

EBA/RTS/2024/20

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Final report

Draft Regulatory Technical Standards on the exemption from the residual risk add-on own funds requirements for certain type of hedges under Article 325u(4a) of Regulation (EU) No 575/2013 (CRR)

Contents

1. Executive Summary	3
2. Background and rationale	5
3. Draft regulatory technical standards	9
4. Accompanying documents	19
4.1 Draft cost-benefit analysis / impact assessment	19
4.2 Feedback on the public consultation	23

1. Executive Summary

One of the pillars of the standardised approach (SA) under the new fundamental review of the trading book (FRTB) framework is the residual risk add-on. It is calculated for all those instruments the risk of which is not sufficiently covered by the sensitivity-based method (SbM) and the default risk charge (DRC) – the other two building blocks of the FRTB-SA. CRR2 provisions as well as the EBA RTS specifying technical details on the RRAO¹ provide guidance on the RRAO calculation.

As part of the CRR3 package, the co-legislators introduced a provision in the RRAO framework allowing exemptions from the RRAO charge for those hedging instruments bearing residual risks taken as a hedge for hedged instruments bearing residual risks too. What is subject to the exemption is just the hedge, i.e. the hedged position must always be capitalised with an RRAO charge.

Along with such provision, the co-legislators mandated the EBA to develop RTS specifying when an instrument qualifies as a hedge for the purpose of the exemption and when not. The mandate has been accordingly included in the EBA roadmap on Basel 3 implementation².

The RTS require institutions to identify whether the RRAO charge for which the institution seeks the exemption relates to a risk factor that is not shocked in the SbM (i.e. non-SbM risk factor), or it is due to other reasons.

When the RRAO relates exclusively to a non-SbM risk factor, the RTS envisage conditions aiming at assessing that as a result of the hedge, the sensitivity towards the non-SbM risk factor is reduced – CMS spread plain vanilla options are expected to fall under this case³. To ensure a fair application of the exemption, the RTS also require institutions to have in place detailed internal policies setting out the details of the hedging strategy, as well as its expected effectiveness in terms of sensitivity against the non-SbM risk factor.

A similar framework is applied to instruments referencing an exotic underlying in the form of dividend, future realized volatility or variance. For these instruments institutions are indeed expected to be able to measure a sensitivity in a meaningful way.

Instead, where the RRAO charge is due to other reasons than the presence of a non-SbM risk factor, or an exotic underlying in the form of dividend, future realized volatility or variance, the RTS allow the hedging instrument to be recognised as hedge, and as such exempted from the RRAO charge, only if it completely offsets the RRAO risk stemming from the hedged instruments. This prudent stance is also used in the context of instruments referencing an exotic underlying other than dividend, future realized volatility or variance, such as natural disasters. Given the importance of the exemption in

¹ <https://www.eba.europa.eu/regulation-and-policy/market-risk/regulatory-technical-standards-residual-risk-add#pane-new-7bdd87fb-e02f-492a-99d6-129449e3cf9d>

² See [EBA Roadmap on strengthening the prudential framework 1.pdf \(europa.eu\)](#)

³ CMS spread options are typically hedged by other CMS spread option. The exemption from the RRAO charge is expected to be mostly (if not only) triggered in the context of CMS spread option.

terms of capital requirements, the RTS also include a requirement for a review of the fulfillment of the conditions set out in the RTS from an independent reviewer.

It should be stressed that in accordance with the Commission Delegated Act⁴ postponing the FRTB by one year, institutions are required to use the CRR2 version of the FRTB requirements. Accordingly, the RRAO exemption framed by these RTS will be applicable only once the CRR3 FRTB implementation will be applicable – in other words, the RRAO exemption cannot be used during the postponement period (under a scenario where the abovementioned Delegated Act enters into force).

⁴ <https://webgate.ec.europa.eu/regdel/#/delegatedActs/2528>

2. Background and rationale

1. In the past years, the EBA has developed several RTS implementing in EU law the fundamental review of the trading book (FRTB) framework. This followed the approach set out in the EBA roadmap on FRTB⁵ and allowed credit institutions to prepare for the implementation of the FRTB in EU in accordance with the recently agreed CRR3 package. This package transformed the FRTB reporting requirements into own funds requirements and transposed in EU law the building blocks of the so-called Basel III reforms.
2. Among others, the EBA developed RTS specifying technical details on the residual risk add-on (RRAO) framework⁶, i.e. one of the three pillars of the FRTB standardised approach introducing a specific capital charge for those instruments bearing residual risks.
3. As part of the CRR3 package, the co-legislators introduced a provision in the RRAO framework allowing the exemptions from the RRAO charge for those hedging instruments bearing residual risks taken as a hedge for hedged instruments bearing residual risks too. What is subject to the exemption is just the hedge, i.e. the hedged position must always be capitalised with an RRAO charge.
4. Along with such provision, the co-legislators mandated the EBA to develop RTS specifying when an instrument qualifies as a hedge for the purpose of the exemption and when not. The mandate has been accordingly included in the EBA roadmap on Basel 3 implementation.
5. When developing these RTS, the EBA considered that based on the feedback received to its consultation paper on instruments subject to RRAO, the material case to be addressed by this provision is that relating to constant maturity swap (CMS) spread options. For other instruments, it appears that institutions do not use instruments bearing residual risks to hedge instruments bearing residual risks too.
6. The RTS therefore distinguish between cases where the residual risk:
 - a. Does not relate to an instrument that reference an exotic underlying and exclusively relates to risk factor that is not shocked in the SbM (i.e. non-SbM risk factor). Simple CMS spread options are expected to fall under this case, given that they bear an additional correlation risk factor that is not shocked as part of the sensitivity-based method.
 - b. Relates to an instrument that refers to an exotic underlying that is a dividend, a future realized volatility or variance. Simple variance swaps are expected to fall in this case.

