Single Rulebook Q&A

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Status	Final Q&A
Legal act	Regulation (EU) No 575/2013 (CRR)
Topic	Own funds
Article	45, 59, 69
Paragraph	a, a, a
Subparagraph	-
COM Delegated or Implementing Acts/RTS/ITS/GLs/Recommendations	Not applicable
Article/Paragraph	n/a
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Disclose name of institution / entity	No
Type of submitter	Other
Subject matter	Treatment of Hedges for Equity-Linked Employee Compensation Schemes and Impact on FSE Capital Deductions
Question	As part of their Corporate Equity Derivatives businesses, European banks are often asked to provide Financial Sector Entity ("FSE") and non-FSE clients with hedges to their equity-linked employee compensation schemes or share savings plans. Typically in these circumstances the client goes long its own equity price risk synthetically, via purchasing call options or buying a total return swap ("TRS"). The TRS is an ISDA-based derivative contract under which the purchaser (in this case the client) receives the dividend and any price appreciation on the underlying equity security, and the seller (in this case the bank) receives a LIBOR / EURIBOR return plus a spread, along with any price depreciation on the underlying equity security. As the bank is short the client's equity price risk under the TRS contract, it will typically purchase the client's physical shares in the market in order to hedge the delta exposure under the sold TRS position. These positions are allocated to the regulatory trading book subject to the applicable requirements, and for the purposes of this discussion it is assumed the short position satisfies either the CRR Art 45 maturity matching criteria or the CRR Art 75 exemption. Where the bank has credit risk to the client (under the TRS), the client will, in most circumstances, be asked to provide cash margin on a daily

	basis to cover any mark-to-market movements in the bank's favour. The TRS will be documented using standard ISDA documentation, with the cash collateralisation taking place under a CSA or similar arrangement. Would the TRS be considered an eligible hedge for the purposes of Article 45 under those circumstances?
Background on the question	Example Transaction: ?? Bank A ("TRS Purchaser") wishes to hedge its equity linked employee compensation scheme, under which it has granted employees awards over 2 million Bank A shares, vesting in 2 years time. ?? Bank A buys TRS protection on Bank A shares from Bank B ("TRS Seller"). ?? The TRS references 2 million Bank A shares with a current market value of EUR 100mln, and has a maturity of 2 years. ?? The TRS is a physically settled derivative instrument whereby Bank B will deliver 2 million Bank A shares to Bank A at maturity, in exchange for a payment of EUR 100mln. ?? Bank B's insignificant FSE holdings currently exceed 10% of the relevant Common Equity Tier 1 (CET 1) measure, thus any incremental long FSE holding would represent a capital deduction item. Whilst the considerations outlined in this paper focus on the specific example of short positions in the form of TRS hedging contracts, they will in principle also apply to other types of hedging contracts. 2 Regulatory assessment (with regards to SWWR and capital deductions of holdings in FSE and own shares) a) TRS Purchaser (Bank A) Treatment of TRS as synthetic long position in own shares under CRR Art 36 (1) (f) In the above example transaction, under CCR Art 36 (1) (f) Bank A will deduct EUR 100mln from its CET 1 capital as a result of its synthetic long exposure to its own equity instruments through the TRS. Note that as a physically settled instrument this deduction will already have been effected through Bank A's IFRS financial statements. b) TRS Seller (Bank B) Treatment of TRS in the context of Specific Wrong Way Risk (SWWR) The TRS exhibits SWWR as the counterparty to the TRS (Bank A) is identical to the issuer of the shares representing the reference asset of the TRS. The exposure value of the TRS is then determined based on a jump-to-default scenario of Bank A in accordance with the provisions of CRR Art 291 (5). Treatment of TRS as eligible synthetic short position in FSE shares for the purposes of netting In determining Bank B's CET 1 capital as a result of the transaction, it is necessary to assess whether the TRS represents an "eligible" short FSE position that can be used to offset the gross long FSE position arising from the direct investment of Bank B in the shares of Bank A. In our example, the short position satisfies the CRR Art 75 exemption as a result of it being physically settled. In assessing whether the SWWR impacts the ability of the TRS to be considered as an eligible short FSE position the following points are relevant: a) The CRR provisions for the netting of long and short FSE positions do not prohibit the use of a synthetic short position with SWWR attributes to offset the gross long position arising from the long direct FSE holding. The February 2010 Commission Services Staff Working Document titled "Possible Further Changes to the Capital Requirements Directive"

	(http://ec.europa.eu/internal_market/consultations/2010/crd4_en.htm) preceding the CRR included the absence of counterparty credit risk as a condition to a short position being eligible for netting (page 77 of the above document), however the draft and final CRR do not include this requirement in respect of short positions in FSE holdings. b) The TRS Seller (Bank A) on the other side of the contract (i.e. the party going long equity risk exposure under the TRS) will, under Basel 3 and the CRR, deduct the full TRS notional amount from its CET 1 capital given that the TRS gives rise to a synthetic long exposure in its own shares (c.f. Basel 3 para 78, CRR Art 36 (1) (f)), if the long exposure remains unhedged. If Bank B would also be required to deduct (by considering the short position as ineligible for netting with the long FSE position) this would result in a double-deduction from capital for the sector as a whole. c) Through the hedge with Bank A the economic and legal risk position assumed by Bank B under the transaction does not represent a risk position to a capital instrument of Bank A but rather to a senior debt instrument of the same FSE. This is because in the event the share price of Bank A went to zero, Bank B would have a senior credit claim against Bank A ranking pari-passu with other senior creditors, in addition to an equity claim. d) Were the short position to be considered an eligible hedge, the counterparty credit risk charge would reflect the SWWR in accordance with the provisions of CRR Art 291 (5), thus providing a conservative measure of the risk on the contract while continuing to respect the legal form and economic substance of the position.
Final answer	For the purposes of Article 45 of Regulation (EU) No 575/2013 (CRR), long positions may be netted with short positions in the same underlying exposure if the maturity criterion in Article 45(a)(i) is met, and if both the long and the short position are booked in the same book (either both in the trading book or both in the non-trading book) as required under Articles 45(a)(ii), 59(a) and 69(a), as applicable. It is worth noting that, in the CRR, total return swaps are only mentioned in the context of the calculation of the own funds requirements for credit and market risk (for instance, Article 204). Regardless of its name, a derivative such as the one described in the question would constitute a short position for the derivative seller in the equity instrument of the counterparty for the purposes of Article 45(a) of the CRR. It should be stressed that the short position involves counterparty credit risk and, in this case, specific wrong way risk. Thus institutions shall meet all the requirements related to specific wrong-way risk as stated in Article 291 of the CRR.
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