

6<sup>th</sup> July, 2016

**The European Banking Authority**

One Canada Square (Floor 46), Canary Wharf  
London E14 5AA - United Kingdom

**Re: Industry Response to the EBA Consultative Paper on Draft Regulatory Technical Standards (RTS) for determining proxy spread and limited smaller portfolios for credit valuation adjustment (CVA) under Article 383(7) of Regulation (EU) No 575/2013 (the Capital Requirements Regulation - CRR).**

Dear Mr. Enria,

The International Swaps and Derivatives Association and the Association for Financial Markets in Europe (ISDA and AFME, together “the industry”) welcome the opportunity to comment on the EBA Consultative Paper (CP) on Draft RTS for determining proxy spread and limited smaller portfolios for CVA under Article 383(7) of Regulation (EU) No 575/2013 (CRR), published on 6<sup>th</sup> April 2016.

The industry welcomes the proposed amendments made by the EBA to the RTS for determining proxy spread and limited smaller portfolios for credit valuation adjustment under Article 383(7) of Regulation (EU) No 575/2013. We particularly welcome EBA’s acknowledgement that the first term  $LGD_{MKT}$  in the regulatory formula (Art 383.1.) reflects the “recovery term of the general CVA formula”, and that this term may differ from the other term  $LGD_{MKT}$  appearing in the denominators of the exponential terms which rather correspond to the standard way market participants imply the default probabilities from market information from observed credit spreads of CDS contracts. The relaxation of the formula allowing a specialized recovery term attached to the CVA itself is the only way to allow market participants to reflect various market situations and specificities in the CVA, notably difference in seniority, specific securities attached to the exposure, but also to other pure market factors which can only be evidenced through observation of prices and competitive feedback. We are however concerned with the restrictions implied by the proposed framework for the determination of  $LGD_{MKT}$ . We set out below the reasons underlying our concerns and

suggest alternatives we believe would improve the risk sensitivity of the proposals as well as better align the framework with CVA practices.

## 1. Concerns with the proposed LGD<sub>MKT</sub> amendment

The industry remains concerned about the way the amendment regarding LGD<sub>MKT</sub> is drafted, as it appears to be restricted to transaction cases of relative seniority between the derivatives and the unsecured bonds, and doesn't cover other cases such as secured transactions. This concern was raised by the industry in its response<sup>1</sup> to the BCBS CVA consultative document d325 in October 2015, where we recommended that the BCBS goes further by clarifying that banks should also be able to use different recovery rates for a broader range of exposures.

We therefore recommend that the EBA goes further by clarifying that banks should also be able to use different recovery rates for certain specific types of exposures, e.g. because they are secured (such as covered bonds or project finance vehicles) or because the bank is able to evidence that the nature of its exposure to the counterparty differs significantly from that traded in the public credit market for the counterparty. For example, we note that the historically-realized recoveries on certain bilateral OTC derivative portfolios with sovereign counterparties has differed significantly from that on senior bonds from the same issuer even when the claims are pari-passu in the capital structure.

We suggest that the RTS retains appropriate wording to ensure that when institutions are able to gather good market-based information on the recovery term of the general CVA formula, this information is given precedence over the regulatory assumption that a difference exists solely due to seniority of the instruments. The EBA may decide that such methodology is subject to independent internal review, approval by senior management level and notification to the relevant NCA.

**We therefore suggest the following changes to the wording of Article 2 new paragraph 2:**

*2. ~~Where the seniority of the transactions with the counterparty differs from the seniority of senior unsecured bonds that is implied by the value of LGD<sub>MKT</sub> referred to in paragraph 1~~ **Where it can be justified to the satisfaction of competent authorities that the expected LGD for a given netting set is different from the LGD<sub>MKT</sub> convention used to infer probability of defaults from market observations – e.g. on the basis of persuasive market-based information, institutions may should be entitled to reflect this difference in seniority by adjusting the value of the first occurrence of LGD<sub>MKT</sub> that appears in the formula provided for in Article 383(1) third subparagraph.***

<sup>1</sup> <http://www2.isda.org/attachment/NzKxOQ==/Trade%20Associations%20Response%20-%20BCBS%20CVA%20CP%20-%20FINAL.pdf>

## 2. Responses to the Consultation Paper's questions

**Question 1:** *Do stakeholders agree with the amendment?*

The industry agrees with the amendment.

