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Capital Requirements Directive IV Framework
Credit Valuation Adjustment (CVA)

Allen & Overy Client Briefing Paper 10 | January 2014

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CRD IV Framework: *Credit Valuation Adjustment (CVA)*

This briefing paper is part of a series of briefings on the implementation of Basel III in Europe via the Capital Requirements Directive IV[1] (**CRD IV**) and the Capital Requirements Regulation[2] (**CRR**), replacing the Banking Consolidation Directive[3] and the Capital Adequacy Directive.[4] The legislation is highly complex: these briefings are intended to provide a high-level overview of the architecture of the regulatory capital and liquidity framework and to draw attention to the legal issues likely to be relevant to the in-house lawyer. This briefing is for general guidance only and does not constitute definitive advice.

NOTE: In relation to the topics discussed in this briefing, the CRR contains a number of discretions for member states in relation to national implementation. The regime may therefore differ across member states in a number of respects.

This briefing paper is based on information available as at 17 January 2014.

[1] 2013/36/EU.
[2] Regulation 575/2013.
[3] 2006/48/EU.
[4] 2006/49/EU.

Background and Scope

The global financial crisis has prompted legislators and regulators to introduce reforms and strengthen existing legislation to address perceived weaknesses in derivatives markets. These reforms include a number of measures aimed at reducing counterparty credit risk including more robust back-testing and stress testing, the requirement for certain derivatives contracts to be cleared through a central counterparty (**CCP**), increased capital requirements and, to the extent derivatives contracts are not cleared, increased collateral and even higher capital requirements (thus incentivising central counterparty clearing). This briefing paper will focus on capital requirements and, in particular, the new requirements in respect of CVA risk.

Sources

CRR (*Regulation 575/2013*): Recital (83); Part Three: Article 92(3)(d), Article 162(2)(h), Article 273(6), Title VI (Articles 381-386), Part Nine: Article 456(2), Article 457(h) and, Part Ten: Article 482.

UK Financial Conduct Authority (**FCA**) Policy Statement (*PS13/10*) CRD IV for Investment Firms (December 2013) (the **FCA Policy Statement**).

UK Prudential Regulation Authority (**PRA**) Policy Statement (*PS7/13*) Strengthening capital standards: implementing CRD IV, feedback and final rules (December 2013) (the **PRA Policy Statement**).

PRA Supervisory Statement (*SS12/13*) Counterparty credit risk (December 2013) (the **PRA Supervisory Statement**).

Introduction

Previously, the Basel II regulatory capital regime addressed the risk of counterparty default in respect of derivatives transactions but did not address CVA risk and, thus, failed in some cases to capture the risk of mark-to-market losses resulting from a deterioration in the creditworthiness of counterparties to derivatives transactions. This led to a number of institutions not holding adequate capital to cover CVA losses during the financial crisis, and indeed, mark-to-market losses being a "greater source of losses than those arising from outright defaults".[5]

Consequently, as part of the drive to make sure all underlying, material risks are addressed in the capital regime, Basel III sought to strengthen the global counterparty credit risk framework by, amongst other things, increasing the risk weights of counterparty credit exposures relating to derivatives transactions entered into with financial institutions (although these will be lower in respect of cleared transactions) and introducing requirements for institutions to set aside regulatory capital to cover CVA risk (in addition to counterparty default risk). The measures target financial institutions specifically as they are perceived as being the most sensitive to systemic risk due to the sheer volume of derivatives exposures concentrated within a relatively small number of counterparties which could, as it did in 2008, lead to a simultaneous deterioration of credit quality at times of market stress and pro-cyclicality.

[5] See BCBS: *Basel III: A global regulatory framework for more resilient banks and banking systems* dated June 2011 at Section A, paragraph 2(14)(b).

In Europe, CVA risk is addressed in the CRR although it differs in some significant respects to the Basel III proposals. The European CVA regime took effect from 1 January 2014 and applies to credit institutions and investment firms entering into uncleared OTC derivatives transactions and securities financing transactions which are not subject to an exemption.