⁵ <https://www.eba.europa.eu/eba-publishes-its-roadmap-for-the-new-market-and-counterparty-credit-risk-approaches-and-launches-consultation-on-technical-standards-on-the-ima-under>

⁶ <https://www.eba.europa.eu/regulation-and-policy/market-risk/regulatory-technical-standards-residual-risk-add#pane-new-7bdd87fb-e02f-492a-99d6-129449e3cf9d>

- c. Relates to other reasons than the one stated in point a or b. For example, digital options or barrier options trigger the RRAO for their complex pay-off, or for the path dependent nature of the derivative. It should be noted that under this case, also fall instruments characterized by an exotic underlying that is not a dividend or a future realized volatility or variance.

7. In all cases, it is important to stress that:

- a. The instrument must act as a hedge for the source of risk that triggered the RRAO charge. For example, in case the hedged position is a CMS spread option, the hedging instrument must hedge the correlation risk (i.e. the course of RRAO risk).
- b. What is subject to the exemption is the RRAO charge as the source of risk is hedged. However, the SbM-charge and the default risk charge for the hedging instrument must always be capitalised. Furthermore, the RRAO charge is waived only for the hedging instrument – it is not waived for the hedged instrument.

The RRAO charge exclusively relates to the presence of one or more non-SbM risk factor

8. When the RRAO charge of a financial instrument – not referencing an exotic underlying – exclusively relates to a non-SbM risk factor, the RTS aim at ensuring that the financial instrument actually reduces the sensitivity towards that non-SbM risk factor. In particular, the RTS require the following:

- a. First, the institution needs to identify the above-mentioned non-SbM risk factor, and after having done so, it must map to that non-SbM risk factor the positions being hedged. The objective is to assess that the non-SbM risk factor in the instrument taken as a hedge has a clear relationship with the RRAO risk factor of the hedged instrument. The term “clear relationship” signals that the risk factors do not need to be exactly the same but that they need to be strongly correlated (e.g. two risk factors may differ in the maturity dimensions and represent a 2y and 2.3 year tenor respectively). Requiring the hedging risk factor and the hedged risk factor to be exactly the same would risk excluding from the regulatory treatment those instruments bearing risk factors that slightly differ, for example, in the maturity dimension only. That being said, it is not considered an acceptable practice that e.g. an institution considers two risk factors in two currencies, or two risk factors referencing two different names, as having a clear relationships for the purpose of these RTS.
- b. Second, the instrument taken as a hedge must not bear other RRAO risk factors other than that it aims at hedging. This is to avoid exempting instruments that while hedging some risks, they would create other RRAO risks that are not capitalised.
- c. Third, the instrument taken for hedging reduces the sensitivity towards the non-SbM risk factor for which it is intended as a hedge. This to ensure that the primary purpose of the instrument is to hedge. The RTS require the level of the assessment (of the

sensitivity reduction) to be consistent with the level at which the hedging is performed in accordance with the internal policy of the institution.

It should be stressed that the wording used here above refers to a “non-SbM risk factor”. The legal text of the RTS however acknowledges that there could be cases where the hedging instrument attracts more than one non-SbM risk factor. That instrument could still qualify for the exemption, as long as the sensitivity towards all those risk factors is reduced when entering in the hedge.

9. The provisions above are completed by a requirement for the institution to have in place an internal policy setting out several aspects relating to the hedging, such as the hedging strategy, the level at which such hedging is performed, which are the trading desks involved, how the bank identifies and distinguishes the hedge from the hedging instrument. Furthermore, considering that the provision may have a material impact on banks’ own funds requirements, the RTS require that the fulfillment of the conditions for being recognised as a hedge are also subject to an independent review.
10. Similar requirements were built for cases where the RRAO charge of a financial instrument referencing an exotic underlying that is a dividend or a future realized volatility or variance, and that it is taken to hedge another instrument referencing an exotic underlying that is a dividend or a future realized volatility or variance. For these instruments, it is considered that institutions can compute sensitivities in a meaningful way, and as such they can provide an assessment of the effectiveness of the hedge.

The RRAO charge relates to other reasons than the presence of a non-SbM risk factor

11. Where the RRAO relates to other reasons than the presence of a non-SbM risk factor, it appears more difficult to objectively assess whether the hedging instrument actually hedges the source of risk generating the RRAO charge, e.g. how a barrier in a given option can be hedged (by means of another RRAO-bearing instrument). Most importantly, in this case, since there is not a risk factor, it is not possible to compute an ex-ante and ex-post sensitivity (i.e. prior and after the hedge has been taken).
12. Furthermore, as mentioned in paragraph 5, the EBA developed the RTS, considering that the material case to be addressed is that of CMS spread vanilla options, which clearly fall in the category of instruments subject to RRAO exclusively because of the presence of non-SbM risk factors.
13. The RTS therefore takes a particularly prudent stance to qualify an instrument as a hedge for an RRAO risk that does not relate to a non-SbM risk factor. In particular, the RTS requires the hedging instrument to completely offset the RRAO risk linked to the hedged instrument. For example, in case of a barrier option, it means that the hedging instrument de-facto removes the effect of the barrier. Not taking such prudent stance would risk seeing instruments that do not genuinely act a hedge to be recognised as such.
14. These requirements also apply to financial instruments referencing an exotic underlying that is not a dividend, or a future realized volatility or variance. Hence, they apply for example, to financial instruments having longevity risk or natural disasters as exotic underlyings. As explained in the

previous section (paragraph 10), this prudent stance was taken on the basis that the EBA has identified only three types of underlying for which it is considered that a sensitivity can be computed in a meaningful way. Furthermore, also on the basis of the feedback received from consultation, it is considered that the hedging between instruments with an exotic underlying is non-material – hence, creating a complex framework to cater for cases other than the three abovementioned exotic underlyings appears to be non-proportionate, and a simple and prudent approach is preferred.