**Question 2:** *Could stakeholders elaborate on the type of alternative credit quality assessments to be performed and on the precise cases or type of counterparties, for which such alternative credit quality assessments would be absolutely necessary, in particular, where relevant, with reference to accounting CVA treatment?*

A type of alternative credit assessment would for example relate to the level of the credit spread of the counterparty. An example case of fundamental analysis for which such alternative credit quality assessments would be absolutely necessary are funds and hedge funds, particularly relating to the assessment of fund specifics (NAV, Strategy, Leverage, Asset quality, Performance, Capital base) and controls (Management, Infrastructure & Support, Risk Management, Transparency). In these cases, relying on historic PDs only cannot provide any satisfactory credit quality assessment.

**Question 3:** *Do stakeholders agree with the amendment? Do stakeholders consider that an additional condition is necessary on rating?*

The industry agrees with the amendment.

**Question 4:** *Do stakeholders agree with the possibility provided by the amendment to adjust the value of the  $LGD_{MKT}$  term of the regulatory formula?*

The industry agrees with the possibility provided by the amendment to adjust the value of the  $LGD_{MKT}$  term of the regulatory formula.

**Question 5:** *Could stakeholders elaborate on cases (types of counterparties, business activities) where this adjustment would have a particularly significant impact and on the rationale for performing the adjustment in such cases?*

Seniority should not be the only criteria for assessing whether the first occurrence of  $LGD_{MKT}$  can be adjusted. Secured transactions and products should also benefit from an adjustment of the first iteration of  $LGD_{MKT}$ .

## Scope

- Quasi all specialised finance hedging business is secured, in particular:
  - Non-recourse Infrastructure & Energy hedging
  - Media Telecom & leverage hedging
  - Asset finance hedging (eg. transportation finance & real estate hedging)

## Why a secured business?

The rating of secured borrowers may often be of lower quality than that of unsecured corporates or the borrower may be a special purpose entity with limited credit history and its only assets are likely to be the project assets, in which case the entity's creditworthiness is dependent on predictable future cash-flows. Offering security over the project assets or future cash-flows is one way for the borrower to enhance its creditworthiness and increase the lenders' confidence about being repaid. These counterparties tend to have lower ratings but higher recovery rates to reflect the higher recoveries relative to unsecured counterparties (as shown historically) given the specific security package that is earmarked for secured parties and the additional covenants to restrict dilution of assets upon a distress situation.

## What does it mean to be secured?

Unlike in an unsecured corporate situation where hedge counterparties have recourse to a credit worthy counterparty (with potential light negative covenants and most importantly a negative pledge), secured parties (including typically lenders and hedge counterparties) are protected by an ad hoc security package (which may include, depending on the jurisdictions, mortgages and fixed or floating charges over all assets<sup>2</sup>, including contracts and accounts as permitted by the relevant laws, step-in rights in case of distress, direct agreements with off-takers...) ring fenced from other unsecured creditors. Secured parties have a direct privileged access to the security package, ensuring greater protection for lenders/swap counterparties and a clear, quick recovery regime. A very important part of security is a restricting covenant package, with clauses defining for instance how to avoid over-hedging (keeping liabilities/asset ratio), LTV ratio test, Maximum Leverage, scope of business that the counterparty is allowed to undertake, negative pledge beyond the transaction security already granted etc. Typically, secured parties have control as to when and how to liquidate the asset.

In general, hedging counterparties rank pari-passu to secured debt holders, meaning that hedging counterparties are paid scheduled payments pro-rata to loan interest payments and termination payments pro-rata to loan principal repayments. Sharing is ensured through a pre-defined waterfall process to be followed by a security agent (holding assets on behalf of the secured parties). Release of the security package is conditional and requires approval from all secured parties.

