Implementation of the Basel IV

CVA Framework in Hong Kong

January 2021

BCBS finalized the "*Targeted revisions to the credit valuation adjustment risk framework*[1]" on 8th July 2020 and the HKMA subsequently released their consultation paper[2] 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:

Options for Calculation

- 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.

Scope of Application

- 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.

CVA Hedges

- 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.

Output Floor

- 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.

[1]https://www.bis.org/bcbs/publ/d507.pdf
[2]https://www.hkma.gov.hk/media/eng/regulatory-resources/consultations/CP20_03_CVA_Risk.pdf

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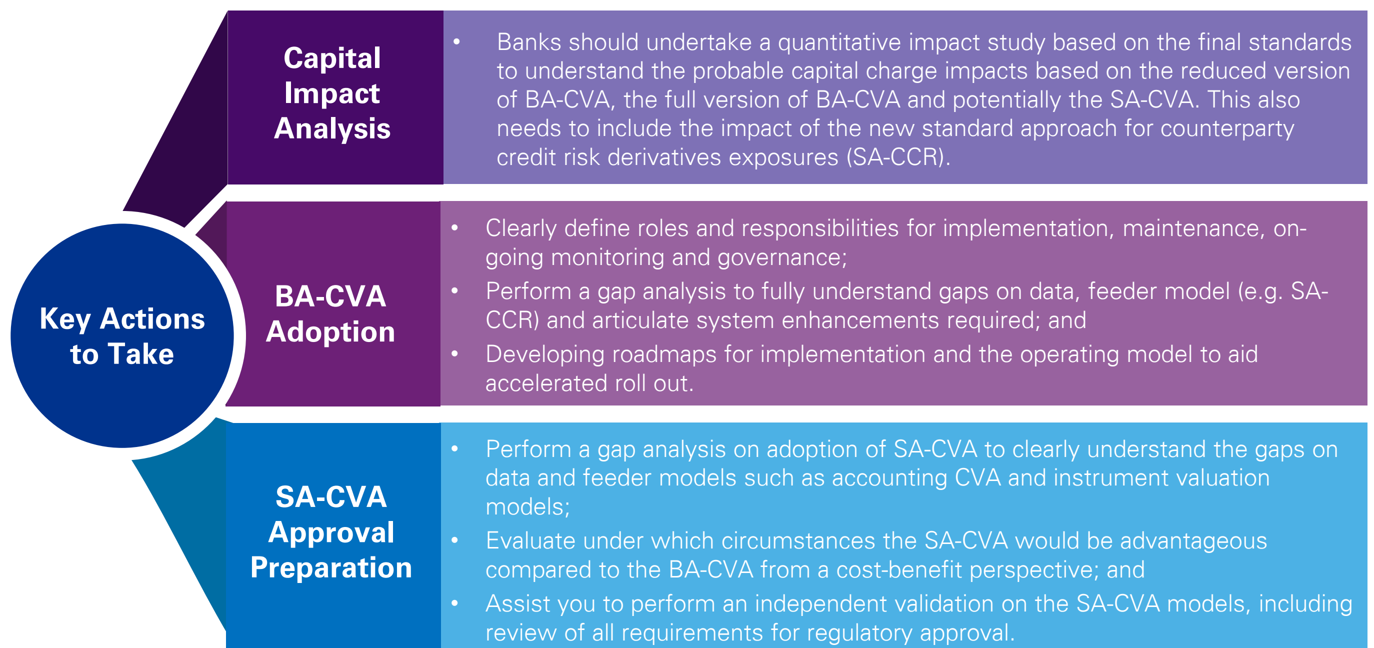
Key considerations for adoption of the new CVA framework:

- 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:



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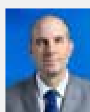

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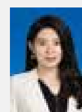

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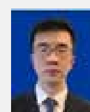

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