3. Draft regulatory technical standards

COMMISSION DELEGATED REGULATION (EU) .../...

of XXX

supplementing Regulation 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria that the institutions are to use to identify the positions qualifying as a hedge for the determination own funds requirement for residual risks in accordance with Article 325u(4a) of that Regulation

(Text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012⁷, and in particular Article 325u(6) thereof,

Whereas:

- (1) Instruments not referencing an exotic underlying may be exposed to residual risks either because they bear a risk factor that is not captured as part of the sensitivity-based method or for other reasons, including the presence of a complex pay-off. In the former case, it is possible to calculate a sensitivity towards that residual risk factor and it is therefore possible to objectively assess whether an instrument is hedging the open position to that risk factor. This is not possible with the same degree of accuracy in the latter case. Accordingly, a different framework should apply depending on whether the residual risk borne by the instruments subject to the exemption exclusively relates to the presence of a risk factor that is not shocked as part of the sensitivity-based method.
- (2) Similarly, there are some instruments referencing an exotic underlying for which it is possible to calculate the sensitivity towards that underlying, notably those referencing a dividend, or those with a future realised volatility or variance as an underlying. It is not possible to do so to the same degree in the context of other instruments, for example, instruments with natural disasters as an exotic underlying. Accordingly, a different framework should apply depending on whether institutions would potentially be able to calculate a sensitivity to the exotic underlying that captures the risk in a meaningful way.
- (3) Where it is not possible to measure the hedging effects in a sufficiently appropriate way, to ensure a prudent application of the exemption from the residual risk add-on own funds requirements, an instrument should be recognised as a hedge only if such

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OJ L 176, 27.6.2013, p. 1.

a hedge completely offsets the residual risk borne by other instruments in the institution's portfolio.

- (4) Where the nature of the instruments allow for the hedging to be assessed appropriately, institutions should ensure that the instrument that may be exempted from the residual risk add-on own funds requirements actually acts as a hedge. For that reason, requirements aiming at assessing that the hedged instrument bears the same type of risk as of the hedging instrument and requirements ensuring that the sensitivity towards the relevant risk factor is significantly reduced as a result of the hedge should be laid down.
- (5) Given the potential materiality of the exemption in terms of impact on the own funds requirements, prudential safeguards should be envisaged, including the mandatory independent review of the process establishing whether an instrument acts as a hedge or not.
- (6) To further ensure a consistent application of the exemption by institutions and competent authorities, a non-exhaustive list of instruments not referencing an exotic underlying should be specified, clarifying whether those instruments are considered to bear residual risks that exclusively relate to the presence of a risk factor that is not shocked as part of the sensitivity-based method.
- (7) Similarly, this Regulation should identify the list of instruments referencing an exotic underlying for which institutions would potentially be able to calculate the sensitivity to the underlying in a meaningful way. Considering that the waiver would apply to exotic instruments, such list should be limited to some specific cases to ensure a prudentially sound outcome. This Regulation is based on the draft regulatory technical standards submitted to the Commission by the European Banking Authority.
- (8) The European Banking Authority has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the advice of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 109x/2010 of the European Parliament and of the Council⁸,

HAS ADOPTED THIS REGULATION:

Article 1

Requirements for hedging instruments

1. Hedging instruments meeting the conditions set out in Article 325u(2), point (a) of Regulation (EU) No 575/2013 that reference a dividend or a future realised volatility

⁸ Regulation (EU) No 109x/2010 of the European Parliament and of the Council ...[+full title] (OJ L [number], [date dd.mm.yyyy], [p.]).

or variance shall be subject to the exemption laid down in Article 325u(4a) of that Regulation where they meet the conditions set out in Article 2 of this Regulation.

2. Hedging instruments meeting the conditions set out in Article 325u(2), point (b) of Regulation (EU) No 575/2013 exclusively because of their exposure to risk factors that are not included in the sensitivities-based method ('SbM') laid down in Part Three, Title IV, Chapter 1a, Section 2 of that Regulation ('non-SbM risk factors'), shall be subject to the exemption laid down in Article 325u(4a) of that Regulation where they meet the conditions set out in Article 3 of this Regulation.
3. Hedging instruments other than those referred to in paragraphs 1 and 2 shall be subject to the exemption laid down in Article 325u(4a) of Regulation (EU) No 575/2013 where they meet the conditions set out in Article 4 of this Regulation.
4. For the purposes of paragraph 2:
 - (a) the instruments listed in Annex 1 shall be considered as meeting the conditions set out in Article 325u(2), point (b) of Regulation (EU) No 575/2013 exclusively because of their exposure to non-SbM risk factors;
 - (b) the instruments listed in Annex II shall not be considered as meeting the conditions set out in Article 325u(2), point (b) of Regulation (EU) No 575/2013 exclusively because of their exposure to non-SbM risk factors.

Article 2

Requirements for hedging instruments referencing a dividend or a future realised volatility or variance