It is worth noting that, in respect of uncleared derivatives transactions, the European Market Infrastructure Regulation (**EMIR**)[6] also requires financial counterparties to hold an "appropriate and proportionate amount of capital to manage the risk not covered by appropriate exchange of collateral"[7]: it is expected that this requirement will be satisfied by compliance with the CRR.[8] It is, however, unclear how financial counterparties (as defined in EMIR) will be expected to comply with their EMIR capital obligations to the extent they are not subject to the CRR (ie they are not institutions).

[6] Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories dated 4 July 2012.
[7] See Article 11(4) EMIR.
[8] See Joint ESMA/EIOPA/EBA Discussion Paper on Technical Standards on Risk Mitigation Techiques for Uncleared OTC Derivatives dated 6 March 2012.

What is CVA risk?

CVA risk is the risk of loss caused by changes in the credit spread of a counterparty due to changes in its credit quality. CVA is "an adjustment to the mid-market valuation of the portfolio of transactions with a counterparty" which "reflects the current market value of the credit risk of the counterparty to the institution".[9] It has also been described as "the difference between the 'hypothetical' value of the derivative transaction assuming a risk-free counterparty and the true value of the derivative transaction that takes into account the possibility of changes in creditworthiness of the counterparty

[9] See Article 381 (*Meaning of Credit Valuation Adjustment*) CRR.

(including the possibility of the counterparty's default)".[10] The purpose of CVA is to quantify the risk that counterparties to derivatives transactions may be more or less creditworthy at any given time during the life of a transaction because this will affect the value of the transaction to the counterparties. It is, therefore, an important component in valuing derivatives. It is imperative that this value is as accurate as possible, particularly during times of market stress when markets are more volatile, so that counterparties can ensure that transactions are correctly valued for accounting purposes and appropriate regulatory capital is set aside to protect against the risk of insolvency arising from such losses.

[10] See EC consultation on counterparty credit risk – frequently asked questions (MEMO/11/77) dated 9 February 2011.

The calculation of CVA takes into account certain counterparty credit risk mitigants such as netting and collateral arrangements and certain offsetting hedges and seeks to cover any risk that is left after these other mitigants have been factored in.

Scope

Under the CRR, credit institutions and investment firms are required to hold additional own funds due to CVA risk arising from OTC derivatives (other than credit derivatives used for credit risk mitigation (**CRM**)[11] purposes) and, if CVA risk exposures are material, securities financing transactions.[12]

However, exemptions are available in respect of:

(i) transactions cleared through a CCP (including transactions with a qualifying CCP and transactions between a client and a clearing member when the clearing member acts as an intermediary between the client and the relevant CCP);[13]

(ii) transactions with non-financial counterparties[14] which do not exceed the 'clearing threshold' as defined in EMIR[15] (known as **NFC-s**) regardless of whether such counterparties are established in the EU or in a third country - this effectively includes all undertakings other than financial counterparties[16] and CCPs;[17][18]

(iii) intra-group transactions (subject to national laws requiring the structural separation of a banking group);[19]

(iv) transactions with pension scheme arrangements[20] (until the transitional provisions in EMIR cease to apply);[21]

(v) transactions with entities out-of-scope of EMIR (including members of the ESCB and other member states' bodies performing similar functions and other EU public bodies charged with or intervening in the management of the public debt, the Bank for International Settlements, multilateral development banks, certain public sector entities, the European Financial Stability Facility and the European

[11] Article 92(3)(d) CRR. "OTC derivatives" are not specifically defined in the CRR but derivative instruments relevant for counterparty credit risk purposes are listed in Annex II of the CRR. Annex II sets out a list of derivative types which includes derivatives within points (4) to (7) and (9) and (10) of Section C of Annex I of MiFID (*2004/39/EC*). "OTC" means derivatives executed on a regulated market or third country equivalent (this is how EMIR defines "OTC"). It is worth noting that the CRR definition of derivatives differs from EMIR in that it does not include point (8) of Section C of Annex 1 of MiFID.
[12] Article 382(2) CRR. "Securities financing transactions" are not defined in the CRR but are understood as meaning references to securities or commodities lending or borrowing transactions and repurchase transactions. See PRA Consultation Paper (CP5/13) "Strengthening capital standards: implementing CRD IV" dated August 2013 at paragraph 8.11. See also the PRA Policy Statement at paragraph 8.5 and the PRA Supervisory Statement at paragraph 3 in respect of the PRA's determination of when risk exposures arising from securities financing transactions should be deemed material and be included in the scope of the own funds requirements for CVA in accordance with Article 382(2) CRR.
[13] Article 382(3) CRR.

