of the CVA risk could support creation of a level-playing field, our view is that the reasonability and the easiness of implementation of those criteria that is vital. The current proposal, as per last formulation, would not necessarily help in achieving this.

Additionally, should the RTS call into question the way credit spread shocks are determined within internal VaR models, then the impact in terms of implementation cost and risk analysis would be drastic. Concretely, a large
majority of banks would face the overwhelming challenge to revisit in depth their credit VaR models within a very tight timeframe (rules become live on January 1st, 2014) without prior assessment of the impacts both in terms of capital charge and risk management. VaR indicators are a cornerstone of use test requirements and imposing banks to comply with prescriptive rules that come at odds with the way positions are monitored and risk managed will undoubtedly severely undermine the necessary consistency between capital requirement and risk management.

Finally, the cost/benefit assessment currently ignores the burden to switch between the advanced CVA charge and the standard CVA charge as a consequence of the requirement introduced in CRR Article 383(6) to fallback to standard method in case proxy spreads are deemed not compliant. Indeed, in major institutions, standardized methods are under the Finance function responsibility while advanced methods are under the Risk function responsibility. As a result, switching from a method to the other will be burdensome in terms of workflow and aggregation of results.
Appendix 1: availability of CDS data by which to build proxy spreads

The EBA proposed levels of granularities for proxy spreads are rating, industry and region. There are typically 7 different non-default ratings AAA-CCC. Furthermore, EBA proposes to consider at least 6 different industries and 4 different regions. This amounts to a maximum of 168 possible combinations of rating, industry and region to be populated for proxy spreads.

Analysis regarding the number of CDS by which to build proxy spreads

Selected CDS universe from Markit as follows. All relevant attributes from Markit.
- Only for entities which have a Markit Liquidity Score\(^1\)
- Liquidity Score for each issue of 1-4 (out of a possible range of 1-5, 1=highest level of liquidity)\(^2\)
- Currencies of EUR for Europe and USD for North America and Rest of the World
- On senior claims only (Tier = SNRFOR)
- 5 year tenor
- Underlying entity having an external rating\(^3\).

As of August 2013, the above universe entails 1,214 CDS against 1,214 different entities with the breakdown into rating, industry and region as shown in Table 1.

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1) Markit CDS Liquidity provides independent measures of liquidity on CDS single names and indices, giving insight into trading liquidity risk, the risk a firm will not be able to convert an asset into cash without occurring minimum loss of value due to inadequate market depth or other market disruptions.

2) Liquidity score of 5 is discarded in this analysis based on the observation that no constituent of on-the-run ITRX or CDX indices has a liquidity score of less than 4.

3) Average of the Moodys and S&P ratings adjusted to the seniority of the instrument.
Table 1: Number of CDS issuers as per proposed EBA level of granularity

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<td>115</td>
<td>34</td>
<td>1,214</td>
</tr>
</tbody>
</table>

A total of 63 (38%) out of 168 possible combinations does not present a single underlying CDS to contribute to a proxy spread construction. Highlighted in green are those segments with 10 or more constituents.

**Note:** Above sample of 1,214 CDS has not yet been submitted to market data quality checks. It is expected that a significant number of these CDS do not meet a bank’s market data standards for use in a daily Value-at-Risk process (where returns of proxy spread levels are needed). However, they might still be useful for determining proxy spread levels for the determination of CS01s.