1. Hedging instruments referred to in Article 1(1) shall be subject to the exemption laid down in Article 325u(4a) of Regulation (EU) No 575/2013 where all of the following conditions are met:
 - (a) the hedging instrument has been taken on to hedge an instrument referencing an exotic underlying;
 - (b) the single name or index corresponding to the dividend or future realised volatility or variance is the same in the hedged and hedging instrument;
 - (c) the institution maps the exotic underlying of the hedged instruments to the exotic underlying of the hedging instruments;
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- (d) the mapping referred to in point (c) shows a clear relationship between the exotic underlying of the hedged instruments and the exotic underlying of the hedging instruments;
 - (e) the hedging instrument is not exposed to any residual risk or any exotic underlying other than those stemming from the underlying mapped in accordance with points (c) and (d);
 - (f) the institution's sensitivity towards the exotic underlying is reduced as a result of the hedge;
 - (g) the remaining exposure towards the exotic underlying is dynamically managed within a limit specific to that underlying that is consistent with the limits set out in accordance with Article 103(2), point (b)(ii) of Regulation (EU) No 575/2013;
 - (h) the hedging instrument is entered into in accordance with an internal policy of the institution that meets all of the following conditions:
 - (i) it specifies the risk management and hedging strategy, including the level of risk appetite in relation to the exotic underlying;
 - (ii) the risk appetite referred to in point (i) is consistent with the position limits set out in accordance with Article 103(2), point (b)(ii) of Regulation (EU) No 575/2013;
 - (iii) it specifies the hedged instruments, the instruments that the institution intends to use as hedge, and their corresponding exotic underlyings;
 - (iv) it specifies whether the hedging is done at transaction, sub-portfolio, or portfolio levels;
 - (v) it specifies the designed duration of the hedge;
 - (vi) where more than one trading desks are involved in entering the hedge and the hedged positions, it identifies the trading desks involved and specifies the role of each of them;
 - (vii) it lays down appropriate criteria for distinguishing the hedging instruments from the hedged instruments;
 - (viii) it lays down the institution's policy in choosing counterparties for the purpose of performing the hedge;
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- (ix) it lays down appropriate criteria for carrying out the mapping referred to in points (c) and (d);
- (i) compliance with the conditions set out in points (a) to (h) is subject to the independent review referred to in Article 325c(4) of Regulation (EU) No 575/2013.

For the purposes of point (f), institutions shall assess the risk reduction achieved at the level at which the hedge is performed in accordance with point (h)(iv).

2. When setting out the criteria to distinguish the hedging instruments from the hedged instruments in accordance with paragraph 1, point (h)(vii), the internal policy shall consider all the following elements and shall require the trading desks that carry out the hedging process to document all of them:

- (a) the identity of the counterparty;
- (b) whether the trade was made in the interbank market;
- (c) that the trade was done at arm's length;

Article 3

Requirements for hedging instruments exposed to non-SbM risk factors

1. Hedging instruments referred to in Article 1(2) shall be subject to the exemption laid down in Article 325u(4a) of Regulation (EU) No 575/2013 where all of the following conditions are met:
 - (a) the institution maps the non-SbM risk factors of the hedged instruments to the non-SbM risk factors of the hedging instruments;
 - (b) the mapping referred to in point (a) shows a clear relationship between the non-SbM risk factors of the hedged instruments and the non-SbM risk factors of the hedging instruments;
 - (c) the hedging instrument is not exposed to any residual risk other than those stemming from the non-SbM risk factors mapped in accordance with points (a) and (b);
 - (d) the institution's sensitivity towards the non-SbM risk factors is reduced as a result of the hedge.
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- (e) the remaining exposure towards the non-SbM risk factor is dynamically managed within a limit specific to that risk factor that is consistent with the limits set out in accordance with Article 103(2), point (b)(ii) of Regulation (EU) No 575/2013;
- (f) the hedging instrument is entered into in accordance with an internal policy of the institution that meets all of the following conditions:
 - (i) it specifies the risk management and hedging strategy, including the level of risk appetite in relation to the non-SbM risk factors;
 - (ii) the risk appetite referred to in point (i) is consistent with the position limits set out in accordance with Article 103(2), point (b)(ii) of Regulation (EU) No 575/2013;
 - (iii) it specifies the hedged instruments, the instruments that it intends to use as hedge, and their corresponding non-SbM risk factors;
 - (iv) it specifies whether the hedging is done at transaction, sub-portfolio, or portfolio levels;
 - (v) it specifies the designed duration of the hedge;
 - (vi) where more than one trading desks are involved in entering the hedge and the hedged positions, it identifies the trading desks involved and specifies the role of each of them;
 - (vii) it lays down appropriate criteria for distinguishing the hedging instruments from the hedged instruments;
 - (viii) it lays down the institution's policy in choosing counterparties for the purpose of performing the hedge;
 - (ix) it lays down appropriate criteria for carrying out the mapping referred to in points (a) and (b);
- (g) compliance with the conditions set out in points (a) to (f) is subject to the independent review referred to in Article 325c(4) of Regulation (EU) No 575/2013.

For the purposes of point (d), institutions shall assess the risk reduction achieved at the level at which the hedge is performed in accordance with point (f)(iv).

2. When setting out the criteria to distinguish the hedging instruments from the hedged instruments in accordance with paragraph 1, point (f)(vii), the internal policy shall consider all the following elements and shall require the trading desks that carry out the hedging process to document all of them:
 - (a) the identity of the counterparty;
 - (b) whether the trade was made in the interbank market;
 - (c) that the trade was done at arm's length.

Article 4

Requirements for other hedging instruments

1. Hedging instruments referred to in Article 1(3) shall be subject to the exemption laid down in Article 325u(4a) of Regulation (EU) No 575/2013 where all of the following conditions are met:
 - (a) the hedging instrument completely offsets the residual risk of the hedged instrument, and as a result, the combination of the hedging instrument and the hedged instrument replicates an instrument that would not be subject to the residual risk add-on own funds requirement;
 - (b) the hedging instrument is not exposed to any residual risk other than that it aims at hedging;
 - (c) the hedging instrument is entered into in accordance with an internal policy of the institution that meets all the following conditions:
 - (i) it specifies the instruments the institution intends to use to hedge other instruments, and substantiates the fact that those instruments when assessed together fulfill the conditions referred to in point (a);
 - (ii) it lays down appropriate criteria for distinguishing the hedging instruments from the hedged instruments;
 - (iii) it ensures that the trading desks that carry out the hedging process monitor the evolution of the hedges during their lifetime, including the unwinding of the hedged instruments, and the net profit and loss of the combined positions;
 - (iv) it lays down the institution's policy in choosing counterparties for the purpose of performing the hedge;
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- (d) compliance with the conditions set out in points (a) to (c) is subject to the independent review referred to in Article 325c(4) of Regulation (EU) No 575/2013.
2. When setting out the criteria to distinguish the hedging instruments from the hedged instruments in accordance with paragraph 1, point (c)(ii), the internal policy shall consider all the following elements and shall require the trading desks that carry out the hedging process to document all of them:
- (a) the identity of the counterparty;
 - (b) whether the trade was made in the interbank market;
 - (c) that the trade was done at arm's length.

