

Murex - Capital and Margin Reforms in Asia – Implementation and Impact

The State of Global xVA Standards and their Adoption in Asia

Jon Gregory, 22nd November 2016

We May Struggle to Agree on What We Mean by xVA

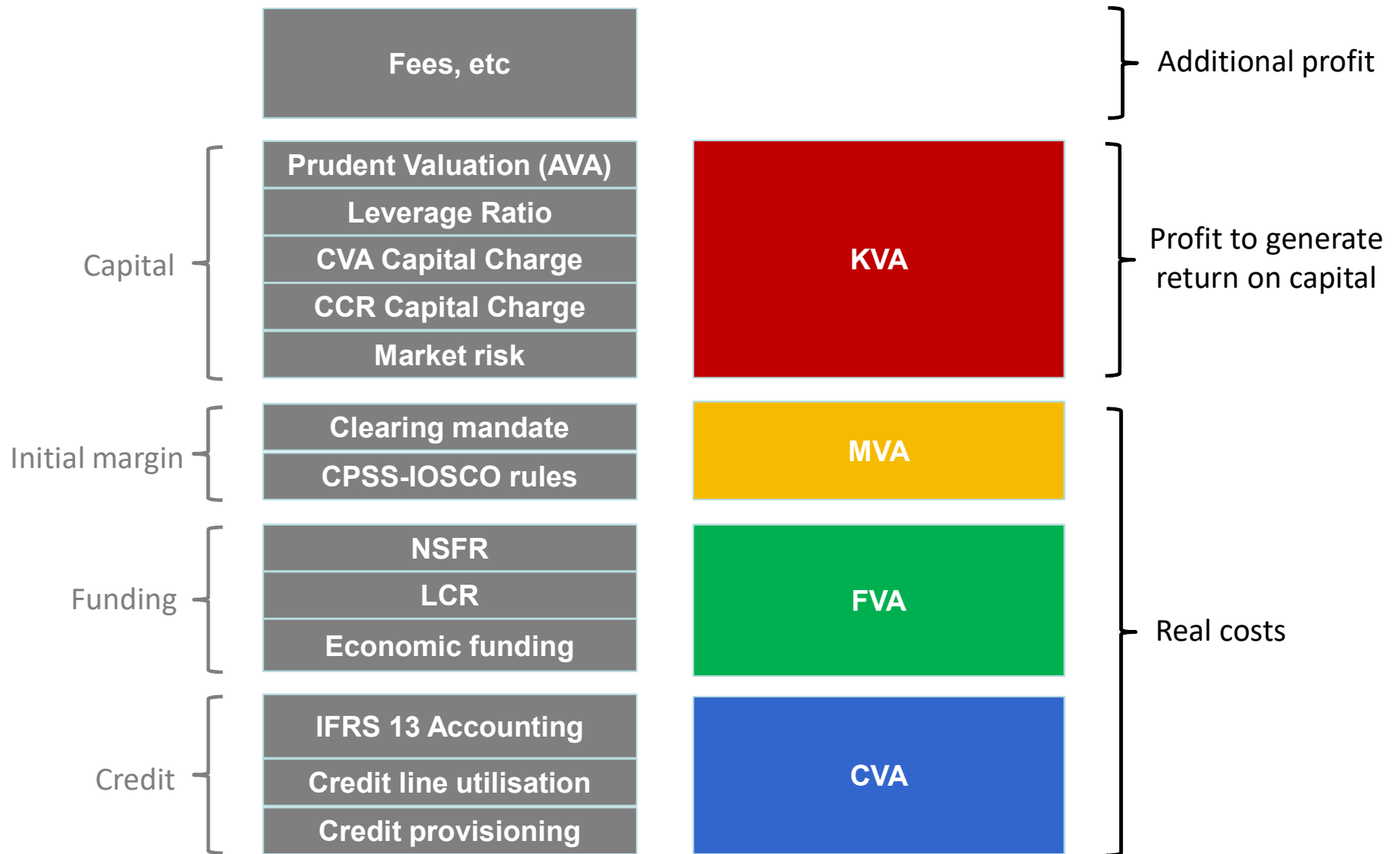
Salesperson: suppose you charge me CVA and then the counterparty never defaults. What happens to my CVA?



