

Question ID	2019_4675
Status	Final Q&A
Legal act	Regulation (EU) No 575/2013 (CRR)
Topic	Own funds
Article	45
Paragraph	1
Subparagraph	a
COM Delegated or Implementing Acts/RTS/ITS/GLs/Recommendations	Not applicable
Article/Paragraph	n.a.
Date of submission	16/04/2019
Published as Final Q&A	01/04/2022
Disclose name of institution / entity	No
Type of submitter	Competent authority
Subject matter	Definition of short position
Question	<p>1. Can a put option which is subject to certain conditions qualify as a short position for the purposes of Article 45 CRR provided that (i) the fulfilment of the conditions depends only on the holder of the put and (ii) all the other conditions mentioned in Article 45 are met?</p> <p>2. In case a bank has on its banking book a holding of CET1 instruments in a financial sector entity and it buys an unconditional put option with the same underlying, which amount should be netted, either the notional value (strike price multiplied by the number of underlying instruments of the option) or the market value of the put, provided that all the other conditions mentioned in Article 45 CRR are met?</p> <p>3. In case the answer to question 2 is the notional value, if a put option does qualify as short position for the purposes of Article 45 CRR, how should this short position be treated for the purposes of credit risk requirements?</p>
Background on the question	A bank ("bank") is engaged in a transaction with another bank ("counterparty") involving a reorganisation of the group. The two banks are the shareholders of a financial sector entity ("entity A"). The bank has the

right to sell (put option) a holding of CET1 instruments of entity A to the counterparty only after certain actions have been initiated by the bank (i.e. the put option is subject to certain conditions). The fulfilment of those conditions (e.g. asset disposals, IPO of entity A, among others) is exclusively under the bank's full. Neither the CRR, nor Commission Delegated Regulation 241/2014 (RTS on Own Funds) provide for: 1. A definition of a short position; 2. The way in which purchased put options should be treated for netting purposes when the bank has a long position in the underlying that is on the balance sheet (e.g. either in the form of stock or due to trade date accounting); 3. In case the netting is recognized, how the short position should be treated for the purposes of credit risk.

Final answer

1. A put option which is subject to the conditions described in the background does not qualify as short position for the purposes of Article 45 CRR even though the fulfilment of the conditions depends only on the holder of the put option.

Due to the nature of these conditions, the put option described in the background does not provide an adequate hedge for entity A shares, and therefore should not be allowed to net the exposure. This is because there may be instances where, even if the bank is willing to fulfil the conditions, it may not be possible to do so. For example, in a downturn event, where entity A shares fall below a certain threshold, an Initial Public Offering (IPO) would not be initiated. Under this scenario, the bank would still have the exposure to entity A, but would not be able to exercise its right to sell (i.e. the hedge would not be effective). Additionally, short positions and their use for netting purposes shall always be carefully scrutinized, to ensure that they provide a genuine hedge for the value of the long position.

2. According to Article 36(1)(h) and (i) CRR, an institution shall deduct the applicable amount of direct, indirect and synthetic holdings of CET 1 instruments of financial sector entities. Article 45 CRR allows for institutions to make the deductions required under Article 36(1)(h) and (i) calculating the holdings on the basis of the net long position provided that the conditions in Article 45 are met.

Article 15f(1)(b)(ii) of the RTS on Own Funds substantiates Article 36(1) CRR by defining that the amount of synthetic holdings, other than call options, booked in the non-trading book to be deducted from CET 1 shall be the nominal or notional amount, as applicable.

3. Any netting of holdings of CET1 instruments with a short position according to Article 45 CRR constitutes a credit risk exposure to the counterparty of the short position, for which the exposure value is determined by the full amount that is no longer deducted due to netting with the short position.

The CRR does not treat the holding of a CET1 instrument as solely

	<p>constituting an equity exposure but already as a total loss due to the deduction, similarly to a first loss tranche in a securitisation. Not deducting an amount of such holdings of CET1 instruments due to netting with a short position according to Article 45 CRR effectively treats the non-deducted amount as if the total loss has been replaced by a receivable, i.e. as if the CET1 instrument had been sold and the payment had not already been received from the counterparty of the short position. Thus, the payment still outstanding is equivalent to a loan to this counterparty over the full applicable amount of the put option that has been considered in the calculation of the net long position.</p>
Link	<p>https://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2019_4675</p>

European Banking Authority, 03/10/2022
www.eba.europa.eu