EBA/RTS/2021/03

19 February 2021

Final report

Draft Regulatory Technical Standards on the determination of indirect exposures to underlying clients of derivative and credit derivative contracts under Article 390(9) CRR2

Contents

1. Executive summary

As part of the 'Risk Reduction Measures Package' adopted by European legislators in May 2019, CRR2[1] has updated the large exposures framework. The amendments ensure greater alignment with the Basel standard (LEX).[2]

With regard to derivative contracts listed in Annex II of the CRR and credit derivative contracts, the requirement to take indirect exposures into account was taken up. A derivative contract can give rise to a direct credit exposure and an indirect credit exposure. Pursuant to paragraph 5 of Article 390 of Regulation (EU) No 575/2013 (CRR), as amended by Regulation (EU) 2019/876, institutions shall add to their total exposures to a client the exposures arising from derivative contracts and credit derivative contracts where the contract was not directly entered into with that client but the underlying debt or equity instrument was issued by that client. Under paragraph 9 of the same Article, the EBA is mandated to develop draft regulatory technical standards (RTS) to determine the indirect exposures arising from such contracts.

For large exposures purposes, an institution shall calculate the exposures to a client or group of connected clients by adding the direct and indirect exposures in the trading book and in the non-trading book. The indirect exposure to the issuer of the underlying instrument of a derivative contract shall be calculated as the loss that would result from the default of the issuer itself.

The draft RTS propose a methodology for the calculation of exposures under Part four of the CRR for different categories of derivative contracts and credit derivative contracts with a single underlying debt or equity instrument, namely: options on debt and equity instruments, credit derivative contracts, and other derivatives having as underlying a debt or equity instrument. Only derivative and credit derivative contracts where the underlying of those instruments entails a default risk of the underlying reference names should be relevant for the calculation of the indirect exposures set out in these RTS. In addition, the draft RTS provide a separate methodology for the calculation of exposures stemming from contracts with multiple underlying reference names. In each case, a general methodology as well as a fallback approach is provided.

In order to ensure consistency through the different pieces of the regulatory framework, these draft RTS build on the Basel LEX with the intention of being consistent with market risk rules for the calculation of exposures from (credit) derivatives, complemented where needed by specificities or objectives stemming from the large exposures framework.

These RTS are part of the roadmap previously published by the EBA.[3]

[1] Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 – Capital Requirements Regulation (CRR).

[2] BCBS Supervisory framework for measuring and controlling large exposures. https://www.bis.org/publ/bcbs283.pdf.

[3] https://eba.europa.eu/eba-publishes-its-roadmap-risk-reduction-measures-package.

Next Steps

The final draft RTS will be submitted to the Commission for adoption. Following the submission, the RTS will be subject to scrutiny by the European Parliament and the Council before being published in the Official Journal of the European Union.

2. Background and rationale

2.1 Changes to the European Large Exposures framework to align with the new Basel LEX Standard

1. An institution with a strong capital ratio may fail if it experiences significant losses on large exposures in the event of a sudden failure of a counterparty or a group of connected counterparties ('a single counterparty'). The risk of large losses associated with the failure of a single counterparty was not captured by the risk-based capital standards of the Basel Committee on Banking Supervision (BCBS).

2. In April 2014, the BCBS introduced a new standard with the aim of ensuring that internationally active banks' exposures to single counterparties are appropriately monitored and limited.[4] Banks are exposed to different types of concentration risk, such as sectoral and geographical concentration of asset exposures. The scope of the large exposures framework is limited to losses incurred due to a default of a single counterparty. The new Basel standard came into force on 1 January 2019.[5]

3. Furthermore, in December 2019 the BCBS published a consolidated chapter – LEX Large exposures, Exposure measurement (LEX 30) – which describes the value of exposures to counterparties used in the large exposures framework, including those for which a specific treatment is deemed necessary. The BCBS also published a LEX 30 version reflecting the new market risk requirements.[6] That version will become effective as of 1 January 2023.[7]

4. In October 2016, the EBA issued an opinion in response to a European Commission call for advice, setting out its views on the review of the European large exposures regime.[8] In that opinion, the EBA called on the EU institutions to introduce some amendments with a view to (a) aligning the CRR with the Basel standard on large exposures, (b) removing some exemptions and (c) improving some technical details.

5. As part of the Risk Reduction Measures (RRM) package adopted by the European legislators in May 2019, the Capital Requirements Regulation (CRR) was amended.[9] The amended CRR (CRR2) retained some of the elements of the EBA's opinion. These amendments ensure greater alignment with the Basel standard (LEX). For instance, the capital basis on which large

[4] Supervisory framework for measuring and controlling large exposures. April 2014. See: https://www.bis.org/publ/bcbs283.pdf.

[5] See: http://bis-org.com/basel_framework/standard/LEX.html.

[6] See: http://bis-org.com/basel_framework/chapter/LEX/30d6df.html?inforce=20220101. LEX 30 – Exposure measurement.

[7] The Governors and Heads of Supervision announce deferral of Basel III implementation to increase operational capacity of banks and supervisors to respond to COVID-19 (https://www.bis.org/press/p200327.htm).

[8] The EBA's response to the European Commission's call for advice, EBA-OP-2016-17 of 24 October 2016.

[9] See Regulation (EU) 2019/876 of 20 May 2019 ("CRR2") (https://data.consilium.europa.eu/doc/document/ST-6288-2019-INIT/en/pdf), amending Regulation (EU) No 575/2013.

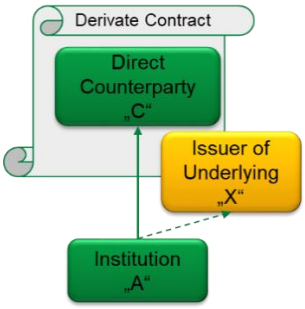
exposures and large exposure limits are calculated will be restricted to Tier 1 capital and a tighter limit on exposures between global systemically important institutions (15% of Tier 1 capital) was introduced (as of 28 June 2021).