Article 5

Entry into force

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Commission

The

President

[For the Commission

On behalf of the President

ANNEX I

1. multiunderlying options, including spread options and options with a basis as an underlying, which meet the following two conditions:

- (i) the price of the option depends only on SbM risk factors and on the correlation between the underlyings;
- (ii) the option does not fall in any of the categories listed in Annex II.

2. options not falling in any of the categories listed in Annex II and that are on an underlying denominated in one currency but whose pay-offs are settled in a different currency, with a predetermined exchange rate between the two currencies;

ANNEX II

1. options where the pay-offs depend on the path followed by the price of the underlying asset and not just its final price on the exercise date;

2. options that start at a predefined date in the future and whose strike price is not yet determined at the time at which the option is in the trading book of the institution;

3. options whose underlying is another option;

4. options with discontinuous pay-offs;

5. options allowing the holder to modify the strike price or other terms of the contract before the maturity of the options;

6. options that can be exercised on a finite set of predetermined dates;

7. options subject to behavioural risk.

4. Accompanying documents

4.1 Draft cost-benefit analysis / impact assessment

A. Background, Problem identification and Baseline scenario

Under the FRTB framework, the standardised approach (SA) comprises of three parts: a) the sensitivities-based method (SbM) for calculating the own funds requirement for market risk; b) the residual risk add-on (RRAO); c) the own funds requirements for the default risk (DRC). RRAO applies to instruments exposed to residual risks where they are either instruments referencing to an exotic underlying or instruments bearing other residual risks. CRR2 Article 325u(2) as well as the EBA RTS specifying technical details on the RRAO⁹ provide guidance on the RRAO calculation.

In the CRR3, the introduced a provision in the RRAO framework allowing the exemptions from the RRAO charge for those instruments bearing residual risks taken as a hedge for hedging instruments bearing residual risks too. What is subject to the exemption is just the hedge, i.e. the hedged position must always be capitalised with an RRAO charge.

The lack of common specification on when instruments constitute a hedge for the purpose of the RRAO exemption could result in an inconsistent application of the RRAO across institutions, undermining the implementation of the FRTB standardized approach in the EU (called the alternative standardised approach).

B. Policy objectives

The specific objective of these draft RTS is to establish common criteria of when an instrument bearing residual risk qualifies as a hedge for the purposes of the RRAO exemption. In this way, these draft RTS aim to ensure a consistent implementation of the RRAO across EU institutions.

Generally, these draft RTS aim to create a level playing field, promote convergence of institutions practises and enhance comparability of own funds requirements across the EU. Overall, these draft RTS are expected to promote the effective and efficient functioning of the EU banking sector.

⁹ <https://www.eba.europa.eu/regulation-and-policy/market-risk/regulatory-technical-standards-residual-risk-add#pane-new-7bdd87fb-e02f-492a-99d6-129449e3cf9d>

C. Options considered, cost-benefit analysis, preferred option

General

The draft RTS has considered two options when setting the conditions that need to be met to recognise an instrument as a hedge for the purpose of the RRAO exemption:

Option 1a: Set conditions that distinguish between instruments that bear residual risks exclusively because they attract non-SbM risk factors, and the rest of instruments.

Option 1b: Set common conditions for all instruments, regardless of whether they bear residual risks exclusively because they attract non-SbM risk factors.

Option 1c: Set conditions that distinguish between instruments that bear residual risks exclusively because they attract non-SbM risk factors and certain instruments with an exotic underlying, and the rest of instruments.

Option 1a allows to set different conditions for the two types of financial instruments, while Option 1b will set common conditions for all financial instruments. Option 1a recognises that the two types of financial instruments are of different nature and have different sources of risk. For instruments that bear residual risks exclusively because they attract non-SbM risk factors the hedging instrument attracts an RRAO charge exclusively because of the presence of one or more non-SbM risk factors. This allows to compute an institution's sensitivity to these non-SbM risk factors with and without the hedge and set specific conditions that need to be met for this sensitivity. For the rest of instruments, the RRAO charge relates to other reasons than the presence of a non-SbM risk factor, not allowing to compute an ex-ante and ex-post sensitivity (i.e. prior and after the hedge has been taken) and set any specific conditions in this regard. This important difference between the two types of instruments, allows Option 1a to set more specific and less punitive requirements for the case of instruments hedging non-SbM risk factors. On the other hand, Option 1b would err on the punitive side for all instruments, simply to avoid recognising hedging instruments other than instruments hedging non-SbM risk factors as hedges that do not genuinely act as a hedge. One respondent to the CP noted that under Option 1a, instruments with an exotic underlying as a hedge would not be captured under the treatment envisaged for non-SbM risk factors, although in his/her view the market risk of the positions will be reduced via the hedge. Option 1c extends the treatment envisaged for non-SbM risk factors also to certain instruments with an exotic underlying. The treatment is limited to those instruments for which the bank is able to compute an ex-ante/ex-post sensitivity (i.e. as the exotic underlying is a dividend or a future realised volatility or variance). In this way, Option 1c allows to set more specific and less punitive requirements for these types of instruments.

Option 1c is kept.

Requirements for instruments hedging non-SbM risk factors

a. Institution's sensitivity towards the non-SbM risk factors

For instruments hedging non-SbM risk factors to be recognised as hedging instruments, the draft RTS require that the institution's sensitivity towards the non-SbM risk factors is reduced as a result of the hedge. The EBA has considered two options for the level of this reduction:

Option 2a: the institution's sensitivity towards the non-SbM risk factors is reduced as a result of the hedge.

Option 2b: the institution's sensitivity towards the non-SbM risk factors is reduced by at least 50% as a result of the hedge.