[14] As defined in Article 2(9) EMIR.
[15] As defined in Article 10 EMIR.
[16] As defined in Article 2(8) EMIR.
[17] As defined in Article 2(1) EMIR.
[18] Article 382(4)(a) CRR.
[19] Article 382(4)(b) CRR.
[20] As defined in Article 2(10) EMIR.
[21] Article 382(4)(c) and Article 482 CRR.

Stability Mechanism) (**Out-of-Scope Entities**);[22] [23] and

(vi) transactions with regional governments or local authorities which are assigned a 0% risk weight in accordance with Article 115 of the CRR.[24]

CVA capital charges will, therefore, only apply to OTC derivatives and certain securities financing transactions entered into by credit institutions and investment firms with:

(i) other financial counterparties (**FCs**) which do not benefit from an exemption (including other authorised credit institutions, authorised investment firms, alternative investment funds (**AIFs**) managed by authorised or registered alternative investment fund managers (**AIFMs**), authorised insurance, assurance and reinsurance undertakings and authorised UCITS) and third country equivalents of them; and

(ii) non-financial counterparties above the 'clearing threshold' (**NFC+s**) and third country equivalents of them,

provided that such transactions are not cleared through a CCP (either directly or via a clearing member as intermediary for a client) and are not intra-group. As cleared transactions are exempt, the introduction of the CVA charge can be seen as an incentive to encourage central counterparty clearing.

Further analysis may be needed to ascertain whether certain legal persons fall within the exemptions (for example, individuals contracting in a personal capacity, certain international organisations and non-EU central banks) and also in respect of which entities constitute equivalent third country entities for the purposes of the NFC categorisation.

The carve-out for NFC-s, pension scheme arrangements and Out-of-Scope Entities from the scope of the change is not consistent with the Basel III requirements, which do not provide exemptions for such entities. This potentially places European institutions at a considerable advantage in respect of pricing trades with these counterparties as compared to third country institutions who have followed the Basel III approach and who will, consequently, be required to apply a CVA charge to such trades. The rationale for the European exemption is that the CVA charge is likely to be much more significant in respect of transactions with counterparties (such as certain corporates) who trade on an uncollateralised basis and/or in respect of whom there is no suitable offsetting CDS hedge and whose trades will also be exempt from clearing and increased collateral requirements. As such entities have been specifically exempted from clearing and increased collateral requirements, it seems punitive to subsequently apply increased capital requirements to those transactions (the cost of which will likely be passed on the relevant counterparties). It is possible that the European position may change in line with the Basel III framework to create a more level playing field globally if European national authorities choose to apply additional capital charges in respect of these counterparties in response to pressure from the international community.

[22] As defined in Articles 1(4) and 1(5) EMIR.
[23] Article 382(4)(d) CRR.
[24] Article 382(4)(d) CRR.

How CVA is calculated

Calculating CVA risk is complex. Historically, institutions did not calculate CVA but it became more common in the early 2000s with some large institutions setting up dedicated CVA desks to hedge CVA risk often across the firm as a whole (but sometimes on a desk-by-desk basis). Following the financial crisis there has been a renewed focus on managing counterparty credit risk and managing CVA risk has become more common and more sophisticated. The sophistication of a firm's existing system for calculating and hedging CVA will vary depending on a number of factors, for example, the size of the firm and whether it has been cost effective to build the relevant systems in the context of the business.

