EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Publication of the draft ECB guide on the assessment methodology (EGAM) for the internal model method and advanced CVA capital charge for counterparty credit risk

Frequently asked questions (FAQs)

1 What is the purpose of the guide?

The guide addresses the supervisory assessment methodology for models used by banks to calculated capital requirements for counterparty credit risk (CCR) and covers initial approvals, changes and extensions of internal models as well as ongoing model monitoring. The respective internal models are used to determine the capital requirements when banks enter into derivative or securities financing 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 exposure from these transactions relating to a potential default of the counterparty, which then determines their capital requirement.

An assessment methodology determines which model components need to be investigated by supervisors and the minimum level of depth and detail needed to form a supervisory judgement on the model's compliance with existing regulation. Of course, supervisors can always opt to go beyond the minimum requirements defined in an assessment methodology.

The guide aims to provide a common understanding of the supervisory approach to assessing the compliance of these internal models for CCR with existing regulation. The latter comprise the internal model method (IMM) as part of credit risk, providing the exposure value, and the advanced method for calculating own funds requirements due to credit valuation adjustment risk (A-CVA). The guide should not be construed as going beyond the current applicable EU and national law and therefore is not intended to replace, overrule or affect applicable EU and national law.

The assessment methodology outlined in the EGAM can also be used for the self-assessments of credit institutions that have or are preparing internal models of CCR.

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

The European Commission was mandated to adopt regulatory technical standards that set out assessment methodologies for initial approval, extensions and changes to banks' internal models for credit risk, operational risk and market risk. However, mandatory standards are not envisaged for the IMM and A-CVA models, which are less widely used by banks.

The ECB therefore considered it helpful to provide supervisory guidance for those institutions it supervises directly on how to assess the compliance of such models with existing regulation, drawing as far as possible on the approaches already defined by the European Banking Authority (EBA) for other risk types.

3 Why are you asking for industry feedback and what would be the next step?

ECB Banking Supervision decided to use a two-step approach for this guide to be transparent and invite experts to give their opinions. First, industry feedback is being collected. The guide will then be finalised following another call for feedback in 2018.

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

The guide deals with models used to calculate CCR risks for over-the-counter (OTC) derivatives and securities financing transactions (SFT). In this context, the counterparty risk covered by the IMM represents the expected exposure of a bank for portfolios of such transactions in the event that the counterparty defaults. The expected exposure is the expected cost to the institution of replacing the transaction by entering into an equivalent new transaction with a new counterparty.

The CVA is a fair value adjustment for OTC derivatives and SFTs reflecting the expected loss from such a transaction in the event that the counterparty defaults. This adjustment is not constant over time, because the credit quality of the counterparty can improve or decline. CVA risk is a measure of the risk associated with the volatility from these changes.

Under the Capital Requirements Regulation (CRR), financial institutions can apply to use:

- the IMM to calculate the exposure value used in regulatory procedures to calculate capital requirements for credit risk related to the counterparty of OTC derivatives and/or SFTs;

- the A-CVA to get directly the capital requirements related with the risk of changing CVA.

5 What are OTC derivatives and security-financing transactions?

Derivatives are contracts that derive their value from financial data such as the values of indices or underlying financial assets. OTC derivatives are contracts that are traded and privately negotiated directly between two parties, without going through an exchange, but include transactions with central counterparties where contracts are based on novation. Examples of OTC derivatives are an interest rate swap and an equity option.

SFTs are transactions in which securities are used to borrow cash or vice versa. An example of a securities financing transaction is a repurchase transaction, where a security such as a bond is sold for a cash amount and the receiver of the cash amount simultaneously agrees to buy the security back a later date.

Their market values depend on the underlying in the case of an option and the security in the case of an SFT, as well as interest rates and potentially also foreign exchange rates.

6 Why do you focus on OTC derivatives and securities financing transactions?

The guide focuses on the CCR of OTC derivatives and SFTs 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 SFTs, the exposure depends on the development of market risk factors, such as interest rates and foreign exchange rates, during the term of the product. It is this exposure to developments in market risk factors that introduces additional complexity when calculating the exposure values.

7 Which banks does the guide apply to?

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