BANKING STAKEHOLDER GROUP

CONSULTATION ON EBA/CP/2015/10 ON

"DRAFT REGULATORY TECHNICAL STANDARDS -
ON THE VALUATION OF DERIVATIVES PURSUANT TO ARTICLE 49(4)
OF THE BANK RECOVERY AND RESOLUTION DIRECTIVE (BRRD)"

General Comments and Replies to Questions

BY THE EBA BANKING STAKEHOLDER GROUP

London, 13th August, 2015

Foreword

The EBA Banking Stakeholder Group ("BSG") welcomes the opportunity to comment on the Consultation Paper EBA/CP/2015/10 "Draft Regulatory Technical Standards – On the valuation of derivatives pursuant to Article 49(4) of the Bank Recovery and Resolution Directive (BRRD)".

This response has been prepared on the basis of comments circulated and shared among the BSG members and the BSG's Technical Working Group on Recovery Resolution and Systemic Issues.

The BSG supports the initiative of setting procedures for the valuation of derivatives contracts in case of resolution, providing the resolution authorities with the tools to find a provisional and a final valuation that helps in the decision making process of write down or convert the liabilities from derivatives.

This response outlines some general comments by the BSG, as well as our answer to the questions indicated in the Consultation Paper.

General comments

The BSG welcomes this consultation on the EBA's proposed RTS "On the valuation of derivatives pursuant to Article 49(4) of the Bank and Resolution Directive". The goal of this RTS is to complement the rest of the developments required by the BRRD to help the resolution authorities in the first stages of the resolution process, and particularly in the decision to write down or convert the liabilities from netting derivatives contracts in the entity under resolution.

In our comments, there are three main points that we suggest the EBA should consider in the final RTS:

1) The problem of OTC derivatives. As long as there is the possibility of finding a market for some of them, their values have to be calculated using valuation techniques by the independent valuer (that could be based on the internal model used by the entity). In such cases, as well as in the cases where the market becomes illiquid or so narrow that the prices are not representative, some guidance should be provided to help in the determination of relevant values (for instance, in the form of a hierarchy of variables to be used in the estimations).

2) The close interrelation between resolution authority and the independent valuer. For the valuer, this is not a traditional engagement that ends by delivering a valuation report. In lieu of that, the valuer is a continuous provider of information and valuations to the resolution authority that must update the valuation made as frequently as needed by the resolution authority for decision-making purposes. In this role, the valuer becomes more and more dependent on the information required by the authority and, therefore, less and less independent. This would be the tribute to pay for the expected efficiency in the resolution process and, particularly, in the decision to write down or convert the liabilities from derivatives contracts after netting.

3) The possibility of litigations or claims against the valuations accepted by the resolution authority under the no-creditor-worse-off principle. The appropriate trade-off between the amount of information needed and the required swift decision is sometimes hard to achieve. The treatment of some counterparties with claims that are difficult to assess, including the possibility to review the estimations one or more times and the subjectivity of the corresponding amounts, could raise problems for the resolution authority. In the process described across the RTS a particular focus should be placed on providing the resolution authority with tools to make appropriate decisions and then to justify them. In this regard, the RTS provides for the necessary procedure to compare the potential destruction in value with the potentially obtainable amount of the derivative contract. As a matter of fact, such a decision will always be based on provisional valuations. As the recent discussion raised by rating agencies has shown, a decision to close-out a derivative contract will most likely only be taken if a serious net (bail-inable) benefit can be expected from the close-out. This should provide enough justification for taking either decision.

What follows are the responses to the questions raised in the RTS Draft along with some reflections made by the BSG in order to discuss the limitations and implications of the approach.

Replies to Questions

Question 1: Do you agree with the definitions above? Do you consider it necessary to specify some of them further and, in particular, the definitions of “commercially reasonable replacement trades” and “unpaid amounts”?

Most definitions are based on the text of EU Regulations or Directives. Regarding the two definitions cited in the Question, the “unpaid amounts” definition reflects the sum due to cancelling the derivative transaction in its entirety. The “commercially reasonable

replacement trades" definition is a description of the ideal market situation in which the valuer makes the valuation.