2.2 Large Exposure treatment of indirect exposures stemming from derivative contracts

General background and mandate

6. Article 390(9) of the CRR mandates the EBA to develop draft regulatory technical standards '*to specify how to determine the exposures arising from derivative contracts listed in Annex II and credit derivative contracts, where the contract was not directly entered into with a client but the underlying debt or equity instrument was issued by that client for their inclusion into the exposures to the client'*. The EBA shall submit those draft regulatory technical standards (RTS) to the Commission by 28 March 2020.[10]

7. A derivative contract can give rise to a direct credit exposure (i.e. the counterparty of the derivative contract) and an indirect credit exposure (i.e. the issuer of the underlying).



8. The direct credit risk exposure is the exposure of institution A to counterparty C of the derivative. The counterparty credit risk exposure captures the risk of a loss that an institution may suffer due to a default of counterparty C. As this direct counterparty credit risk exposure is already captured in the large exposures framework, it is not relevant for the purpose of these RTS.

9. Instead, with regard to the wording 'where the contract was not directly entered into with a client', Article 390(9) CRR2 requires developing draft RTS to specify how institutions should determine the indirect exposure with respect to the issuer of the underlying instrument of a derivative (indirect client X). Once the value of the indirect exposure to client X is calculated, it must be added to the other exposures, if any, of the institution towards the same client.

[10] However, the EBA published on 21 November 2019 a roadmap on the risk reduction package, indicating in particular the planned timetable for delivering the regulatory deliverables according to the mandates given by the CRR2 to the EBA, including those on large exposures. According to this roadmap, the mandate to submit draft RTS to the Commission under Article 390 (9) of the CRR should be delivered by December 2020.

10. The indirect credit risk exposure stems from issuer X of the underlying debt or equity instrument. This indirect exposure shall be considered for the large exposures framework because the default of underlying client X affects the value of the derivative and, therefore, it affects the maximum loss that an institution could face in the event of X's default.

11. As a concrete example of the case in which the default of X leads to a loss, consider an institution A that has a long position on a call option – entered with counterparty C – on an equity issued by client X. If X defaults, the option will expire worthless and institution A will lose the current market value of the option.

12. If the issuer of the underlying instrument is a sovereign, such exposure would be exempted from the large exposure limits. However, an analysis of these exposures (and thus the correct calculation of the exposure value) is still required because the large exposures regime nonetheless applies to them (even though no upper limit is established) – i.e. the institution is required to monitor and control whether the value of any on- and/or off-balance sheet exposures reaches or exceeds 10% of its Tier 1 capital.

13. It should be emphasised that these RTS do not impact on the calculation of own funds requirements, their valuation or reporting. Especially, the indirect exposure values calculated on the basis of these RTS do not affect the size of the trading book or non-trading book. The RTS serve the sole purpose of specifying the measurement methods for indirect exposures arising from derivative and credit derivative contracts for institutions to correctly identify and limit their large exposures.

14. The scope of the mandate of these RTS encompasses all derivative contracts as listed in Annex II of the CRR and credit derivatives contracts. As matter of example, embedded derivatives and credit-linked notes fall into the scope since, from an economic perspective, institutions could incur a loss when the underlying reference name of the embedded derivative defaults; therefore, an institution shall consider those indirect exposures in the calculation. The indirect exposure arising from derivative contracts and credit derivative contracts for which the underlying does not entail a default risk of an indirect client X shall not be considered by institutions. Examples of such references of derivative contracts are commodities, interest rate benchmarks, interest rate curvature spreads, and exchange rates.

Calculation method for indirect derivative exposures

15. A derivative may be allocated to the non-trading book or the trading book. In particular, in accordance with Article 104 of the CRR, institutions must have clearly defined policies, procedures and documented practices in order to determine the correct allocation of derivative instruments to the trading book. The CRR strictly frames the ability of banks to move instruments between the trading book and the non-trading book restricting possible reclassifications to exceptional circumstances as laid down in Article 104a(2) of the CRR. Indeed, Article 102 of the CRR regulates the requirements for the trading book, specifying that institutions are mandated to assign derivative instruments to the trading book in case those instruments are held for a short-term resale, profiting from short-term market value

movements, looking at arbitrage or hedging risks that arise from those instruments. On the other hand, institutions shall allocate derivative instruments to the non-trading book that do not qualify as trading book positions. In general, and as required by the CRR provisions on large exposures, to obtain the total exposure to a client, it does not matter whether the indirect exposure is assigned to the non-trading book or the trading book, since an institution needs to calculate its overall exposures by adding those in the trading book and in the non-trading book.[11] In particular, the treatment of the indirect exposure value described in these RTS applies to derivative contracts and credit derivative contracts independently of the allocation of the instrument to the trading book or to the non-trading book.

16. Article 390(3)(a)-(b) of the CRR allows the offsetting between positive and negative exposures held in the trading book as long as some specific conditions are met.[12] Netting between positions held in the non-trading book and in the trading book is not allowed[13] nor is netting between non-trading book positions.[14] According to Article 390(5) CRR2, an exposure to the issuer of the underlying instrument of a derivative needs to be added to the total exposure to that issuer. Under the large exposures regime, the overall exposures to individual clients are relevant only when positive, i.e. an exposure leading to a loss following the client's default. Negative overall exposures shall be set to zero.

17. Institutions shall calculate the indirect exposure towards a client as the difference between the current market value of the derivative or credit derivative contracts and the amount that the institution would receive or give under the scenario of a default of the issuer of the underlying instrument when the settlement transactions take place – i.e. the indirect exposure towards a client shall be the loss that would result from the default of the underlying client of the derivative or credit derivative contract. Where the resulting exposure is negative, the client's default results in a gain for the institution (which shall be set to zero as not relevant for limiting large exposures).

18. Institutions shall calculate that indirect exposure with the following formula:

$$Indirect\ exposure\ value = market\ value + A_d - A_r$$

Where 'A_d' is the amount due to the counterparty of the derivative under the scenario of a default by the issuer of the underlying, and 'A_r' is the amount received from the counterparty of the derivative under the same scenario.

19. According to Article 325v of the CRR, an institution has a short exposure (i.e. a negative exposure) where the default of an issuer or group of issuers leads to a gain for the institution,

[11] Article 390(2) of the CRR.

