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From:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
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To:	Mr Uwe CORSEPIUS, Secretary-General of the Council of the European Union

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Subject:	COMMISSION DELEGATED REGULATION (EU) No .../.. of 12.3.2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for determining proxy spread and limited smaller portfolios for credit valuation adjustment risk

Delegations will find attached document C(2014) 1555 final.

Encl.: C(2014) 1555 final



EUROPEAN
COMMISSION

Brussels, 12.3.2014
C(2014) 1555 final

COMMISSION DELEGATED REGULATION (EU) No .../..

of 12.3.2014

supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for determining proxy spread and limited smaller portfolios for credit valuation adjustment risk

(Text with EEA relevance)

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE DELEGATED ACT

Article 383(7) of Regulation (EU) No 575/2013 ('the Regulation') empowers the Commission to adopt, following submission of draft standards by the European Banking Authority (EBA), and in accordance with Articles 10 to 14 of Regulation (EU) No 1093/2010, delegated acts specifying how a proxy spread is to be determined for the purposes of identifying s_i and LGD_{MKT} and the number and size of portfolios that fulfil the criterion of a limited number of smaller portfolios.

In accordance with Article 10(1) of Regulation (EU) No 1093/2010 establishing the EBA, the Commission shall decide within three months of receipt of the draft standards whether to endorse the drafts submitted. The Commission may also endorse the draft standards in part only, or with amendments, where the Union's interests so require, having regard to the specific procedure laid down in those Articles.

2. CONSULTATIONS PRIOR TO THE ADOPTION OF THE ACT

In accordance with the third subparagraph of Article 10(1) of Regulation (EU) No 1093/2010, the EBA has carried out a public consultation on the draft technical standards submitted to the Commission in accordance with Article 383(7) of the Regulation. A consultation paper was published on 5 July 2013 on the EBA internet site, and the consultation closed on 25 September 2013. Moreover, the EBA invited the EBA's Banking Stakeholder Group set up in accordance with Article 37 of Regulation (EU) No 1093/2010 to provide advice on them.

Together with the draft technical standards, the EBA has submitted an explanation on how the outcome of these consultations has been taken into account in the development of the final draft technical standards submitted to the Commission.

Together with the draft technical standards, and in accordance with the third subparagraph of Article 10(1) of Regulation (EU) No 1093/2010, the EBA has submitted its Impact Assessment, including its analysis of the costs and benefits related to the draft technical standards submitted to the Commission. This analysis is available at <http://www.eba.europa.eu/regulation-and-policy/credit-risk/draft-regulatory-technical-standards-in-relation-to-credit-valuation-adjustment-risk>, pages [14-16] of the Final Draft RTS package.

3. LEGAL ELEMENTS OF THE DELEGATED ACT

Article 383(7) of the Regulation requires the development of draft regulatory technical standards specifying how a proxy spread is to be determined for the purposes of identifying s_i and LGD_{MKT} . The delegated act specifies the data quality requirements and the minimum granularity of the attributes of rating, industry and region that institutions should consider when estimating an appropriate proxy spread for the determination of the own funds requirements for CVA. It also clarifies how LGD_{MKT} should be derived for counterparties subject to a proxy spread.

The delegated act also specifies the number and size of portfolios that fulfil the criterion of a limited number of smaller portfolios and, therefore, are allowed into the CVA Advanced approach despite not forming part of the scope of the Internal Model Method (IMM) for counterparty credit risk. Thresholds in terms of number and size are defined, below which non-IMM netting sets are deemed to fulfil the criterion of a limited number of smaller portfolios and, subject to permission from competent authorities, are allowed into the Advanced method for the calculation of their own funds requirements for CVA risk.

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(Text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 575/2013 of 26 June 2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 and in particular the third subparagraph of Article 383(7) thereof,

Whereas:

- (1) The application of the advanced method to the determination of own funds requirements for Credit Valuation Adjustment (CVA) risk may involve counterparties for which no Credit Default Swap (CDS) spread is available. Where this is the case, institutions should use a spread that is appropriate having regard to the rating, industry and region of the counterparty (*'proxy spread'*) in accordance with the third subparagraph of Article 383(1) of Regulation (EU) No 575/2013.
- (2) Rules on the determination of proxy spread for CVA risk should provide for the use of broad categories of rating, industry and region, and they should allow institutions the necessary flexibility to determine the most appropriate proxy spread based on their expert judgment,.
- (3) When specifying in more detail how the attributes of rating, industry and region of the single issuers should be considered by institutions when estimating an appropriate proxy spread for the determination of the own funds requirements, as required by Regulation (EU) No 575/2013, rules should be established for the consideration of those attributes by reference to minimum categories for each attribute, in order to ensure a harmonised application of those conditions.
- (4) Furthermore, in the case of single issuers, where a link, such as between a regional government or local authority and the sovereign, exists, it should be possible to allow for the estimation of an appropriate proxy spread on the basis of the credit spread of a single issuer, where this leads to a more appropriate estimation.