Option 2a is more general and does not specify a specific level for the reduction in the institution's sensitivity as a result of the hedge. Option 2b is prescriptive specifying the minimum level of reduction that should occur in the institution's sensitivity towards the non-SbM risk factors as a result of the hedge. This can result in Option 2b being overly prescriptive compared to Option 2a. On the other hand, Option 2b can generally improve harmonisation across banks, although with the caveat that the level of the assessment of the achievement of such percentage is not specified (e.g. transaction level or portfolio level).

Respondents to the consultation highlighted that hedges should be exempted from RRAO charges whenever they reduce the institution's sensitivity to the non-SbM risk factor, regardless of the exact extent. They indicated that this is on the basis of CRR Article 325u(6), which explicitly considers the possibility of partial hedging as part of the criteria to identify the hedging positions qualifying for the derogation. Additionally, one respondent remarks that the proposed treatment is subject to a very cumbersome internal policy, highlighting that the existing exclusion for hedges in the alternative correlation trading portfolio (ACTP), as per CRR Article 325u(2)(b)(ii), does not require any conditions to be met.

Taking into account that the internal policy requirements already include the criteria for distinguishing the hedging instruments from the hedged instruments, as per Article 2(1)(f)(vi), and also the possibility of partial hedging, as per CRR Article 325u(6), the EBA decided to keep Option 2a as long as the institution can demonstrate that the sensitivity towards the non-SbM risk factor is reduced at the level at which the hedge is performed, in accordance with Article 2(f)(iv).

Option 2a is kept.

b. Institution's internal policy: criteria for identifying what is the hedge and the hedged instruments

For instruments hedging non-SbM risk factors to be recognised as hedging instruments, the draft RTS require that the hedge is entered in accordance with the institution's internal policy, which, among others, lays down criteria for identifying what is the hedge and the hedged instruments. The EBA has considered two options when setting these criteria:

Option 3a: The institution shall ensure that the internal policy takes into consideration the counterpart of the trade.

Option 3b: No specific considerations about the counterpart of the trade are prescribed.

Option 3a allows for a better identification of the hedge and hedged position, as it is expected that most hedges will be made in the interbank market and hence the information on the counterpart of the trade can be important for distinguishing between hedged and non-hedged positions. On the other hand, it may be more burdensome than Option 3b which would allow the institution to set these criteria as it sees appropriate.

Option 3a is kept.

c. Independent review

For an instrument hedging non-SbM risk factors to be recognised as a hedging instrument, it needs to meet the conditions laid out in Article 1(a)-(f). The EBA has considered two options to ensure compliance with these conditions:

Option 4a: Compliance with the conditions is subject to the independent review referred to in Article 325c(4) of Regulation (EU) No 575/2013.

Option 4b: Compliance with the conditions is not subject to the independent review referred to in Article 325c(4) of Regulation (EU) No 575/2013.

Option 4a ensures that compliance with the conditions is independently assessed, either as part of the institution's regular internal auditing process, or by mandating a third-party undertaking to conduct that review. Although an independent review may put an additional burden on institutions, the additional costs should be weighted against the need to have a more prescriptive framework in the absence of such safeguard. In that sense, Option 4b, which does not include an independent review of the conditions, would require a more prescriptive framework to ensure that the conditions are fulfilled.

Option 4a is kept.

Requirements for hedging instruments other than instruments hedging non-SBM risk factors

For hedging instruments other than instruments exclusively attracting non-SbM risk factors, the EBA has considered two options when setting the conditions to be met to recognise them as hedging instrument for the purposes of the RRAO exemption:

Option 5a: Require the hedging instrument to completely offset the RRAO risk linked to the hedged instrument.

Option 5b: Consider alternative less strict conditions.

Option 5a is based on a very strict condition, while Option 5b considers alternative less prudent conditions. The rationale behind Option 5a is that where the RRAO relates to other reasons than the presence of a non-SbM risk factor, it is more difficult to objectively assess whether the hedging instrument actually hedges the source of risk generating the RRAO charge, e.g. how a barrier in a given option can be hedged (by means of another RRAO-bearing instrument). Most importantly, in this case, since there is not a risk factor, it is not possible to compute an ex-ante and ex-post sensitivity (i.e. prior and after the hedge has been taken) and hence more difficult to set specific conditions that will be less strict under Option 5b. As a result, Option 5b has the risk of seeing instruments that do not genuinely act a hedge to be recognised as such. Furthermore, the EBA expects that there are no material cases, except for CMS spread options, where banks would hedge a RRAO instrument by means of another RRAO instrument. Accordingly, considering that CMS spread options are under the scope of those instruments exclusively relating to a non-SbM risk factor, an overly complex framework to capture other cases is not warranted. Hence, option 5a, although being punitive, is preferable to option 5b, as it doesn't add complexity. Option 5a is kept.

4.2 Feedback on the public consultation

The EBA undertook a public consultation on these RTS contained in this paper. The consultation period lasted for 3 months and ended on 03 May 2024. Four responses were received, two of which non-confidential and as such published on the EBA website.

This section presents a summary of the key points and other comments arising from the consultation (only based on the non-confidential responses), the analysis and discussion triggered by these comments and the actions taken to address them if deemed necessary. Changes to the draft RTS have been incorporated as a result of the responses received during the public consultation.

