### ****Introduction & Objective****

Today’s discussion focused on opportunities to **optimize Capital** by reducing **Stressed VaR (S-VaR)**, with a particular focus on Credit risk. The objective is to explore **practical and defensible ways** to bring our **S-VaR-to-J-VaR ratio** closer to industry standards while ensuring alignment with regulatory expectations.

**Current State & Key Observations**

1. **S-VaR Reduction is Challenging Without Structural Changes**
   * Our current **S-VaR-to-J-VaR ratio is significantly higher** than industry peers (~7x vs. 2x).
   * Achieving a drastic reduction (50-70%) would require **fundamental shifts in methodology or exposure management**.
2. **Data Refinements Will Only Deliver Marginal Gains**
   * Efforts to **eliminate incorrect proxies, add granularity, and introduce regional segmentation** are valuable.
   * However, these **incremental improvements will not meaningfully move the needle**—best-case impact is reducing the ratio to ~10x, still far from peers.
3. **Methodology & Exposure Drive S-VaR More Than Data Gaps**
   * Our VaR models **map all USD-denominated bonds to US credit drivers**, missing regional diversification benefits.
   * While this inflates risk estimates, the impact is **not enough** to explain the gap vs. peers.
   * **Key industry practice:** Many firms **actively hedge** tail risk using CDX options, bond ETF options, or S&P 500 puts—**a strategy we currently do not employ**.

**Key Takeaways & Next Steps**

✅ **Refining data & proxies is necessary but not sufficient** – It will **not** yield the level of capital efficiency improvement required.

✅ **Significant reduction in S-VaR requires** either:

* **Changing the VaR methodology** (e.g., introducing a hybrid absolute-relative shift model—though this is difficult to justify from a regulatory standpoint).
* **Strategic risk hedging**, similar to peers, to mitigate tail-risk exposure.

✅ **A decision is needed on risk strategy alignment:**

* **Maintain current conservative approach** and accept higher capital charges.
* **Adopt active hedging strategies** to optimize capital efficiency while managing risk appropriately.

**Action Items & Leadership Alignment**

📌 **Internal alignment needed before presenting to senior leadership.**  
📌 **Reassess exposure management strategy**, focusing on whether strategic hedging is a viable path forward.  
📌 **Validate industry best practices**—How are competitors achieving a lower S-VaR?

**Summary: Capital Optimization on Credit Scope**

**1. The Core Issue: Reducing S-VaR**

* The primary goal is to **significantly reduce S-VaR** (Stressed Value at Risk) by 50-70%.
* This can only be done by **changing the spread driver** or **modifying the shifts**.
* Changing the shifts involves altering the VaR methodology (e.g., using relative shifts or alternative approaches).

**2. Challenges in Credit Risk Modeling**

* **Proxy Issues:**
  + Many USD-denominated corporate bonds, even if issued by Asian companies, get mapped to **US corporate bond drivers**, leading to **misalignment in risk modeling**.
  + This results in **overstated** S-VaR as diversification from different regions is not captured.
* **Region as a Missing Dimension:**
  + A lack of regional differentiation in risk factors means shocks are applied uniformly.
  + For example, **COVID-19 impacted China differently than the US**, but since the same shocks are applied, potential offsets are missed.
  + Not having regional segmentation inflates S-VaR.

**3. Proposed Enhancements**

* **Adding Region-Specific Factors:**
  + Could **moderately reduce** S-VaR (e.g., potential $5M–$10M savings).
* **Enhancements on CDS Side:**
  + While regions are considered in CDS, name-specific risk is not.
  + Potential room to improve by incorporating name-specific data.

**4. Absolute vs. Relative Shifts Debate**

* **How VaR is Modeled Matters:**
  + If using **relative shifts**, today’s spreads are multiplied by past relative changes.
  + If spreads were low before a crisis (like COVID-19), relative shifts may not show significant benefits.
  + **A hybrid approach** (combining absolute and relative shifts) could optimize S-VaR but would be difficult to defend from a regulatory perspective.

**5. Structural Barriers to Large S-VaR Reduction**

* **Comparing to Peers:**
  + Some banks have much lower S-VaR to J-VaR ratios (2x compared to the current 7x).
  + Achieving this level requires **drastic methodology changes or significant exposure reductions**.
* **Other Banks' Capital Optimization Strategies:**
  + Many peers hedge their exposure more aggressively, particularly through **tail-risk hedging strategies**.
  + This could include **CDX options, bond ETF options, or put options on S&P 500**, providing protection against severe market shocks.
  + These strategies **don’t show in spread driver models** but help lower S-VaR significantly.

**6. Data Issues vs. Fundamental Modeling Issues**

* **Current efforts focus on fixing data proxies** (e.g., eliminating incorrect mappings, improving granularity).
* However, **these data fixes alone will not drastically reduce S-VaR**.
* Example:
  + BlackRock was previously blamed for overstating VaR.
  + Even after transitioning to an in-house model, the issue remains **due to the inherent exposure itself**.

**7. Key Conclusion: Limited Impact from Data Fixes**

* **Data improvements will only yield marginal benefits** (best case: reducing S-VaR from 20x to 10x).
* The fundamental issue is the **methodology and exposure itself**, which requires:
  + **Strategic hedging**
  + **More aggressive exposure management**
  + **Potential adjustments to the VaR framework**
* **Decision-makers must align on realistic expectations**:
  + Addressing **known data issues** is important but will **not** be sufficient to match peer levels without structural risk management changes.

**8. Next Steps & Leadership Alignment**

* **Internal discussions are ongoing** to refine messaging before presenting to senior leadership (e.g., Dan Thomas, Packer).
* The focus is on whether the firm will **accept its current high S-VaR levels or adopt hedging strategies similar to competitors**.
* Future decisions will hinge on **whether the institution prioritizes capital efficiency over conservative risk modeling**.