Hedging counterparties can from time to time rank super senior to senior lenders, with pre and post enforcement priority over secured lenders (typical of inflation linked transactions, Holdco financing, cross currency swaps on levered counterparties etc.).

The type of security available varies with the underlying and will typically be:

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<sup>2</sup> Fixed or floating charges give a lender a higher position in the queue for the net proceeds of a borrower's assets in the event of a borrower's insolvency

- Case of hedging activities relating to non-recourse infrastructure or energy project financing: typically a mortgage or charge over the shares in the project company and any rights attaching to, a fixed and floating charge over the project assets (including accounts and guarantees given by sponsors), a mortgage over the project site, assignments by way of security of key project contracts/agreements, assignments by way of security of rights under any shareholder loans within the group, and assignments by way of security of the project insurances.
- WBS (whole-business securitisation): alternatively, ongoing, stable business can choose to pledge their assets as a going concern as a way to increase the leverage and hence allow for greater distributions. This is typically known as a whole-business securitisation, but in spirit it is just a subset of non-recourse Energy/infrastructure financing (relating to ongoing, fully operational businesses) and it uses the same secured financing technology as all other non-recourse energy/infrastructure financings.
- Media Telecom & leverage finance: fixed and floating charge over the company's assets
- Transportation finance: typically mortgage on the asset, assignment of insurance proceeds, assignment of rental proceeds, access to cash collection accounts
- Commodity structured debt: fixed and floating charge over the company's assets, typically on a borrowing base basis. Depending on the structure of the particular asset, security package may resemble a more traditional infrastructure/energy security package.
- Real estate finance: typically mortgage on the asset, assignment of insurance proceeds, assignment of rental proceeds

The stronger the security package and control of the cash proceeds, the higher the expected recovery rate. The combination of mortgage on the asset and high LTV ratio explains the higher recovery rates observed in the asset finance hedging world. The more the security package and cash proceeds are ring-fenced and are accessible in terms of priority, the more justified it is to apply a higher recovery rate.

**Question 6:** *What are stakeholders' views on proposed Options A and B?*

The industry favors option A over option B. Option A is the most appropriate in the considered situation as it defines two LGD figures, which indeed correspond to explicitly different levels of seniority. As suggested above, however, we recommend that the EBA goes further by clarifying that banks should also be able to use different recovery rates for certain specific type of exposures, e.g. because they are secured (such as covered bonds or project finance vehicles) or because the bank is able to evidence that the nature of its exposure to the counterparty differs significantly from that traded in the public credit market for the counterparty. Furthermore, we demonstrate with an example in Appendix 1 that one cannot always find  $LGD_{\text{implied}}$  for any pair of  $(LGD_1, LGD_2)$ , therefore Option B is not always an equivalent alternative to Option A, and should as such not be retained.

### 3. Conclusion

In conclusion, the industry thinks that restricting the possible adjustment of the value of the first occurrence of  $LGD_{MKT}$ , in the formula provided for in Article 383(1) third subparagraph, to using only a senior unsecured reference, would significantly understate the recovery rate. Indeed, in a secured transaction:

- Secured creditors have priority over unsecured creditors of the borrower.
- Secured creditors have a better chance of recovering their money in an insolvency scenario as they will have an opportunity to take on remedial actions before the business deteriorates beyond repair (that is not the case with unsecured counterparties).
- Secured creditors have the right to appoint a receiver or administrator if certain conditions are met and the lenders have means to control the borrower's (and any other security provider's) assets.

We would welcome an ongoing dialogue with the EBA to address the points raised in this response.

Yours sincerely,



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## Appendix 1 – Illustrative example relating to Questions 6 in EBA CP

**Background:** In the EBA Consultation Paper (Questions 4,5,6) on amending the RTS on the CVA proxy spread, two options were proposed to modify the current formula in Article 383(1) to account for the potential difference between the seniority of the transactions with the counterparty and the seniority of the senior unsecured bonds used to infer the default probability.