[12] See also Basel Standards: The relevant conditions for netting between trading positions are provided in paragraphs 30.23 to 30.31 of the LE Basel standard.

[13] See Basel standard on LEX 30.30 of the consolidated text, effective as of December 2019.

[14] Please note that for non-trading book positions only CRM techniques can be recognised in order to reduce the value of the exposure to the original counterparty. Article 399(1) of the CRR provides for a treatment of bought credit protection where credit derivatives are entered into for CRM-purposes.

regardless of the type of instrument or transaction creating the exposure. On the contrary, an institution has a long exposure (i.e. a positive exposure) where the default of an issuer or group of issuers leads to a loss for the institution, regardless of the type of instrument or transaction creating the exposure. Thus, these RTS follow the provisions of Article 325v of the CRR with respect to terminology – i.e. where the calculations provided in these RTS lead to a negative (positive) indirect exposure, this would reflect a gain (loss) following a potential default of the issuer of the underlying instrument. Moreover, for the sake of clarity, for a short position, the market value of the derivative or credit derivative contract has to reflect that the institution is acting as the seller of the instrument, while for a long position, the institution is acting as the buyer; accordingly, a short position in a put option does have a negative market value for the purpose of the formula in the previous paragraph.

20. Based on the EBA mandate, these RTS seek to ensure consistency with the international standards for the calculation of indirect exposures to underlying clients of derivatives and credit derivatives for large exposures purposes. In particular, the EBA proposes methodologies that are based on the market risk framework used by institutions to measure the loss that would result from the settlement of these instruments under the scenario of a default by the underlying client. It is to be noted that some aspects of these RTS might be impacted in the future by the changes stemming from the Fundamental Review of the Trading Book.

21. In addition, these RTS build on aspects specific to the large exposures objectives and framework. This is in particular the case for aspects relating to the calculation of indirect exposures for contracts constituted with multiple underlying reference names. Indeed, while the calculation of the indirect exposure value relies on the market risk framework, the allocation of those exposures is based on Commission Delegated Regulation (EU) No 1187/2014 of 2 October 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council as regards regulatory technical standards for determining the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets.[15]

Calculation method for indirect exposures arising from derivative and credit derivative contracts with a single underlying reference name

22. In accordance with these RTS, institutions shall distinguish between indirect exposures with single or multiple underlying reference names. For indirect exposures with a single underlying reference name, and with a view to rationalising the variety of derivatives and credit derivatives, the RTS divide them into three categories, in line with examples provided for in the LEX standard:

    i. Category 1: Options on debt and equity instruments;

    ii. Category 2: Credit derivative contracts; and

[15] See here: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014R1187.

iii. Category 3: Other Derivatives having as underlying a debt or equity instrument.

23. These RTS identify the methodology to calculate the exposure value for each of the three categories.

Category 1: Options on debt and equity instruments

24. Options are financial derivatives that give buyers (long position) the right, but not the obligation, to buy or sell an underlying asset (i.e. call and put options) at an agreed-upon price within a certain period or at a certain date. The option seller (short position), on the other hand, has the obligation to deliver or buy the security if the option is exercised by the option buyer. One of the main features of an option is its non-linear risk profile.

25. For options, to calculate the maximum loss it is necessary to consider changes in option prices that would result from a default of the respective underlying instrument (see Article 3 of these RTS). In particular, for call options, the indirect exposure value shall be equal to the market value of the option. Long call options would result in a positive exposure while for a short position (short call) the exposure would be negative. For put options, the indirect exposure value would be the difference between the market value of the option and its strike price. For a short position in a put option, the exposure would be a positive exposure while for a long position in a put option the exposure would be a negative exposure.

26. As matter of example, for a long call option, in the case of default of the issuer of the underlying instrument the loss, and thus the indirect exposure value, would be equal to:

$$Indirect\ exposure\ value = market\ value$$

Where 'A_d' and 'A_r' would both be zero because the institution would not use the option in the case of default of the issuer of the underlying instrument and the loss would be equal to the market value of the option. On the contrary, for a long put option, in the case of default of the issuer of the underlying instrument, the loss, and thus the indirect exposure, would be equal to:

$$Indirect\ exposure\ value = market\ value - A_r$$

Where 'A_r' would be equal to the strike price because the institution would use the option in the case of default of the issuer of the underlying instrument and the profit would be equal to the market value reduced by the strike price. For a long put option 'A_d' is zero.

Sign of the exposure / (Exposure value)	Call option	Put option

Long	+ / MV	– / (MV – X)
Short	– / – (MV)	+ / – (MV – X)

Note: The table shows: i) the sign of the indirect exposure arising from long/short call and put options; and, ii) the exposure value. 'MV' is the market value of the option and 'X' is its strike price.

27. For put options not having the strike price available at the transaction date but available at a later stage at any time (e.g. Asian option with a floating strike), the strike price should be set equal to the expected modelled strike price used for the calculation of the fair value of this option.

28. For options not having the market value available on a given date, the value of the option has to be measured at the fair value of the option. Where the market value and fair value of an option are not available on a given date, institutions shall take the most recent of the market value or fair value. Finally, if the market value and the fair value are not available, institutions shall use the value at which the option is measured with the applicable accounting framework.

Category 2: Credit derivative contracts

29. A credit derivative is a bilateral financial contract whose pay-off is linked to a credit event (e.g. the cash flow of a CDS is triggered only by a default event). The purpose of a credit derivative is to transfer credit risk and all or part of the income stream in relation to the borrower without transferring the asset itself. A credit derivative serves as a sort of insurance policy allowing an originator or buyer to transfer the risk stemming from a credit asset (of which he may or may not be the owner) to the seller(s) of the protection or counterparties (i.e. Credit Default Swaps or Total Return Swaps). Credit default swap options are credit derivatives but are excluded from this category because they are options and thus fall under Category 1.

30. According to Article 4 of these RTS, the indirect exposure underlying a credit derivative contract is equal to the market value of the credit derivative adjusted by the amount due or expected to be received in the event of default of the issuer of the underlying instrument.