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
General comments			
Internal policy requirements at trading desk level.	One respondent points out that the notion of trading desks does not exist in the FRTB SA framework and is only valid in the context of FRTB IMA as per Article CRR Articles 102(4) and 104b(1).	While it is true that CRR introduces requirements for trading desks only in the context of internal models, this does not imply that institutions using a standardised approach do not have a trading desk structure in the front-office functions. Hence, the requirement envisaged in the CP can be applied by any institution, i.e. regardless of the approach used to capitalise market risk positions.	No amendments.
Responses to questions in Consultation Paper EBA/CP/2024/04			
Question 1. Do you agree with the distinction between instruments with residual risks that are characterised by a non-SbM risk factor, and the rest of the instruments? Please elaborate.	Some respondents do not agree that the application of this rule should be restricted to solely non-path dependent options, to the extent that these options contain a non-SbM risk factor, which has been sufficiently hedged. Therefore, the respondents suggest that hedges of the non-SbM risk factor should be exempted from RRAO charges, regardless of whether the product that is being hedged contains some form of path dependency (e.g. Bermudan Options).	While acknowledging that the respondents advocate for the inclusion of e.g. path-dependent instruments in the scope of instruments referred to in Article 2, the EBA considers that none of the instrument included in Annex II of the RTS would allow a prudent assessment of the conditions set out in Article 2. Accordingly, the list in Annex II has not been amended.	No amendments.
Question 2. Do you agree with the requirements set out in Article 2 for instruments with residual risks that are characterised by a non-SbM risk factor? What is your preferred option between option A and option B	Some respondents while overall agreeing with the conditions set out in Article 2, believe that hedges should be exempted from RRAO charges whenever they reduce the institution's sensitivity to the non-SbM risk factor, regardless of the exact extent. This is on the basis of CRR Article 325u(6), which explicitly considers the possibility of partial hedging as	The EBA acknowledges the fact that the CRR does not prescribe a minimum reduction of the sensitivity towards the non-SbM risk factor for a hedging instrument to qualify for the RRAO exemption. On the other hand, the EBA highlights that the significance of the sensitivity reduction towards the non-SbM risk factor was originally introduced in the RTS to	Amendments to Article 2(d): modified version of Option A.

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
<p>in point (d) of that Article? Please elaborate, highlighting operational challenges that you may face under the two options.</p>	<p>part of the criteria to identify the hedging positions qualifying for the derogation.</p> <p>Additionally, one respondent remarks that the proposed treatment is subject to a very cumbersome internal policy, highlighting that the existing exclusion for hedges in the alternative correlation trading portfolio (ACTP), as per CRR Article 325u(2)(b)(ii), does not require any conditions to be met.</p> <p>Regarding the preference between options A and B, one respondent proposes a modified version of option A where the words “significantly” and “significant” are removed to allow for partial hedging, provided the hedge is dynamically managed within the established position limits.</p> <p>In the same vein, one respondent expresses its preference for a third option by which partial hedges could be exempted regardless of the exact extent of the reduction in the sensitivity to the non-SbM risk factor, so the fulfilment of the condition can be unambiguously determined and moving EU regulation closer to a level playing field with the US NPR treatment exempting all CMS spread options.</p>	<p>ensure that the primary purpose of the instrument is to hedge.</p> <p>Nevertheless, taking into account that the internal policy requirements already include the criteria for distinguishing the hedging instruments from the hedged instruments, as per Article 2(1)(f)(vi), and also the possibility of partial hedging, as per CRR Article 325u(6), the EBA decided to remove the significance criterion as long as the institution can demonstrate that the sensitivity towards the non-SbM risk factor is reduced at the level at which the hedge is performed, in accordance with Article 2(f)(iv).</p>	
<p>Question 3. Do you agree with the requirements set out in Article 1 for instruments with residual risks that are not characterised by a non-SbM risk factor? In which cases, other than</p>	<p>Some respondents argue that when a back-to-back transaction has taken place, whereby the terms of the client trade are perfectly offset by a hedging transaction, the RRAO should be computed on the net notional of the two positions, on the basis that the net risk to the portfolio has been eliminated. In</p>	<p>The EBA acknowledges that open residual risk can be totally eliminated by perfectly matching back-to-back transactions. Those transactions (both legs) are already removed from the RRAO charge as per Article 325u(4) CRR.</p>	<p>No amendments.</p>

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
<p>back-to-back positions, do you think hedging instruments would meet the conditions referred to in Article 1? Do you think there are alternative objective ways of assessing whether instruments currently falling under the treatment set out in Article 1 act as a hedge? Please elaborate.</p>	<p>this view, a zero RRAO charge both for the hedged position and the hedge instrument is proposed, as per the case of perfect hedges exemption in CRR Article 325u(4)(c).</p> <p>Likewise, another respondent believes that the net notional should be the basis for the RRAO calculation in case of partially hedged residual risks, i.e. where a hedge is characterised by similar terms but different notional than the hedged position.</p> <p>Regarding the internal policy requirements, one respondent considers the requirement to monitor the evolution of hedges during their lifetime, as per Article 1 paragraph 1(c)(iii), as overly burdensome, on the basis that trading desks constantly monitor the profit and loss (PnL) and hedge effectiveness of their portfolio as a whole. In this view, the respondent suggests to remove this requirement.</p>	<p>However, where the complete offsetting of the RRAO risk is obtained via other means than a perfect back-to-back i.e. the RRAO risk is removed, but the other market risks remain, then only one of the legs (the hedge) is to be removed from the RRAO charge. Indeed, the provision referred to in Article 325u(4a) CRR requires a complete removal of all market risks.</p> <p>Regarding the requirement to monitor the evolution of hedges during their lifetime, including the unwinding of the hedged instruments, and the net profit and loss of the combined positions, the EBA acknowledges that this monitoring can be performed at different levels, provided that it allows the institution to assess the performance of the hedging strategy on an ongoing basis.</p>	
<p>Question 4. What are your views in relation to the requirement to consider whether an instrument has been taken in the interbank market, as a way to distinguish the hedge from the hedged instrument? Which are the cases where the hedge is not performed with the interbank market? Please elaborate.</p>	<p>Some respondents, while acknowledging the interbank market as a standard practice for hedging, remark that it is not the sole route that institutions may use to hedge their risks.</p> <p>In particular, one respondent highlights that hedging derived from market-making activity, by which banks acting as market-makers hedge dynamically their portfolio throughout the day. By this practice, the market-making desk quotes instrument prices to balance bid and offers such that trades hedge</p>	<p>The RTS as proposed in the CP do not exclude hedges taken outside the interbank market from the possibility of being subject to the RRAO waiver. The institution may also have a mix, i.e. part of the hedge may be done with the interbank market and part not (e.g. where the hedging process is performed on a net basis at the level of a trading desk, or at the level of the institution).</p> <p>To remove operational burden, the EBA has amended the proposed RTS, by removing the requirement in Article 1(2)(d) and 2(2)(d) to justify the choice of the</p>	<p>Amendments to Article 1(2)(d) and 2(2)(d)</p>