CVA trader: I probably use it to hedge my cross gamma

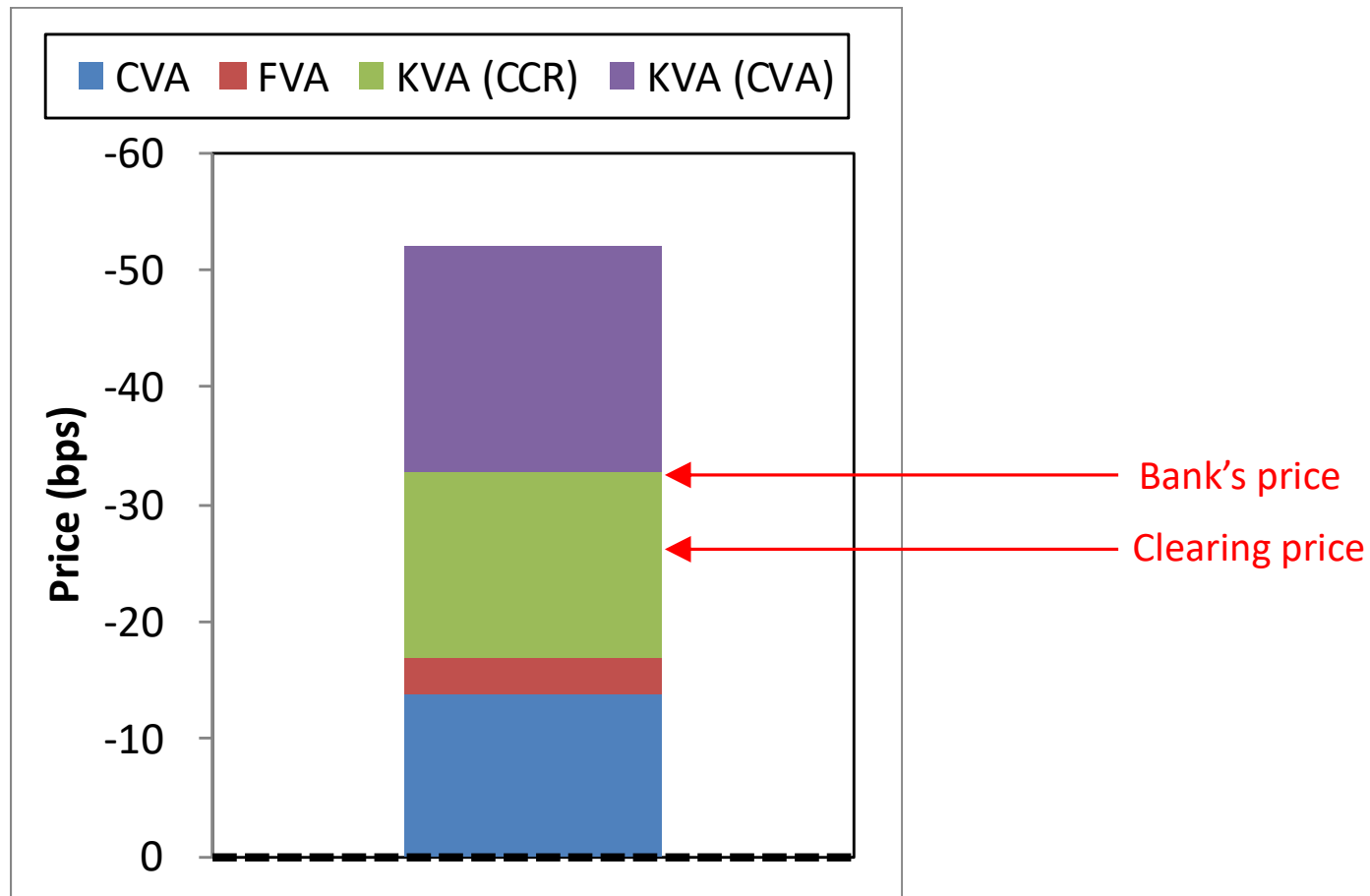


Economic, Accounting and Regulatory Drivers of xVA



Competitive Pricing is Still Diverging

- Cross-currency swap with double-B corporate (uncollateralised, no refix)