31. It should be noted, however, that the protective effect of a credit derivative for which the institution is a protection buyer, may have already been recognised as a credit risk mitigation technique (CRMT) in accordance with Article 399 of the CRR. Thus, in order to avoid double counting when recognising the protective effect arising from those credit derivative contracts as a CRMT, institutions should set their indirect exposure values to zero.

32. For credit derivatives not having the market value available on a given date, institutions shall take the fair value of the credit derivatives on that date. Where the market value and fair value of the credit derivatives are not available on a given date, institutions shall take the most recent of the market value or fair value. If the market value and the fair value are not available, institutions shall use the value at which the credit derivative contract is measured with the applicable accounting framework.

Category 3: Other Derivatives having as underlying a debt or equity instrument

33. This category covers all other derivatives not belonging to the previous categories, i.e. those which are neither options nor credit derivatives. In this case, to determine the indirect exposure value of underlying debt or equity instruments, institutions shall treat those indirect exposures as positions in debt and equity instruments. Institutions shall decompose derivative contracts that constitute a combination of long and short positions into individual transaction legs and apply the large exposures framework as if they had a position in those legs. Only the transaction leg(s) with default risk, where institutions have a risk of loss in the case of default, should be relevant for the calculation of the indirect exposures set out in this Regulation.

34. As matter of example, a forward contract on a listed stock is composed by two transaction legs, which are two agreements to exchange short and long position in opposing directions. In this case, a forward contract has both the strike leg and the stock leg. Both legs are towards the same client. Institutions shall apply the large exposures framework considering a short cash position with the counterparty (i.e. the strike leg), and a long stock position with the counterparty (i.e. the stock leg). Only the leg associated with default risk of the issuer of the underlying (i.e. the stock leg) should be taken into account – i.e. the exposure value should be calculated as if the position of the institution were a long position in the stock.

35. However, there might be cases for which decomposition into individual transaction legs cannot apply. For those cases, the RTS include, in paragraph 3 of Article 5, a fallback calculation based on the maximum loss that could occur following the default of the underlying client to which the derivative refers.

Calculation method for indirect exposures arising from derivative and credit derivative instruments with multiple underlying reference names

36. Institutions shall calculate exposures also stemming from derivatives with multi-underlying reference names – e.g. where the derivative contract is written on debt, equity or credit default swap indices, CIU or Best-Of Call options.[16]

37. In order to establish the exposure value of multi-underlying reference names, where an institution can look through all the components constituting the underlying of the derivative contract, the indirect exposure value shall be calculated by looking at the variation in the price of the derivative assuming the default of each of the underlying reference names in the multi-underlying instrument. Then, the rules laid down in Articles 6(1) and 6(2) of Commission Delegated Regulation (EU) No 1187/2014 shall apply. In particular, for each underlying exposure for which the issuer can be identified, an institution shall add this exposure value to the other exposures the institution has to the same client. If an institution cannot identify the issuer of the underlying exposure, the indirect exposure value shall be assigned to:

[16] A best-of option is a derivative instrument whose payoff at maturity is equal to whichever is higher of two values: zero or the maximum return obtained from an asset belonging to a basket of assets minus the option's strike price.

a) a separate client if the exposure value does not exceed 0.25% of the institution's Tier 1 capital or exceeds 0.25% of its Tier 1 capital and the institution can ensure, by means of the transaction's mandate, that the underlying exposures of the transaction are not connected with any other exposures in its portfolio, or

b) to the unknown client in other cases.

38. Only where an institution is not able or it would be unduly burdensome for the institution to perform a look-through on the underlying reference names itself, the indirect exposure value shall be calculated by treating the exposure as a direct exposure to those underlying reference names of the derivative – i.e. by looking at the variation of the price of the derivative assuming a default of all those reference names of the structure. Then, the rules applicable to direct exposures as laid down in the Article 6(3) of the Commission Delegated Regulation (EU) No 1187/2014 shall be applied. In particular, the exposure to those underlying reference names where the institution did not perform a look-through shall be assigned to a separate client if the exposure is below or equal to 0.25% of the institution's Tier 1 capital or to the unknown client if the exposure is above 0.25% of its Tier 1 capital.

39. Furthermore, if the underlying reference names are assigned to the unknown client, it would not be prudentially sound to use negative exposure values to offset positive exposure values as such those have been set to zero.

40. Embedded derivatives have to be dealt with accordingly. For example, considering a structured bond with a redemption value that depends on the performance of the underlying stock on which the structured bond is embedded, institutions shall identify the reference names of the direct exposure (i.e. the issuer of the structured bond) and of the indirect exposure (i.e. the issuer of the stock embedded to the structured bond). In this case, according to Article 6(1) of the RTS, the indirect exposure value would be equal to the variation in price of the structured bond due to the default of the issuer of the underlying stock on which the structured bond is embedded.[17]

Additional aspects

41. According to the new version of LEX 30 (effective as of January 2023) institutions shall use the gross jump-to-default amount ('JTD') under the Fundamental Review of the Trading Book in order to identify the exposure values for trading book positions. The JTD approach applies to all trading book positions subject to credit risk and is aimed at covering the risk of sudden default of the issuer of the instrument and applies to derivative contracts as well. However, as the new Basel standard is only applicable as of 1 January 2023 and, due to the interconnection that arises with the EBA mandate under Article 325w(8) CRR2 that requires the EBA to specify the JTD calculation method, these draft RTS do not provide for this approach for the identification and calculation of indirect derivative exposures. Where necessary, these RTS

[17] Please note that no definition of embedded derivatives is provided in the current text of the CRR. Moreover, as stated in the mandate of these RTS, this Regulation applies to all derivative contracts listed in Annex II and credit derivative contracts.

might be further reviewed and possibly amended following the finalisation of the EBA mandate under Article 325w(8) CRR2.

42. In order to facilitate the reading of the provisions of these RTS, a decision tree explaining the different cases and options is provided in the accompanying documents section, Annex I.