- **Current formula:**

$$CVA = LGD_{MKT} \cdot \sum_{i=1}^T \max \left\{ 0, \exp \left( -\frac{s_{i-1} \cdot t_{i-1}}{LGD_{MKT}} \right) - \exp \left( -\frac{s_i \cdot t_i}{LGD_{MKT}} \right) \right\} \cdot \frac{EE_{i-1}D_{i-1} + EE_iD_i}{2}$$

- **Option A:** Adjust the value of the first occurrence of  $LGD_{MKT}$ . To this end, we will label the first occurrence of  $LGD_{MKT}$  as  $LGD_1$ , the second and third occurrences as  $LGD_2$ :

$$CVA_{OptionA} = LGD_1 \cdot \sum_{i=1}^T \max \left\{ 0, \exp \left( -\frac{s_{i-1} \cdot t_{i-1}}{LGD_2} \right) - \exp \left( -\frac{s_i \cdot t_i}{LGD_2} \right) \right\} \cdot \frac{EE_{i-1}D_{i-1} + EE_iD_i}{2}$$

- **Option B:** Substitute a single LGD in all three occurrences in the formula that gives the same CVA value as Option A:

$$CVA_{OptionB} = LGD_{implied} \cdot \sum_{i=1}^T \max \left\{ 0, \exp \left( -\frac{s_{i-1} \cdot t_{i-1}}{LGD_{implied}} \right) - \exp \left( -\frac{s_i \cdot t_i}{LGD_{implied}} \right) \right\} \cdot \frac{EE_{i-1}D_{i-1} + EE_iD_i}{2}$$

where  $LGD_{implied}$  is determined so that  $CVA_{OptionB} = CVA_{OptionA}$

In the Consultation Paper, the two options were proposed as equivalent alternatives.

**Counter-example:** However, we have a counter-example where for a particular pair of values of  $(LGD_1, LGD_2)$ ,  $LGD_{implied}$  cannot be found.

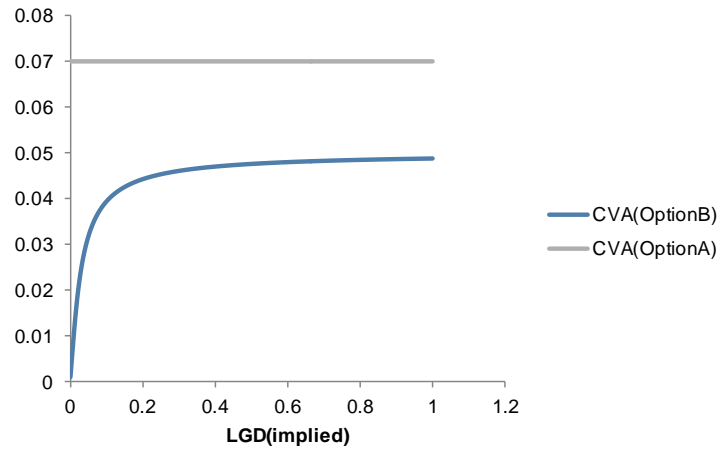
Let

$$T = 1, s_T = 0.05, t_0 = 0, t_T = 1, \frac{EE_0D_0 + EE_1D_1}{2} = 1.$$

For the specific pair  $(LGD_1, LGD_2) = (0.6, 0.4)$ , we have

$$CVA_{OptionA} = 0.6 \cdot \max \left\{ 0, 1 - \exp \left( -\frac{0.05}{0.4} \right) \right\} \cdot 1 \cong 0.07$$

Now, we plot the profile of  $CVA_{OptionB}$  as a function of  $LGD_{implied}$ . Note that for every real number between 0 and 1, there is no  $LGD_{implied}$  that can make  $CVA_{OptionB}$  equal  $CVA_{OptionA}$ .



**Conclusion:** As per the example above, one cannot always find  $LGD_{implied}$  for any pair of  $(LGD_1, LGD_2)$ , therefore Option B is not always an equivalent alternative to Option A.