



EUROPEAN CENTRAL BANK

BANKING SUPERVISION

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Public consultation on the draft guide to changes and extensions to counterparty credit risk models

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What is this guide about? I

- Banks have to hold capital in order to absorb unexpected losses.
- Banks use either a standardised method or an internal model to calculate their minimum capital requirements. An internal model allows banks to more accurately capture its specific risk profile.
- If a bank decides to use an internal model any material extension and change to their internal model needs a prior approval.

What is this guide about? II

- For internal models for i) credit risk, ii) operational risk, and iii) market risk the European Commission has determined what a material change is in a technical standard.
- For internal models for i) counterparty credit risk and ii) credit valuation adjustment risk, which are much less widely used by banks, such standard was not foreseen.
- The ECB therefore considered that it would be helpful to provide guidance to the institutions it directly supervises on how to assess the materiality of extensions and changes to internal models for counterparty credit risk and credit valuation adjustment risk.

What is this guide about? III

- The main purpose of the consultation is to present and collect feedback on the guide which the ECB has developed for institutions directly supervised by the ECB.
- In this presentation we will briefly describe this guidance.
- Comments by the public submitted in the consultation should relate to the draft guide only and not to this summary. In case of doubt, the content of the draft guide prevails.

Structure of the presentation

- 1 Pillar I capital models
 - 2 Extensions and changes to Pillar I capital models
 - 3 Background on counterparty credit risk and credit valuation adjustment risk
 - 4 ECB guide on the materiality assessment of IMM and A-CVA model extensions and changes
- Annex: Overview of the materiality assessment process

Institutions are required to determine their Pillar I capital charge

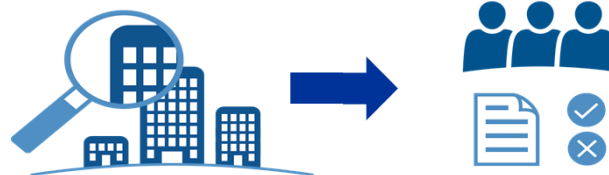


The Capital Requirement Regulation (regulation (EU) No 575/2013) defines minimum capital requirements for credit risk, operational risk, market risk, counterparty credit risk, and credit valuation adjustment risk.

The Capital Requirement Regulation provides for the calculation of Pillar I capital requirements.

Standardised methods

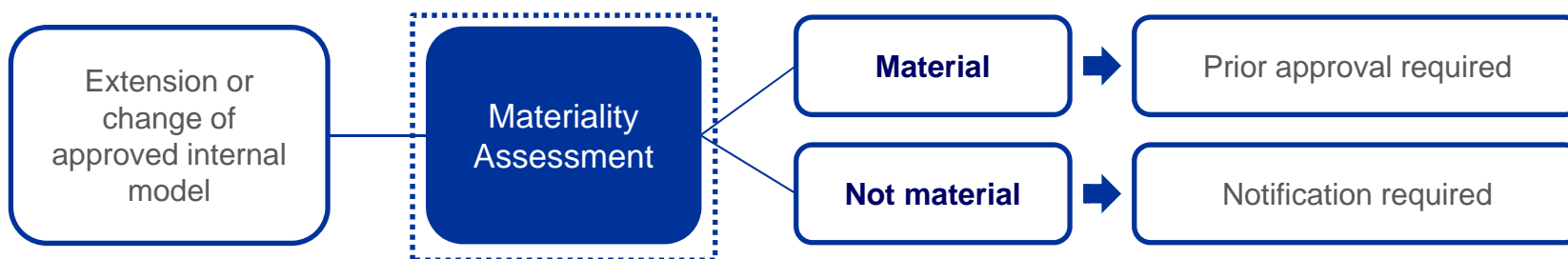
Internal models



Banks need approval in order to use internal models.

Material changes to internal models require prior approval

- The outcome of materiality assessments trigger supervisory processes.



- Materiality assessment criteria relies on published regulation.

Regulatory Technical Standards for assessing the materiality of extensions and changes of internal models		
Credit and Operational Risk	Market Risk	CCR and CVA risk
(EU) No 529/2014 of 12 March	(EU) No 942/2015 of 4 March	Not foreseen

The ECB provides guidance for institutions directly supervised by the ECB.

Background: Counterparty credit risk

- Scope: over the counter derivatives contracts and securities finance transactions.
- The replacement cost of over the counter derivatives and securities finance transactions is not fixed. Counterparty credit risk models calculate the replacement cost, in the event of a default of a counterparty, for these products.
- Internal model: Internal Model Method (IMM).
- Article 283 to 294 of the Capital Requirement Regulation.

Example: Interest rate swaps are initiated with a value of zero. When you receive a fixed rate and pay the floating rate, such an interest rate swap raises in a positive value when interest rate levels come down. This is because the expected future cash flows that you receive are larger compared to the expected future cash flows that you have to pay. Counterparty credit risk is the risk that your counterparty - with who you agreed the swap - is not able to pay these future cash flows.

Background: Advanced measurement of credit valuation adjustment risk

- Scope: over the counter derivatives contracts and securities finance transactions.
- A credit valuation adjustment is the expected loss in the event of the default of a counterparty.
- The value of over the counter derivatives and securities finance transactions includes an credit valuation adjustment. The adjustment is not constant over time as credit risk is not constant. Credit valuation adjustment risk measures the volatility of the credit valuation.
- Internal model: Advanced method for the measurement of the credit valuation adjustment (A-CVA).
- Article 383 of the Capital Requirement Regulation.

Example: During the financial crisis a large part of the observed losses were caused because banks increased their credit valuation adjustments as the creditworthiness of their counterparties decreased. Note that this loss is incurred even when your counterparty does not default.

ECB drafts guide on materiality assessment

ECB Guide on the Materiality Assessment (EGMA) of IMM and A-CVA extensions and changes



The ECB provides guidance to institutions directly supervised by the ECB on the materiality assessment of extensions and changes to internal models for counterparty credit risk and credit valuation adjustment risk.

EGMA has been **structured** drawing as much as possible on the regulatory technical standards defined for other risks.



- General provisions.



- Assessment criteria.



- Documentation requirements.

EGMA follows as much as possible the structure of regulatory technical standards.

Content overview of the EGMA



General provisions

- Extensions and changes are classified either material or not material.
- Material classification based on EGMA and ECB investigation.
- References to other technical standards for the A-CVA.



Assessment criteria

- List of qualitative criteria.
- Quantitative assessment of new capital requirements.
- Conditions for the material classification of A-CVA changes.



Documentation requirements

- Details of the extensions or change needed for banking supervision.

Timeline



Submitting comments

- Comments can be submitted until 14 February 2017
- Comments can be submitted via e-mail or traditional mail
- Details about how to submit a comment can be found on our website: bankingsupervision.europa.eu

Draft guide to changes and extensions to counterparty credit risk models



Overview of the materiality assessment process