3. Draft regulatory technical standards

COMMISSION DELEGATED REGULATION (EU) …/..

of XXX

supplementing Regulation (EU) No 2013/575 of the European Parliament and of the Council with regard to regulatory technical standards specifying how to determine the indirect exposures to a client arising from derivatives and credit derivatives contracts where the contract was not directly entered into with the client but the underlying debt or equity instrument was issued by that client

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 investment firms and amending Regulation (EU) 648/2012[18], and in particular the third subparagraph of Article 390(9) thereof,

Whereas:

(1) Only derivative and credit derivative contracts where the underlying debt or equity instrument entails a default risk of the underlying reference name should be relevant for the calculation of the indirect exposures to a client arising from derivative contracts listed in Annex II of Regulation (EU) No 575/2013 and credit derivative contracts, where the contract was not directly entered into with the client but the underlying debt or equity instrument was issued by that client.

(2) The determination of the indirect exposure values to a client arising from derivative and credit derivative contracts for large exposures purposes should differ from the calculation method of the exposure value used for risk-based capital requirements set out in Regulation (EU) No 575/2013 because a default of the underlying instrument could lead to a profit instead of a loss. The indirect exposure value should therefore be dependent on the loss (i.e. positive exposure value) or gain (i.e. negative exposure value) that would result from a potential default of its underlying instrument. Under the large exposures regime set out in Regulation (EU) No 575/2013, in the case of exposures in the trading book, institutions may offset positive and negative positions in the same financial instruments, or, under certain conditions, in different financial instruments, issued by a given client. The overall net exposure to an individual client is only considered if positive. Similarly, the overall net exposure to a given client, after the inclusion of the indirect exposures to that client arising from derivative or credit derivative

[18] OJ L 176, 27.6.2013, p. 1.

contracts allocated to the trading book, should only be considered if positive. In the same vein, in order to avoid any offset of any indirect exposure arising from derivative or credit derivative contracts allocated to the non-trading book, any negative indirect exposure value arising from those positions should be set to zero.

(3) In order to ensure that the default risk is appropriately captured, the indirect exposure value of options, regardless of whether allocated to the trading book or the non-trading book, should therefore depend on the change(s) in option prices that would result from a default of the respective underlying instrument, e.g. the option's market value for 'call' options and the market value of the option minus its strike price for 'put' options.

(4) The purpose of credit derivatives is to transfer credit risk in relation to borrowers without transferring the assets themselves. The role that institutions play as protection seller or protection buyer and the type of credit derivative they enter into should be taken into account for the determination of the indirect exposure value of the underlying instrument. The indirect exposure should therefore be equal to the market value of the credit derivative contract which should be adjusted by the amount due to or expected to be received from the counterparty in the case of default of the issuer of the underlying debt instrument.

(5) For other types of derivative contracts that constitute a combination of long and short positions, to ensure that the accurate default risk is captured, institutions should decompose those derivative contracts into individual transaction legs. Only the leg(s) with default risk, where institutions have a risk of a loss in the case of default, should be relevant for the calculation of the indirect exposure value arising from those derivative contracts. However, where institutions cannot apply this methodology, and to ensure a conservative treatment, they should be allowed to determine the indirect exposure value of the underlying instruments as the maximum loss that they could incur following the default of the issuer of the underlying to which the derivative refers.

(6) Derivatives can be written on instruments having multiple underlying reference names. For those multi-underlying derivatives, where an institution can look through to the underlying reference names, and to ensure that the most accurate method is used, the indirect exposure value should be calculated by looking at the variation in the price of the derivative in case of default of each of the underlying reference names in the multi-underlying instrument. To ensure consistency with the large exposures framework applicable to transactions where there is an exposure to underlying assets, Articles 6(1) and 6(2) of Commission Delegated Regulation (EU) No 1187/2014 should apply to assign the exposures to the identified client, a separate client or the unknown client. In cases where institutions are not able to apply a look-through approach or where a look-through approach to a derivative with multiple reference names is unduly burdensome for them, and to ensure a conservative treatment, institutions should calculate the indirect exposure value by looking at the variation of the price of the derivative in the case of default of all those underlying reference names. Similarly, to ensure consistency with the large exposures framework applicable to transactions where there is an exposure to underlying assets, Article 6(3) of the Commission Delegated Regulation (EU) No 1187/2014 should apply to assign the exposure to a separate client or the unknown client. In all cases where the underlying instruments are assigned to the unknown client, to avoid the risk that negative indirect exposure values are offset with positive indirect exposure values, institutions should set to zero any negative indirect exposure values.

(7) This Regulation is based on the draft regulatory technical standards submitted by the European Banking Authority to the Commission.

(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 1093/2010[19].

HAS ADOPTED THIS REGULATION:

Article 1

General rules for the determination of the indirect exposure value to a client arising from derivative and credit derivative contracts

1. Institutions shall calculate the indirect exposure value to a client arising from derivative contracts listed in Annex II of Regulation (EU) No 575/2013 and credit derivative contracts, where the derivative contracts were not directly entered into with that client but the underlying debt or equity instrument was issued by that client, in accordance with the methodology set out in Articles 2 to 5.

2. By way of derogation from paragraph 1, where the underlying instruments are included in a debt, equity or credit default swap index or a CIU, or where the derivative contracts have multiple underlying reference names, institutions shall calculate the indirect exposure values to a client arising from the derivative contracts referred to in paragraph 1 and the contribution of that exposure to the exposure to a client in accordance with the methodology set out in Article 6.

3. Where the derivative and credit derivative contracts referred to in paragraph 1 are allocated to the trading book, following the calculation of the indirect exposure values to a client arising from those contracts, institutions shall include those exposure values into the exposures to that client in the trading book. After aggregation, negative net exposures to the client shall be set to zero.

4. By way of derogation from paragraphs 1 and 2, where the derivative and credit derivative contracts referred to in paragraph 1 are allocated to the non-trading book and where, following the calculation of the indirect exposure values to a client arising from those contracts, the indirect exposures have a negative value, institutions shall set to zero those exposure values before counting them towards the exposures to that client.

Article 2

Allocation of the indirect exposures to categories of derivative contracts

For the purposes of this Regulation, institutions shall allocate the indirect exposures referred to in Article 1(1) to one of the following categories of derivative contracts:

(a) Options on debt and equity instruments;

(b) Credit derivative contracts;

[19] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2020, p. 12).