However, "Unpaid Amounts" do not include amounts in respect of interest or compensation accrued during the period from the date on which the relevant payment or delivery obligations fell due through to the relevant close-out date. This should be considered in the final draft.

Regarding, the "Commercially reasonable replacement trade" definition, in our view requiring the counterparty to have made *best efforts* to obtain ***best value for money*** in order for the replacement trade to be considered commercially reasonable, sets too high a standard. It would be interesting to set a practical rule in order to make this easy determination easy, for instance requiring at least two different offers from dealers.

Question 2: Should the deadline given by the resolution authority to the counterparty be further framed? If yes, explain why and how? Does this drafting allow the resolution authority to conclude resolution actions in a sufficiently swift manner?

No: the resolution authority must have the possibility to decide but it should consider the difficulty of valuing some derivatives contracts as structured transactions. The provisions of Article 2.2 are applicable to counterparties that are not CCPs. In those cases, setting deadlines is desirable because there is no guarantee that such counterparties have implemented valuation procedures, in the way that CCPs must do.

The resolution authority, having in mind the particular characteristics of the counterparty, is the agency that must decide on deadlines. It is desirable that such decisions are aligned broadly with common market practice as established under ISDA Master Agreement which is also accommodating for adjustments made under the relevant market conditions / operational considerations.

Question 3. This valuation principle is intended to be aligned with the common market practice that recognises replacement costs in an early termination event, whilst giving certainty to the resolution authority on the methodology to be followed. Do you agree that this valuation principle would result in a fair valuation for the closed-out netting set and as such avoid a breach, from the counterparty's perspective, of the no-creditor-worse-off principle?

Yes. The valuation principle establishes that the derivative value is equivalent to the expected loss to the counterparty derived from the early settlement of the transaction. This valuation methodology is mainly conceived to meet the no-creditor-worse-off-principle.

Nevertheless, the value of collateral previously transferred, and which is to be accounted for in the close-out calculation, should be clarified (particularly if there is an excess of collateral).

Question 4. Do you agree with the preferential status given to commercially reasonable replacement trades? Should there be also a prioritisation among other sources of data?

Yes: we agree with the priority of “actual” commercially-reasonable replacement trades, because this specification gives the possibility to the counterparty to send a notice of real market conditions and transactions. The valuer, after considering the validity of those replacement trades, should decide on final valuation either based on replacement trade prices or otherwise on market prices as described in Article 5.2.

Question 5. Do you agree with the method described under paragraph 2 for the resolution authority to calculate the close-out amount? Is there a reason to believe that mid-market prices might not always be available no possible to derive from other data sources? And under which circumstances? In that case, what do you consider as an appropriate reference for calculating the close-out amount?

Yes: the method in Article 5.2 is appropriate but only in the case that a current market exists for the derivatives concerned. Nevertheless, the RTS has also to consider also the case where the market is unable to set fair prices or the case where there is no market for such derivative.

For instance, the entity under resolution could be the main trader in a particular type of derivatives or it is probable that the market reduces or ceases its activity upon resolution of the entity concerned.

In other cases, the OTC derivative has been negotiated between the entity and the counterparty (not CCP) and there is no current market reference: that means the impossibility to value by using market prices.

In the case of intragroup transactions, the possibility to have derivatives of the types referred to in earlier paragraphs increases because the groups of companies design those specific derivatives for hedging some risks internally.

As an exception for such situations the valuer should be authorized to use valuation techniques that approach the behaviour of market participants in order to determine a fair value, using observable inputs and, if necessary, other assumptions that must be justified to

the resolution authority. To this alternative methodology, the provision of letter c) in order to reflect the size of the exposure and credit worthiness of the counterparty is also applicable.

Our suggestion is to incorporate a new point 5 or, alternatively, to complete the point 4 with a reference to the variables used by the valuer in valuation techniques, by requiring first the use of observable market variables and then unobservable variables or own assumptions. Such hierarchy of sources can help to produce more objective valuations.