One of the reasons for the complexity in calculating CVA is that CVA must be calculated on a portfolio basis for a particular netting counterparty taking into account netting and collateral arrangements for that counterparty (which are also calculated on a portfolio basis) and any offsetting hedges before the effect of CVA can be calculated in respect of a particular trade. To calculate an incremental CVA in respect of any new trades, the CVA desk (if there is one) will look at whether entering into the new trade will have a positive or negative effect on the CVA for that counterparty as a whole. This cost may be recognised in the pricing of the trade. The advent of the new CVA capital charge may increase the cost of entering into new trades within its scope, as the cost of holding extra capital is taken into account by a firm. Institutions will be likely to look to improve their systems and hedge their CVA risk in order to minimise capital charges.

The CRR specifies two main methods for the calculation of CVA (the formulae for which are set out in the text of CRR):

(i) Advanced method[25] – This involves using a firm's internal models (to the extent a firm is permitted to do this under the CRR) to calculate the impact of changes in counterparty credit spreads on the relevant CVA taking into account eligible hedges (using the exposure amount and the relevant credit spread). It does not take into account other market factors that may be relevant such as interest rate or currency risk. The CRR provides that if a credit spread is not available for a counterparty, a proxy spread should be used. There have been concerns about how institutions may need to revise their internal models to comply with the rules on proxy spreads in the CRR.

(ii) Standardised method[26] – To the extent a firm does not use advanced method for the calculation of own funds requirement for CVA risk (including if an appropriate proxy spread with reference to rating, industry and region of the counterparty is not available),[27] it should calculate it in accordance with the standardised method taking into account eligible hedges. In practice, this is likely to be a more capital-intensive option for institutions.

There is also an alternative method of calculating the own funds requirement for those institutions with a small trading book using the Original Exposure Method[28] for CRR valuation if the prior consent of the relevant competent authority is obtained.

[25] Article 383 CRR.

[26] Article 384 CRR.

[27] Article 383(6) CRR.

[28] Article 385 CRR. See also paragraph 8.7 (CVA risk calculation) in the PRA Policy Statement in respect of guidance on the PRA's expectations related to permission to use the approach defined in Article 385 to calculate the own funds requirements for CVA risk.

Eligible hedges

Institutions which do not hedge CVA are likely to be more vulnerable to losses in times of market stress. The CRR regime incentivises institutions to hedge CVA risk, if possible, by providing that entering into "eligible hedges" will reduce the amount a firm must hold against CVA risk. Eligible hedges themselves will not be subject to a CVA charge.

Under CRR, "eligible hedges"[29] must be:

(i) used for the purpose of mitigating CVA risk and be managed as such; and

(ii) either:

(a) single-name credit default swaps (**CDS**) or other equivalent hedging instruments referencing the counterparty directly; or

(b) index CDS, provided that the basis between any individual counterparty spread (or proxy therefor) and the spreads of index CDS hedges is reflected, to the satisfaction of the competent authority, in the value-at-risk and the stressed value-at-risk.

Over-hedging of exposures with a single name CDS under the advanced method is not permitted.[30] Other types of hedge are not permitted and, in particular, tranched or nth-to-default CDS and credit-linked notes.[31]

Notably, the CRR does not permit hedges relating to other factors that may affect CVA (for example, interest rate risk) to be taken into account as eligible hedges (the position may be different in the other jurisdictions where market hedges may be permitted).

By comparison, the Basel III framework additionally allows institutions to enter into "single-name contingent CDS and other equivalent hedging instruments referencing the counterparty directly"[32] so that institutions can tailor the CDS protection to a specific transaction. It is unclear whether a single-name CCDS can be viewed as a single-name CDS for eligible hedge purposes.