(c) All other derivative contracts listed in Annex II of Regulation (EU) No 575/2013 having as an underlying asset a debt or equity instrument and which are not included in the categories referred to in points (a) and (b).

Article 3

Calculation of the indirect exposure value for options on debt and equity instruments

1. Subject to paragraphs 2 to 4, the indirect exposure value for options referred to in point (a) of Article 2 shall be calculated as the sum of the current market value of the option and the amount owed to the counterparty of the option as a result of a potential default of the issuer of the underlying instrument reduced by the amount owed to the institution by that counterparty in that event.

2. For call options, the indirect exposure value shall be equal to the market value of the option. For a long position in a call option, the indirect exposure value shall be positive while for a short position in a call option, the indirect exposure value shall be negative.

3. For put options, the indirect exposure value shall be equal to the difference between the market value of the option and its strike price. For a short position in a put option, the indirect exposure value shall be positive while for a long position in a put option, the indirect exposure value shall be negative.

4. By way of derogation from paragraph 3, for put options not having a strike price available at transaction date but available at a later stage, institutions shall use the expected modelled strike price used for the calculation of the fair value of the option.

5. Where the market value of the option is not available on a given date, institutions shall take the fair value of the option on that date; where neither the market value nor the fair value of an option are available on a given date, institutions shall take the most recent of the market value or the fair value. If neither the market value nor the fair value of an option is available at any date, institutions shall take the value at which the option is measured in accordance with the applicable accounting framework.

Article 4

Calculation of the indirect exposure value for credit derivative contracts

1. The indirect exposure value to a client arising from credit derivative contracts referred to in point (b) of Article 2 shall be equal to the sum of the current market value of the credit derivative contract and the amount owed to the counterparty of the credit derivative contract as a result of a potential default of the issuer of the underlying instrument reduced by the amount owed to the institution by that counterparty in that event.

2. Where the market value of the credit derivative is not available on a given date, institutions shall take the fair value of the credit derivative on that date; where neither the market value nor the fair value of the credit derivative are available on a given date, institutions shall take the most recent of the market value or the fair value. If neither the market value nor the fair value of a credit derivative contract is available at any date, institutions shall take the value at which the credit derivative contract is measured in accordance with the applicable accounting framework.

Article 5

Calculation of the indirect exposure value for other derivative contracts listed in Annex II of Regulation (EU) No 575/2013

1. In order to calculate the indirect exposure value to a client arising from other derivative contracts referred to in point (c) of Article 2, such as swaps, futures or forwards, institutions shall decompose their multiple transaction legs into individual transaction legs.

2. For those transaction legs entailing default risk of the issuer of the underlying instrument, institutions shall calculate their indirect exposure value as if they were positions in those legs.

3. Where an institution cannot apply the treatment provided for in paragraphs 1 and 2, it shall determine the indirect exposure value toward the issuer of the underlying instruments as the maximum loss that the institution would incur from a potential default of the issuer of the underlying instruments to which the derivative contract refers.

Article 6

Calculation of the indirect exposure values arising from multi-underlying derivative contracts

1. In order to determine the indirect exposure value to a client arising from derivative contracts written on debt, equity or credit default swap indices or CIU, or with multi-underlying reference names, institutions shall look through to all the individual underlying instruments and calculate the indirect exposure values as the variation in the price of the derivative contract in the case of default of each of the underlying reference names. Institutions shall assign each indirect exposure value either to an identified client, a separate client or the unknown client, as laid down in Articles 6(1) and 6(2) of Commission Delegated Regulation (EU) No 1187/2014.[20]

2. Where an institution is not able to look through to all the individual underlying instruments of the derivative contract as provided for in paragraph 1 or where it would be unduly burdensome for the institution to do so, it shall:

   (a) look through to those individual underlying instruments where the institution is able to do so or where it would not be unduly burdensome for the institution to do so and calculate the indirect exposure value in accordance with paragraph 1;

   (b) for those underlying instruments where the institution is not able to look through or where it would be unduly burdensome for an institution to do so, calculate the indirect exposure value by looking at the variation of the price of the derivative contract in the case of default of all those underlying reference names. The indirect exposure value shall then be assigned either to a separate client or to the unknown client, as laid down in Article 6(3) of Commission Delegated Regulation (EU) No 1187/2014.

3. By way of derogation from paragraphs 1 and 2, where the indirect exposure values are to be assigned to the unknown client, as laid down in Articles 6(2) and 6(3) of Commission Delegated

[20] Commission Delegated Regulation (EU) No 1187/2014 of 2 October 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council as regards regulatory technical standards for determining the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets (OJ L 324, 7.11.2014, p.1).

Regulation (EU) No 1187/2014, and where the indirect exposure values are negative, the institution shall set to zero those indirect exposure values before counting them towards the exposures to the unknown client.

Article 7

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

[Position]

4. Accompanying documents

4.1 Cost-benefit analysis / impact assessment

Regulation (EU) 2019/876, amending the Capital Requirements Regulation (EU) No 575/2013, amended Article 390 of the CRR by introducing a new paragraph 5 requiring institutions to add to the total exposure to a client the exposures arising from derivative contracts listed in Annex II and credit derivative contracts where the underlying debt or equity instrument was not issued by the institution's direct counterparty. Furthermore, paragraph 9 mandates the EBA to develop draft regulatory technical standards '*to specify how to determine the exposures arising from derivative contracts and credit derivative contracts, where the contract was not directly entered into with a client but the underlying debt or equity instrument was issued by that client for their inclusion into the exposures to the client*'.

Article 10 paragraph 1 of the EBA founding Regulation (Regulation (EU) No 1093/2010) states that the Authority shall conduct open public consultations on draft regulatory technical standards and shall analyse the potential related costs and benefits. This analysis should provide an overview of the findings regarding the problem to be dealt with, the solutions proposed and the potential impact of these options.