- (5) In order to lead to an appropriate computation of the CVA risk charge, a proxy spread should be determined using data that has been observed in a liquid market, and assumptions regarding data, such as interpolation and extrapolation of data relating to different tenors, should be conceptually sound.
- (6) In order to ensure convergence of practices among institutions and to avoid inconsistencies, considering that implied probabilities of default ('PDs'), Credit Default Swaps ('CDS') spreads and loss given default ('LGD') constitute one equation with two unknown variables and that the market convention is to use a fixed value for LGD in order to derive implied PDs from market spreads, institutions should use a value for 'LGD_{MKT}' that is consistent with the fixed LGD commonly used by market participants for determining implied PDs from those liquid traded credit spreads that have been used to determine the proxy credit spread for the counterparty in question.
- (7) For the purposes of permission to use the advanced CVA method for a limited number of smaller portfolios, it is appropriate to consider a portfolio as a netting set as defined in Article 272(4) of Regulation (EU) No 575/2013 the number of non-internal model method ('IMM') transactions subject to the CVA risk charge and the size of non-IMM netting sets subject to the CVA risk charge, and to limit them in terms of a percentage of the total number of all transactions subject to the CVA risk charge and a percentage of the total size of all netting sets subject to the calculation of CVA risk charge, in order to take account of the different dimensions of institutions.
- (8) In order to mitigate possible discontinuities in the use of the advanced CVA method for a limited number of smaller portfolios, the use of the advanced CVA method should cease only when quantitative limits are breached for two consecutive quarters.
- (9) Further, in order to render it possible for competent authorities to perform their supervisory duties in an efficient manner, they should be able to know when the requirement of a limited number of smaller portfolios is no longer met; hence institutions should notify competent authorities in those cases.
- (10) This Regulation is based on the draft regulatory technical standards submitted by the European Banking Authority to the Commission.
- (11) The European Banking Authority has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the opinion of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council¹,

¹ Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12)

HAS ADOPTED THIS REGULATION:

Article 1
Determining an appropriate proxy spread

1. The proxy spread for a given counterparty shall be deemed appropriate having regard to the rating, industry and region of the counterparty according to the fourth subparagraph of Article 383(1) of Regulation (EU) No 575/2013, where the following conditions are satisfied:
 - (a) the proxy spread has been determined by considering all of the attributes of rating, industry and region of the counterparty as specified in points (b), (c) and (d);
 - (b) the attribute of rating has been determined by considering the use of a predetermined hierarchy of sources of internal and external ratings. 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 their mapping to credit quality steps shall follow the approach for multiple credit assessments set out in Article 138 of that Regulation;
 - (c) the attribute of industry has been determined by considering at least the following categories:
 - (i) public sector;
 - (ii) financial sector;
 - (iii) others;
 - (d) the attribute of region has been determined by considering at least the following categories:
 - (i) Europe;
 - (ii) North America;
 - (iii) Asia;
 - (iv) rest of the world.
 - (e) the proxy spread reflects in a representative way available credit default swap spreads and spreads of other liquid traded credit risk instruments, corresponding to the relevant combination of applicable categories and satisfying the data quality criteria referred to in paragraph 3;
 - (f) the appropriateness of the proxy spread is determined with reference to the volatility rather than to the level of the spread.
2. In the process of considering the attributes of rating, industry and region of the counterparty in accordance with paragraph 1, the estimation of the proxy spread shall be deemed appropriate for a regional government or local authority based on the

credit spread of the relevant sovereign issuer where either of the following conditions are met:

- (a) the regional government or local authority and the sovereign have the same ratings;
 - (b) there is no rating for the regional government or local authority.
3. All inputs used in the determination of a proxy spread shall be based on reliable data observed on a liquid two-way market as defined in second subparagraph of Article 338(1) of Regulation (EU) No 575/2013. Sufficient data shall be available to generate proxy spreads for all relevant tenors and for the historical periods referred to in Article 383(5) of that Regulation.

Article 2 *Identification of LGD_{MKT}*

In order to identify the loss given default of the counterparty (LGD_{MKT}) for the purposes of calculating the own funds requirements for CVA risk according to the advanced method for a counterparty requiring the use of a proxy spread, institutions shall use a value for LGD_{MKT} that is consistent with the fixed LGDs commonly used by market participants for determining implied PDs from those market spreads that have been used to determine the proxy spread for the counterparty in question in accordance with Article 1.

Article 3 *Quantitative limits on the number and size of qualifying portfolios*

1. To fulfil the criterion of a limited number of smaller portfolios referred to in Article 383(4) of Regulation (EU) No 575/2013, all of the following conditions shall be satisfied:
 - (a) the number of all non-IMM transactions subject to the CVA risk charge shall not exceed 15 % of the total number of transactions subject to the CVA risk charge;
 - (b) the size of each individual non-IMM netting set subject to the CVA risk charge shall not exceed 1 % of the total size of all netting sets subject to the CVA risk charge;
 - (c) the total size of all non-IMM netting sets subject to the CVA risk charge shall not exceed 10 % of the total size of all netting sets subject to the CVA risk charge.
2. For the purpose of points (b) and (c) of paragraph 1, the size of a netting set shall be the exposure at default of the netting set calculated using the mark-to-market method referred to in Article 274 of Regulation (EU) No 575/2013 by taking account of the effects of netting, in accordance with Article 298 of that Regulation, but not the effects of collateral.

3. For the purpose of paragraph 1, an institution shall calculate, for each quarter, the arithmetical average of at least monthly observations of the ratios of the following:
 - (a) the number of non-IMM transactions to the total number of transactions;
 - (b) the individual size of the largest non-IMM netting set to the total size of all netting sets; and
 - (c) the total size of all non-IMM netting sets to the total size of all netting sets.
4. Where the criterion specified in paragraph 1 is not fulfilled for two consecutive calculations referred to in paragraph 3, an institution shall use the standardised method set out in Article 384 of Regulation (EU) No 575/2013 to calculate the own funds requirements for CVA risk for all of the non-IMM netting sets and notify the competent authorities.
5. The conditions set out in paragraph 1 shall be applied on an individual, a sub-consolidated or a consolidated basis, depending on the scope of the permission to use the internal model method referred to in Article 283 of Regulation (EU) No 575/2013.

Article
Entry into force

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 12.3.2014

For the Commission
The President
José Manuel BARROSO