BCBS finalized the “Targeted revisions to the credit valuation adjustment risk framework” on 8th July 2020 and the HKMA subsequently released their consultation paper to adopt the framework based on the latest BCBS timetable, i.e. by 1 January 2023, for reporting purposes.

Finalization of the CVA framework includes the following changes:

• adjustments to certain risk weights in both the standardized approach and the basic approach to align with the revised market risk framework;
• introduction of new index buckets and revision of the aggregation formula in the standardized approach to align with the revised market risk framework;
• alternations to the scope of the CVA risk framework by excluding some securities financing transactions (SFTs) where the CVA risk stemming from such positions is not material; and
• revision of the overall calibration of the CVA risk framework by reducing the aggregate multiplier in the standardized approach and introducing a similar scalar for the basic approach.

Key facts about the new regulatory CVA framework:

- Banks may choose to adopt 1 out of 3 approaches for CVA capital calculations, namely, 100% of counterparty credit risk capital charge as calculated based on SA-CCR if the total notional for OTC trades is less than HKD 1 trillion, the basic approach (BA-CVA) and the standardized approach (SA-CVA). The BA-CVA is similar to the current standard approach, a conservatively calibrated approach that is relatively simple to implement. The SA-CVA is based on sensitivities and a variance-covariance model, whose input parameters are subject to various requirements and whose application requires prior supervisory approval.

- Banks do not have to apply the same approach to the entire scope of application. If supervisory approval is granted, banks can decide which approach to use at the level of each netting set.

- Both external and internal transactions are permitted as hedges. In the case of internal transactions, specific requirements are applied to the internal risk transfer and the delimitation of capital requirements from CVA risks and market risks. Depending on the respective approach, different ranges of product types are allowed as eligible hedges.

- When determining the output floor across all risk categories, the calculated risk-weighted assets from CVA risks are treated as being a standardized approach irrespective of whether a bank uses SA-CVA or BA-CVA.
- There is therefore no output floor constraint from using the more risk sensitive SA-CVA rather than the BA-CVA.

1https://www.bis.org/bcbs/publ/d507.pdf
2https://www.hkma.gov.hk/media/eng/regulatory-resources/consultations/CP20_03_CVA_Risk.pdf
Key considerations for adoption of the new CVA framework:

- The SA-CVA continues to be the more risk-sensitive and a less conservative approach, which reduces the capital requirements for CVA risks compared with the BA-CVA.
- In particular, for banks whose derivative transactions are materially affected by capital requirements from CVA risks, it is beneficial to consider applying this approach. Since there are no restrictions on product type coverage of eligible CVA hedges in the SA-CVA, the possibilities of optimizing the capital requirement in line with economic CVA management are significantly improved compared to the status quo and previous Basel Committee publications;
- There are two BA-CVA calculation rules, one with and one without consideration of hedging transactions. Even if all CVA risks are mitigated through hedge transactions, the calculation rule without hedge transactions has to be considered as a partial floor.
- Only transactions to hedge credit spread risks are permitted as hedging transactions, with only credit default swaps (Single-Same CDS, Single-Name Contingent CDS and Index CDS) allowed as eligible product types.
- Although the SA-CVA is classified as a standard approach, banks can only adopt this approach if they meet detailed requirements on data, the modelling of sensitivities and governance, similar to the requirements that are currently applied to the use of internal models for market risk or counterparty credit risk. Banks planning to apply for approval to use the SA-CVA should therefore consider at an early stage how to meet this range of requirements.

KPMG services to support you on CVA:

- Capital Impact Analysis: Banks should undertake a quantitative impact study based on the final standards to understand the probable capital charge impacts based on the reduced version of BA-CVA, the full version of BA-CVA and potentially the SA-CVA. This also needs to include the impact of the new standard approach for counterparty credit risk derivatives exposures (SA-CCR).
- Key Actions to Take:
  - Clearly define roles and responsibilities for implementation, maintenance, ongoing monitoring and governance;
  - Perform a gap analysis to fully understand gaps on data, feeder model (e.g. SA-CCR) and articulate system enhancements required; and
  - Developing roadmaps for implementation and the operating model to aid accelerated roll out.
- BA-CVA Adoption:
  - Perform a gap analysis on adoption of SA-CVA to clearly understand the gaps on data and feeder models such as accounting CVA and instrument valuation models;
  - Evaluate under which circumstances the SA-CVA would be advantageous compared to the BA-CVA from a cost-benefit perspective; and
  - Assist you to perform an independent validation on the SA-CVA models, including review of all requirements for regulatory approval.
- SA-CVA Approval Preparation:
  - Banks should undertake a quantitative impact study based on the final standards to understand the probable capital charge impacts based on the reduced version of BA-CVA, the full version of BA-CVA and potentially the SA-CVA. This also needs to include the impact of the new standard approach for counterparty credit risk derivatives exposures (SA-CCR).

Contact us

Paul McSheaffrey
Partner, Head of Banking & Capital Markets, Hong Kong
KPMG China
T: +852 2978 8236
E: paul.mcsheaffrey@kpmg.com

Tom Jenkins
Partner, Head of Financial Risk Management
KPMG China
T: +852 2143 8670
E: tom.jenkins@kpmg.com

Michael Monteforte
Partner, Financial Risk Management
KPMG China
T: +852 2847 5012
E: michael.monteforte@kpmg.com

Gemini Yang
Partner, Financial Risk Management
KPMG China
T: +852 3927 5731
E: gemini.yang@kpmg.com

Mo Liang
Associate Director, Financial Risk Management
KPMG China
T: +852 3927 3108
E: mo.liang@kpmg.com

kpmg.com/cn

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2021 KPMG Advisory (Hong Kong) Limited, a Hong Kong limited liability company and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Printed in Hong Kong, China. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.