The present analysis provides the reader with an overview of the findings as regards problem identification, possible options to remove problems and their potential impacts. Given the nature and the scope of the draft RTS, and pursuant to the principle of 'proportionate analysis', this analysis is high-level and qualitative in nature. A qualitative analysis is provided for the potential impact of the options; whereas a quantitative analysis is provided only for the potential perimeter on which this legislation would apply.

The qualitative analysis presents the advantages and disadvantages of different options. Moreover, the quantitative analysis relies on information available through the Supervisory Reporting Templates (i.e. COREP) and, in particular, it leverages only data provided in the EBA sample. This way, it is not necessary to collect information from National Competent Authorities (NCA) or directly from banks[21].

A. Problem identification and baseline scenario

An excessive concentration of exposures to a single counterparty has long been recognised as a major threat for banks' stability. In 1991, the Basel Committee for Banking Supervision (BCBS) issued supervisory guidance on large exposures. However, until recent years no clear guidance was available on how banks should measure their exposures to a single counterparty and, in particular, which factors they should take into account when considering whether separate legal entities form a group of connected counterparties. This has resulted in a considerable variation in practices across banks. The experience gathered during the 2008 financial crisis showed that banks did not always measure exposures to single counterparties in a consistent manner across their books and operations.

Beside direct exposures, indirect exposures can also arise through financial instruments such as derivatives. Indeed, a derivative contract can give rise to an indirect credit exposure when the issuer of the asset underlying

[21] Ad-hoc data collection is a costly and time-consuming process. For this reason it is preferable, whenever possible, to exploit data that are readily available from statistical agencies and databases.

the derivative is not the counterparty of the derivative contract. Recognising these exposures is important to ensure an exhaustive evaluation of the concentration risk. However, given the technical aspects connected with these instruments, a considerable variation in practices across banks can be expected.

The baseline is represented by the definition of indirect exposures provided by Article 390(5) CRR: '*Institutions shall add to the total exposure to a client the exposures arising from derivative contracts listed in Annex II and credit derivative contracts, where the contract was not directly entered into with that client but the underlying debt or equity instrument was issued by that client'.*

This definition does not provide practical indications as to how to measure the exposures and leaves unclear some aspects regarding the scope of application. For example, it is not specified whether it applies only to issuers that are already a client of the institution or it is sufficient that an institution is indirectly exposed to the issuer of an underlying to consider that issuer as a client. Moreover, since it is possible that the default of the issuer generates a reduction of the exposure (for example, in the case of a long position on a put option) it is not specified whether it is possible to account for this reduction and net the exposures.

The lack of common criteria about these technical aspects could result in inconsistent interpretation across banks.

B. Policy objectives

The rationale of Article 390(5) of the CRR stems from the fact that whenever an indirect derivative exposure arises the institution might incur a loss when the underlying client of the embedded derivative defaults. The objective of the RTS is to provide a harmonised approach to quantify the exposures arising from these financial instruments where the contract was not directly entered into with a client, but the underlying debt or equity instrument was issued by that client. In this regard, the RTS defines the methods to quantify the exposure amount for different categories of derivatives contracts whether they are allocated to the trading or non-trading book.

Quantitative analysis

The following table has been obtained by exploiting the information contained in the COREP templates. In particular, Article 390 paragraph 7 of the CRR requires that all institutions assess their underlying exposures taking into account the economic substance of the structure of the transaction and the risks inherent in the structure of the transaction itself, in order to determine whether it constitutes an additional exposure. Column 180 of template C28 provides the amount of these exposures for borrowers identified as large.

The sample is constituted by 129 banks – excluding subsidiaries – from 27 countries. The data are at consolidated level.

At end-2019, the amount of exposures recognised under Article 390(7) of the CRR stood at EUR 85 bn, equivalent to 0.3% of the exposures to borrowers identified as large. At bank level, average values above 1% can be found in six countries (AT, DE, FI, FR, IT, PT). The highest value at bank level is 11.4%. At single-borrower level, it is possible to observe some cases where this type of exposure represents a relevant portion of the total exposure.

Exposures recognised under Article 390(7) of the CRR. Relative share of Large Exposures, Dec. 2019.

Country	Average	Max. at bank level	Max. at borrower level
AT	0.70%	11.40%	100.00%
BE	0.00%	0.00%	0.00%

BG	0.00%	0.00%	0.00%
CY	0.00%	0.00%	0.00%
DE	0.50%	3.20%	100.00%
DK	0.00%	0.00%	0.00%
EE	0.00%	0.00%	0.00%
ES	0.00%	0.40%	3.40%
FI	0.70%	1.00%	38.50%
FR	0.60%	2.10%	100.00%
GB	0.00%	0.80%	100.00%
GR	0.00%	0.00%	0.00%
HU	0.00%	0.00%	0.00%
IE	0.00%	0.00%	0.00%
IS	0.00%	0.00%	0.00%
IT	0.10%	1.40%	100.00%
LT	0.00%	0.00%	0.00%
LU	0.00%	0.00%	0.00%
LV	0.00%	0.00%	0.00%
MT	0.00%	0.00%	0.00%
NL	0.00%	0.00%	0.00%
NO	0.00%	0.00%	0.00%
PL	0.00%	0.00%	0.00%
PT	0.50%	2.60%	84.40%
RO	0.30%	0.30%	94.70%
SE	0.00%	0.00%	0.00%
SI	0.00%	0.00%	0.00%

Source: Corep

The main conclusion of this analysis is that these RTS would likely affect about 1% of the Large Exposures reported at the end of 2019 at country level. This result thus justifies the present simplified Impact Assessment.

C. Options considered, Cost-Benefit Analysis and Preferred Options

This section presents the main policy options discussed during the development of the CP, the costs and benefits of these options, as well as the preferred options retained in the CP.

Scope of the RTS

The common framework presented in these draft RTS ensures a harmonised identification and quantification of the exposures arising from financial instruments where the underlying debt or equity instrument was not issued by the direct counterparty of the contract. The draft RTS provide the methodologies to specify the exposures arising from derivative contracts as listed in Annex II of the CRR as well as credit derivative contracts, allocated to both trading and non-trading books. The draft RTS classify derivative contracts in three categories, following the Basel methodology, and set out the way to determine the exposures arising from each category.