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	<p>each other, allowing the traders to avoid a large directional position. This way, the client flow becomes a natural provider of hedges, including banks as well as non-bank counterparties.</p> <p>In this view, the respondents do not deem feasible to track the counterparties of all these trades, taking into account that a bank may transact with hundreds of counterparties, but also that each of these trades can be a potential hedge to another instrument (i.e. a “client” transaction from one bank can be a “hedge” for another).</p> <p>One respondent also considers that other potential sources for hedging may exist, such as funds looking for particular payoff profiles in the case of structured products, which may also be considered suitable counterparties.</p> <p>Overall, some respondents are of the opinion that counterparty information should not be considered as a binding factor for an instrument to be exempted from the RRAO charge, but only as a potential indicator to better identify hedges in the context of the overall hedging strategy.</p> <p>Consequently, some respondents propose to amend Article 1(2)(b) of the RTS, changing the reference to “whether the trade was made in the interbank market” for “the industry of the counterparty (e.g. interbank, funds, other)”.</p> <p>Additionally, the respondents propose to remove Article 1(2)(b), on the basis that the rationale for executing a hedge transaction against a counterparty</p>	<p>counterparty for any transaction. A more general requirement has been included in Article 1(1)/2(1) requiring institution to justify in their internal policies how they select the counterparties of the hedge.</p>	

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	<p>should not be relevant to inform the determination of the RRAO charges.</p> <p>One respondent considers that these changes should be applied both to Article 1(2) and Article 2(2), as a minimum, but expresses its preference for removing the whole paragraph 2 of Articles 1 and 2, on the basis that the CRR3 amendment does not refer to the nature of the counterparty.</p>		
<p>Question 5. What are the material cases where institutions hedge an instrument with residual risks using other instruments with residual risks? Does the proposed regulation address those cases? If not, how can the assessment of the hedge be performed in those cases? Please elaborate.</p>	<p>Some respondent outline some cases of hedging by means of instruments attracting RRAO.</p> <p><u>Market marking desks:</u></p> <p>According to the respondents, the proposed regulation states that hedges to be exempted are to be identified at instrument level whereas in the respondent's view, in the context of market-making, such one-to-one relationship between a hedged instrument and the hedging instrument does not always exist – trades being hedged dynamically throughout the day to prevent open directional positions.</p> <p>The respondent suggests instead to consider gross position and net position for a certain type of instrument, and then identify the set of trades which are risk reducing (i.e. the short position if the position in the non-SbM risk factor is net long) as eligible for the hedge exemption. In the respondent's view, the smallest of the net long or net short positions could then be excluded from the residual risk add-on as it</p>	<p>The RTS as proposed in the CP already allow hedges to be exempted even in relation to market making activities. The RTS allow the hedging to be performed on a net basis (i.e. assessing the resulting net position) at the trading desk level/at institution level.</p> <p>In relation to Bermudian options, no changes have been implemented, as the assessment of the hedge in accordance with Article 2 is not considered appropriate. Instead, the treatment proposed in Article 1 is considered to fit more for this exotic instrument.</p> <p>For instruments referencing an exotic underlying, an additional Article (i.e. Article 3) allowing a specific treatment whenever instrument with an exotic underlying is taken to hedge another instrument with an exotic underlying has been added.</p>	<p>Addition of Article 3</p>

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	<p>is providing the hedge – without the need to mark individual trades as “hedges”.</p> <p><u>Interest rate Bermudan options:</u></p> <p>Two respondents mentioned the case of interest rate Bermudan options used to hedge non-SbM risk factors of other Bermudan options. The respondent regretted that under the current proposal hedging a Bermudan option with vanilla hedges only would attract lower market risk RWA than hedging the Bermudan instrument with another (different) Bermudan options, while the latter will reduce the risk more than the former. Indeed, Bermudan options are subject to a non-SbM risk factor called “Berm tax” in the respondent’s wording – reflecting the delta in premium between a Bermudan option and the maximum premium between the equivalent series of European options. This non-SbM risk factor can only be hedge using another Bermudan option, that attracts yet a RRAO charge.</p> <p>In this sense, the respondent suggested to delete point 6 of Annex 2 referring to <i>“options that can be exercised on a finite set of predetermined dates”</i> to allow Bermudan options in the possible instruments eligible to the treatment defined in Article 2.</p> <p><u>Structured notes issues:</u></p> <p>The respondent highlights that also structured note attracting RRAO are typically hedged by instruments that are similar and attracting RRAO.</p> <p><u>Instruments with an exotic underlying as hedge:</u></p>		

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	<p>The respondent also referred to the case where the hedging instrument contains an exotic underlying (as per Art. 324u(2)(a)) instead of bearing other residual risk (as per Art. 325u(2)(b)) as the case foreseen by the proposed regulation.</p> <p>The respondent mentioned the example of auto-callable products (hedged instrument – subject to the RRAO due to featuring other residual risk as per Art. 325u(2)(b)) for which volatility risk can be hedged via variance swaps (hedging instrument – subject to the RRAO due to bearing an exotic underlying as per Art. 325u(2)(a)). Since the hedging instrument is an instrument referencing an exotic underlying and not an instrument bearing other residual risk, the hedge exemption of Art. 2 of the proposed RTS cannot be applied, whereas in the respondent’s view the market risk of the positions is reduced via the hedge.</p>		