EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Public consultation on the ECB guide on materiality assessment for changes to counterparty credit risk models (EGMA)

Frequently asked questions (FAQs)

1 What is the purpose of the guide?

The guide addresses the materiality assessment of changes to internal models used by banks to calculate certain capital requirements. The respective internal models are used to determine the capital requirements when banks enter into certain transactions with customers. These capital requirements act as a safety buffer in case the bank is confronted with unexpected losses from such transactions. Banks can use internal models to calculate the risk they take in these transactions which then determines the capital requirement which they face.

The guide aims to provide a common understanding of the materiality of extensions and changes to the internal models used by significant institutions within the Single Supervisory Mechanism (SSM) to determine counterparty credit risk (CCR) and credit valuation adjustment (CVA) risk. If such a change or extension is considered to be material, it needs to be approved by the supervisor. A change or extension is considered to be material if certain quantitative and qualitative requirements set out in the guide are met.

2 Why are you publishing the guide? Why does it focus on counterparty credit risk?

The European Commission has adopted regulatory technical standards that set out the materiality assessment criteria for extensions and changes to banks' internal models for credit risk, operational risk and market risk. For IMM[1] and A-CVA[2] models, which are much less widely used by banks, this was not foreseen.

The ECB therefore considered that it would be helpful to provide guidance to banks directly supervised by the ECB on how to assess changes and extensions to such models, drawing as much as possible on the approaches already defined by the European Banking Authority (EBA) for other risk types.

1 Internal model method: a bank's internal model for calculating counterparty credit risk.

2 Advanced method for the measurement of credit valuation adjustment risk: a bank's internal model for calculating CVA risk.

3 What are counterparty credit risk and credit valuation adjustment risk?

The guide deals with models used to calculate CCR and CVA risk for over-the-counter (OTC) derivatives and securities finance transactions. In this context, the CCR represents the expected exposure of a bank for groups of such transactions in the event of a potential default of the counterparty. The expected exposure is the expected replacement cost that the institution will have when re-entering a transaction with a new counterparty.

The CVA is an adjustment made for the expected loss from such a transaction in the event of the default of a counterparty. This adjustment is not constant over time because the credit quality of the counterparty might improve or decline. CVA risk is a measure of the risk associated with this volatility.

Under the Capital Requirements Regulation (CRR), financial institutions can use the internal model method (IMM) for counterparty credit risk and the advanced method for CVA risk (A-CVA) when calculating capital requirements.

4 Why do you focus on OTC derivatives and securities finance transactions?

The guide focuses on OTC derivatives and securities finance transactions because, for these products, the exposure is calculated in a different way than for a traditional loan. In the case of a traditional loan, the exposure is, to a large extent, fixed. In the case of OTC derivatives and securities finance transactions, the exposure depends on the development of market risk factors, such as interest rates and foreign exchange rates, in the period between the initiation and maturing of these products. The dependency of the exposure on the development of market risk factors introduces additional complexity when calculating the exposure values of these products.

5 For which banks is the guide applicable?

The majority of banks use standardised approaches to calculate their expected exposures for counterparty credit risk or their credit valuation risk capital requirements. The guide is only applicable to institutions directly supervised by the ECB that have approval to implement an internal model method in accordance Part Three, Title II, Chapter 6, Section 6 of the CRR and to institutions directly supervised by the ECB that have implemented an advanced method for calculating CVA risk in accordance with Article 383 of the CRR.

6 The guide talks about self-assessment by the institutions. What is the role of the supervisor in this process?

An institution under the ECB's direct supervision must follow the assessment criteria set out in the EGMA when assessing the materiality of an extension or change to its IMM or A-CVA. The result of this self-assessment needs to be submitted to the ECB. The ECB will then check the outcome of the self-assessment.

7 What are OTC derivatives and securities finance transactions?

Derivatives are contracts that derive their value from underlying financial data or financial assets. Over-the-counter (OTC) derivatives are contracts that are traded (and privately negotiated) directly between two parties, without going through an exchange or other intermediary. Examples of OTC derivatives are interest rate swaps and equity options.

Securities finance transactions are transactions where securities are used to borrow cash, or vice versa. An example of a securities finance transaction is a repurchase transaction or repo. In a repo transaction a security, e.g. a bond, is exchanged for a cash amount. The receiver of the cash amount agrees to buy the security back at a later point in time.