Market participants have raised concerns about the CVA charge being linked too closely with illiquid CDS markets which can be volatile and, consequently, could introduce more counterparty credit risk rather than help eliminate it. For many counterparties, CDS spreads are not available or are illiquid which is one of the reasons why market participants have been concerned that proxy spreads should be used correctly. It is worth noting, however, that the single-name CDS requirement only permits the counterparty itself to be referenced (and not a proxy) which would mean that only index CDS would be permitted as eligible hedges in respect of names for which no credit spread was available (and these may or may not be well correlated to the underlying exposure). It may also be that the ability to use eligible hedges for regulatory capital purposes increases the market for certain, particularly index, CDS and therefore has wider ramifications for the CDS market as a whole. There have been concerns that, in respect of certain less liquid names, purchasing CDS as a hedge for CVA risk may lead to pro-cyclicality if credit spreads widen as a result of institutions entering into more CDS contracts.

[29] Article 386(1) CRR.
[30] Article 386(1) CRR.
[31] Article 386(2) CRR.

[32] See BCBS: *Basel III: A global regulatory framework for more resilient banks and banking systems* dated June 2011 at paragraph 103.

Impact

The impact in respect of the new CVA charge is still unclear.

Once FCs and NFC+s are required to comply with clearing and collateral requirements under EMIR, the impact of the CVA charge may be more limited as standardised transactions between these entities will be cleared and non-standardised transactions will attract a lower capital charge once collateral and eligible hedges are taken into account (although, as discussed above, it is currently unclear how non-firm FCs will be expected to comply with their EMIR capital requirements). However, on current expectations with regard to the implementation of EMIR, clearing will not take effect until mid-2014 at the earliest and increased collateral requirements may not take effect until the end of 2015 whereas the CVA charge applies from 1 January 2014, leaving institutions potentially facing higher capital requirements in the interim period.

Additionally, if it remains the case that European national authorities do not add additional own funds requirements for transactions with CRR exempt counterparties (for example, NFC-s), the impact of the CVA charge may remain more limited in the long term.

This could put European institutions at a competitive advantage over third country institutions which have implemented Basel III without amendment and, therefore, cannot rely on such exemptions, thus leading to a less competitive pricing of trades. Although it is worth noting that there are fears that this (and other divergences from the Basel III framework, for example the inclusion of market risk hedges in the calculation of CVA in certain jurisdictions) may undermine the credibility of Basel III and global consistency and could lead to regulatory arbitrage.

However, if European national authorities move to realign capital requirements with Basel III by introducing additional national measures (and thus effectively removing the exemptions for certain counterparties included in the CRR), the new CVA charge may have a much greater impact as it will force institutions to hold increased capital in respect of uncleared and/or uncollateralised transactions - the cost of which will likely be passed on to the counterparty when the trade is priced (either by way of CVA charge and/or via the cost of entering into an eligible hedge). It may also put European institutions at a competitive disadvantage in respect of hedging other risks, such as interest rate risk, associated with these trades which may impact the CVA but cannot be classified as eligible hedges under the CRR (whereas certain overseas institutions, for example, may be able to hedge market risk under their implementation of the Basel rules).

There are also concerns about the mismatch between the accounting and regulatory capital treatment of CVA which could, for example, lead to eligible hedges being taken into account for regulatory capital but not accounting purposes and vice versa. Indeed, this has already led to considerable discussion in the market.

The full impact of the new CVA charge, therefore, still remains to be seen.

Transitional provisions

The transitional provisions in EMIR which apply to transactions with pension scheme arrangements[33] also apply in respect of the CRR (ie transactions with pension scheme arrangements are exempt until the transitional provisions cease to apply).[34]

[33] Article 89(1) EMIR.

[34] Article 382(4)(c) and Article 482 CRR.

EBA technical standards and reports

The CRR mandates that various technical standards and reports shall be produced. In connection with CVA risk, the following standards and report have been/shall be produced:

CRR SOURCE	TECHNICAL STANDARDS/GUIDELINES REQUIRED	DEADLINE FOR SUBMISSION TO THE EUROPEAN COMMISSION	EBA PUBLICATIONS
Article 382(5) (*Scope*)	Draft regulatory technical standards to specify the procedures for excluding transactions with non-financial counterparties established in a third country from the own funds requirement for CVA risk.	Within 6 months of the related EBA review (to be conducted by 1 January 2015).	None to date.
Article 383(7) (*Advanced Method*)	Draft regulatory technical standards to specify in greater detail: (a) how a proxy spread is to be determined by the firm's approved internal model for the specific risk of debt instruments for the purposes of identifying 'si' and 'LGDMKT' referred to in Article 383(1); and (b) the number and size of portfolios that fulfil the criterion of a limited number of smaller portfolios referred to in Article 383(4).	1 January 2014.	EBA final draft regulatory technical standards on credit valuation adjustment risk for the determination of a proxy spread and the specification of a limited number of smaller portfolios under Article 383(7) (December 2013) *(EBA/RTS/2013/17)*. Opinion of the EBA on Credit Valuation Adjustment risk for the determination of a proxy spread (December 2013) *(EBA-Op-2013-03)*. Consultation on draft regulatory technical standards for the credit valuation adjustment risk on the determination of a proxy spread and the specification of a limited number of smaller portfolios (July 2012) *(EBA/CP/2012/09)*. Consultation on credit valuation adjustment risk for the determination of a proxy

CRR SOURCE	TECHNICAL STANDARDS/GUIDELINES REQUIRED	DEADLINE FOR SUBMISSION TO THE EUROPEAN COMMISSION	EBA PUBLICATIONS
			spread and the specification of a, limited number of smaller portfolios (July 2013) (EBA/CP/2013/24).
Article 456(2) (*Delegated Acts*)	EBA shall monitor the own fund requirements for credit valuation adjustment risk and submit a report to the European Commission. In particular, the report shall assess: (a) the treatment of CVA risk as a stand-alone charge versus an integrated component of the market risk framework; (b) the scope of the CVA risk charge including the exemption in Article 482; (c) eligible hedges; and (d) calculation of capital requirements of CVA risk.	1 January 2015.	None to date.

National discretions and UK implementation

The CRR provides competent authorities with certain discretions:

CRR SOURCE	NATURE OF DISCRETION	FCA/PRA APPROACH
Article 162(2)(h) (*Maturity*)	An institution that uses an internal model to calculate a one-sided credit valuation adjustment (CVA) may use, subject to the permission of the competent authorities, the effective credit duration estimated by the internal model as "M".	In respect of FCA authorised firms, the FCA indicated it intends to exercise this discretion (see Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). The Prudential sourcebook for Investment Firms (IFPRU) 4.14.4 G sets out guidance on the use of internal CVA model for calculation of the maturity factor "M". In respect of PRA authorised firms, see paragraph 2 (Factors which the PRA expects firms to take into account when applying to certain permissions related to the counterparty credit risk regulatory framework) in the PRA Supervisory Statement.
Article 382(2) (*Scope*)	An institution shall include securities financing transactions in the calculation of own funds required by Article 382(1) if the competent	In respect of FCA authorised firms, the FCA has indicated it intends to exercise this discretion (see Annex 3 (List of

CRR SOURCE	NATURE OF DISCRETION	FCA/PRA APPROACH
	authority determines that the institution's CVA risk exposures arising from those transactions are material.	national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). In respect of PRA authorised firms, see the PRA Policy Statement at paragraph 8.5 and the PRA Supervisory Statement at paragraph 3 (Inclusion of securities financing transactions in the scope of the CVA capital charge) in respect of the PRA's determination of when risk exposures arising from securities financing transactions should be deemed material and be included in the scope of the own funds requirements for CVA in accordance with Article 382(2) CRR.
Article 382(4)(b) (*Scope*)	Intra-group transactions will be excluded from the own funds requirements for CVA risk. However, member states may adopt national laws requiring the structural separation within a banking group, in which case competent authorities may require intragroup transactions between the structurally separated institutions to be included in the own funds requirements.	

Further reading

Client Briefing 1 (*Introduction to Regulatory Capital and Liquidity*)

Client Briefing 5 (*Collateral: Funded Credit Risk Mitigation in the Banking Book*)

Client Briefing 6 (*Unfunded Credit Risk Mitigation in the Banking Book: Guarantees and Credit Derivatives*)

Client Briefing 8 (*Counterparty Credit Risk*)

Client Briefing 9 (*Clearing*)

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