On the other hand, in a termination event there could be other elements adding to replacement cost, such as funding/capital charges which could become particularly high. If this is the case, the valuer should take into account those charges as they suppose part of the replacement cost for the counterparty.

Question 6. Should adjustments to the bid-offer spread, other than those specified under Article 6(4)(c), be considered?

The correct reference in the Question is to Article 5(2)(c), not to 6(4)(c) that does not exist.

For situations in which market prices are available, the adjustments described based on the bid-offer spread are fair. In the case of non-existence of market prices, when the valuer should determine the amounts using valuation techniques, such spread would be simulated according the special market conditions of the derivatives and the counterparties concerned. In any case, this article should try to avoid any form of market manipulation when determining the replacement trade.

Question 7. Do you agree with the treatment of CCPs as laid down in this Article? Are the conditions laid down in this article compatible with a swift and efficient valuation of cleared derivatives within the context of a resolution process? Do you see any material risk that the treatment of CCPs, as laid down in this Article, could conflict with the requirements for a sound risk-management framework to deal with the default of a clearing member?

Yes, we agree.

Question 8. Article 7(1) is intended to be aligned with market practice in early termination events. Do you see a risk of increased market volatility on the first market day following the close-out notification, which could adversely affect the

termination value? Do you consider the notion of "commercially reasonable" date sufficiently self-evident or should it be further specified?

The point in time specification in article 7.1 is sufficient. The increased volatility in market prices following the resolution decision is an effect, not the cause, of the resolution. From a methodological point of view, the volatility after the close-out date should not be included in the determination of value. Nevertheless, it is an argument for the counterparty in case of litigation.

Question 9. As provided for under Article 7(2), the resolution authority will have the possibility to produce a valuation at a date or time earlier than the earliest commercially reasonable date as part of a provisional valuation carried out pursuant to Article 36(9) of the BRRD. This possibility is intended to allow for a swifter resolution process as resolution authorities will be able to apply the write-down and conversion powers on the basis of the early determination. As in all cases where taking resolution action based on a provisional valuation, resolution authorities will update their determination either as part of a subsequent provisional valuation or the final valuation. At that point they will either adjust the write down and conversion of creditors, provided they have previously made the necessary arrangements such as holding sufficient equity, or provide alternative compensation, if necessary, on the basis of the final valuation of difference in treatment pursuant to Article 74 of Directive 2014/59/EU. Do you consider this optional early determination appropriate, or do you consider that this option would unreasonably increase the risk of litigation or ex-post compensation according to Article 74 of the BRRD?

The main commitment of the resolution authority is to carry out the resolution decisions as fast as possible, and particularly those decisions related to writing down or converting liabilities. As in each decision process, there should be a trade-off between relevant information (valuations as accurate as possible) and efficiency in decision making (to write down or convert derivatives liabilities).

By means of this early provisional valuation, the resolution authority can better consider the consequences of the resolution of the entity, and so the convenience and how to proceed with the write-down or conversion of the liabilities. As in other cases, a decision without information can lead to mistakes and having information but not to make a decision would produce inefficiency.

In summary, it is the resolution authority which must decide and the provisional valuation is the most interesting tool to make a decision. The valuer has to do the valuation and inform the resolution authority about the reliability of the estimates made. On the other hand, the resolution authority must decide if the provisional valuation is sufficient to

justify an early decision and, of course, could reconsider that decision after receiving any valuation update.

The communication in each one of the steps between independent valuer and resolution authority is essential to achieving the timeliness and the efficiency in all this process.

Question 10. Alternatively, should resolution authorities always wait until there is pricing available in the market before producing their valuation and, therefore, wait until that date before applying the bail-in tool?

No. While it is interesting to have market prices for a good valuation, to require in each case to wait for market prices would not be justified and would unduly constrain the resolution authority. As noted above, in some cases the market price would be non-existent or the market would disappear or become illiquid as a consequence of the resolution decision.