OTC Derivatives Pre and Post Financial Crisis

- **Pricing has not changed**
 - Transactions still priced rapidly even though they are seen as dramatically more complex
- **xVA is derivatives pricing**
 - So why do so many banks misprice? No arbitrage opportunities, just a winner's curse

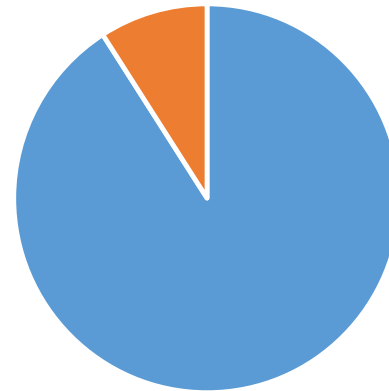
Traders shocked by \$712m CVA loss at StanChart

Feature - Tue 15th Mar

Bank's new methodology has been used by some rivals for more than a decade

- **Still no long-term incentive**

Is any portion of the capital charge currently withheld?



■ No - released immediately into P&L ■ Yes - released over time

The Move to a Long-Term View

	Traditional bank approach	Best Practice
CVA	Trading desk and sales division face default losses	CVA pricing, accounting and central management
FVA/MVA	Treasury funds the bank and charges trading desk overnight funding	FVA inception pricing, accounting and central management
CoIVA	Collateral management manages operational aspects of collateral.	CoIVA inception pricing, accounting and central management
KVA	Trading desk is charged for capital and businesses set soft return on capital metrics	Capital is priced directly into transactions via hurdles and released over the lifetime

The Global View on xVA

- **For large banks with big derivatives balance sheets, xVA is part of business**
 - xVA desk, IMM approval, active management, reg. capital part of the decision making process
 - Adjustments taken for change in methodology (e.g. CVA) or newly discovered costs (e.g. FVA)
- **For very small banks (in derivatives terms), xVA is a nuisance**
 - IFRS 13 and Basel compliance?
 - Pricing with some credit, funding and capital charge
- **Across a derivatives business there are multiple costs (and benefits)**
- **They co-exist and are not mutually exclusive**
 - A consistent treatment is therefore important

Not all counterparties have traded credit spreads. However, the FRTB-CVA framework must capitalise CVA risk arising from dealing with all counterparties, including ones that are not actively traded in credit markets (“illiquid counterparties”). Therefore, in order to use the FRTB-CVA framework, a bank is required to have a methodology for approximating the credit spreads of illiquid counterparties (see Section B.1(f) of the draft Accord text).

Banks normally develop the capability of calculating CVA sensitivities in order to manage their CVA risk. Typically, CVA risk management is performed by a dedicated function, such as the CVA desk. CVA sensitivities calculated by a bank without any internal function to use them would not be deemed reliable. Thus, the existence of a dedicated CVA risk management function will be a requirement.

FRTB May Define Two xVA Business Models

Active Approach	Passive Approach
Central resource management (xVA desk)	No centralised approach
Map to “illiquid” credit spreads	Illiquid credit risk still dealt with in real world
Active and consistent management of CVA, FVA, MVA, etc	No active management
Lower capital charges (SA-CVA and maybe IMM) Capital relief from hedges	Higher capital charges (SA-CCR and BA-CVA) No capital relief (hedges may use capital)
Long-term view on return on capital (KVA) vs. P&L	P&L centric
Correct and consistent pricing and valuation (novations, restructurings, backloading, etc)	Potential for inconsistency as xVA is not dealt with holistically
Optimises around initial margin, capital, P&L etc.	Struggles to define what is optimal
Active derivatives player	Only trades derivatives where critical