Question 11. The possibility to produce an early determination is available also in relation to claims of a CCP. In this case, the final valuation will reflect the CCP claim as determined pursuant to Article 6, on the basis of the CCP default procedures if provided under the conditions of that Article. Do you consider it appropriate to also allow an early determination in relation to CCP claims?

Yes: this early valuation is appropriate.

In general terms, the valuation from CCPs will come in due time and will be reliable. Under normal circumstances, the CCP claims would be determined without delay. Nevertheless, the early valuations made by the independent valuer could be valid information to design a decision process and to challenge the figures elaborated by the CCPs.

Question 12. If so, do you consider that, with regard to CCP claims, resolution authorities should always be obliged to adjust the bail-in treatment of the CCP if and once the CCP provides its determination pursuant to Article 6? In that case, how do you assess the risk that the CCP determination process could hold back the finalisation of the bail-in process also for other claims? Alternatively, does the assessment of difference in treatment pursuant to Article 74 of the BRRD provide a sufficient safety net for CCPs?

Usually the resolution authority respects CCP valuations produced using the default procedures. Any departure from this criterion, if the resulting difference is material, would trigger litigation. Nevertheless, those default procedures are available for testing the values provided, and only if there is an inconsistency the resolution authority can determine its own values and use them after consulting the CCP competent authority.

The design of this due process is well defined in the Draft and the Article 74 of the Directive provides sufficient guaranty for CCPs.

Question 13. Do you find the guidance provided in paragraph 2 of this Article sufficiently clear as to the terms of comparison?

Yes, especially the point (a) is easy to determine. The following responses address the problems with point (b).

Question 14. Do you agree with the main drivers of the destruction in value as described in this Article?

Yes, we agree. But it is important to note that (b) (i) and (ii) are drivers easy to identify and measure. However, drivers (b) (iii) and (iv) are more subjective estimations and, therefore, difficult to measure in practice.

As the decision envisaged in this Article 8 of the Draft is the possible exemption from writing-down or converting the derivatives liability, and this decision is to be made with provisional valuations, the possibility to make a decision without enough reliable information is high.

Question 15. Do you agree with the provision for a precautionary buffer? Do you consider the indicative elements supporting this precautionary buffer as sufficient? Do you see other considerations that should be taken into account when calculating a precautionary buffer?

The existence of a precautionary buffer would be interesting for assessing the entire consequences of the close-out of derivatives contracts; nevertheless it would be useful to provide more guidance on 1) the concepts and situation that the buffer is covering; and b) the way to assess or measure the costs arising from adverse scenarios.

Question 16. In determining destruction in value, should resolution authorities incorporate into their analysis the impairment to the firm's franchise value that would result from the termination and closing-out of a firm's derivatives contracts and the cessation of its related business operations?

As franchise value is the present value of the stream of profits that a firm is expected to earn as a going concern, the destruction of such value due to the closing-out of the derivatives contracts needs an estimation of the reduction in profits that could arise from the termination of the contracts and the cessation of activities in terms of image, reputation and confidence in the entity, including the possible consequences in terms of funding costs. All those assessments are difficult to make and their valuation requires expertise and time.

Although the resolution authorities should incorporate in their analysis the destruction of entity's franchise value, to translate this destruction into figures would be both difficult for the resolution authority (or the valuer) and possibly questioned by third parties, which can base their claims on the lack of knowledge about the consequences derived from the resolution in the entity franchise value.

On the other hand, as the decision to resolve could itself be the cause of the loss of value for the entity, any intent to separate the total loss into its components (i.e. the termination of derivatives contracts) is by nature subjective and questionable.

The suggestion of the BSG on this point is to impose for the assessment of the destruction in value a condition of identification of the drivers that cause the destruction and to require a close association between those drivers and the amount of the loss derived from them. In other words, we would require a clear demonstration of cause-effect relationships between the drivers and the numbers showing the value lost.

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Submitted on behalf of the EBA Banking Stakeholder Group

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