The main disadvantage of any new regulatory product such as RTS is that it increases the complexity of the Regulation and, potentially, increases the costs of compliance. However, given the technicality of the item, it is deemed that without the indications provided by the RTS, the application of Article 390(5) of the CRR could give rise to different interpretations across banks and jurisdictions, thus putting in jeopardy the identification of large exposures arising from derivative contracts and credit derivative contracts in the EU's internal market.

Scope of application

The main options considered in regard to the scope of application are three:

1. Cases in which it is not required to quantify the indirect exposures;
2. Whether to restrict the need to quantify indirect exposures only for issuers that are already clients of the bank or extend it to any issuer;
3. Whether to extend the need to quantify the indirect exposure also when the underlying reference of a derivative contract is an index.

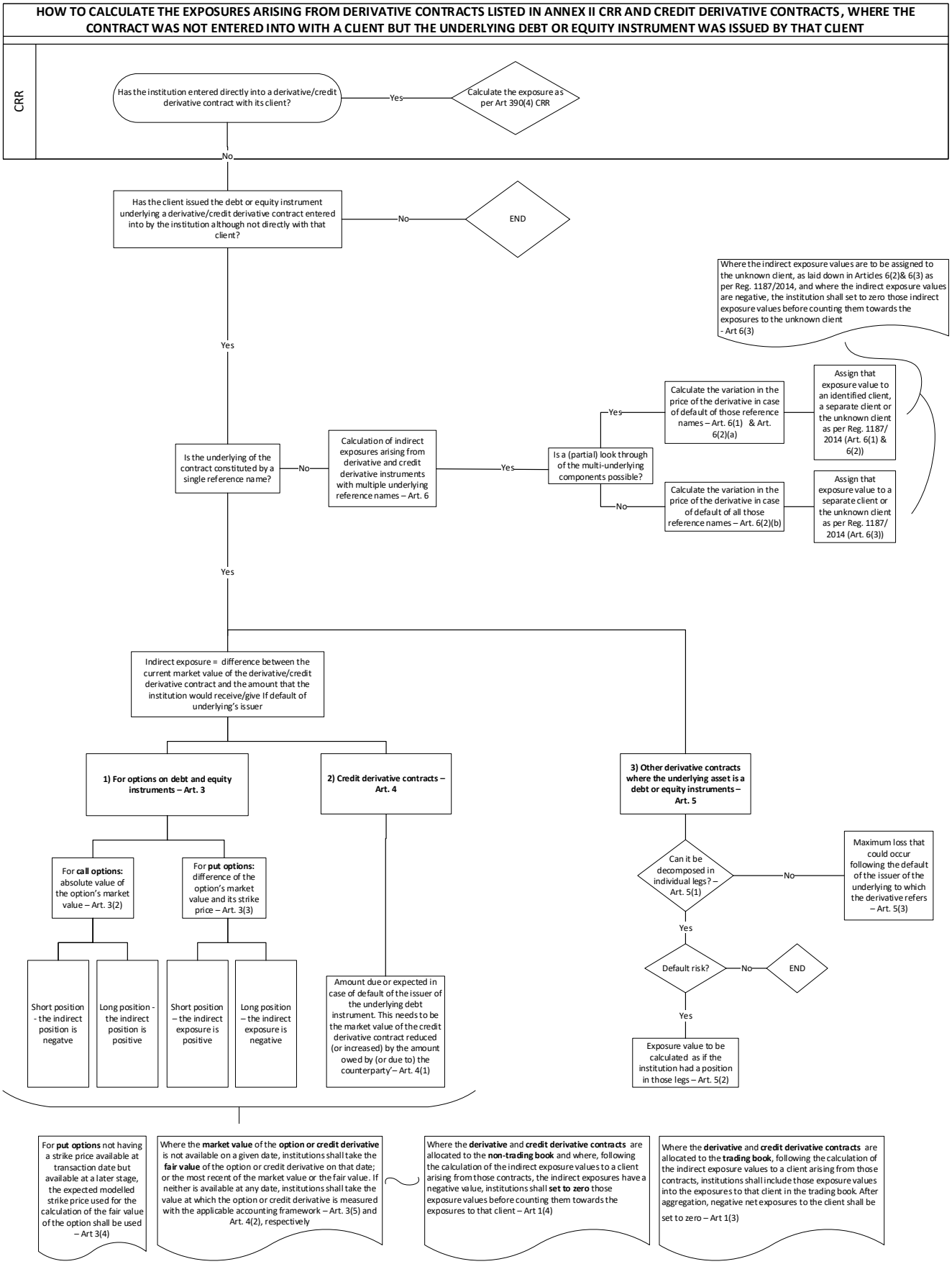
Concerning the first point, an option considered during the discussions was to exclude from the scope of these draft RTS those derivatives where the underlying contracts cannot be issued by the client or where a contract does not entail default risk. This would have had the potential to materially simplify the operational burden.

Furthermore, by extending the scope of application of Article 390(5) of the CRR to issuers that are not already clients of the bank and also to derivatives referring to indices, the draft RTS require the collection of information about clients not already recorded in the bank's systems and a look-through analysis in the case of indices (based on Commission Delegated Regulation (EU) No 1187/2014 of 2 October 2014).

One of the disadvantages of such extensions of the scope of application is the necessity for institutions to collect the information needed to register additional clients in their databases. However, to reduce the operational burden on institutions, a materiality threshold of 0.25% of the bank's Tier 1 is established. The RTS also clarify the approach when an institution is not able to distinguish the underlying exposures of a transaction. An additional option for reducing the burden is that, in cases where the derivatives issuer is committed to substituting an asset on which the issuer has defaulted with an equivalent one, the bank would not be required to perform the look-through analysis.

Considering both the importance of obtaining a comprehensive quantification of the exposures to large borrowers and the provisions envisaged by the RTS to reduce the burden whenever the materiality of the exposure is limited, it is deemed that the benefits offset the costs. An additional reason for catching non-existing clients is to prevent arbitrage, which could lead to an uneven playing field among institutions.

4.2 Annex I


HOW TO CALCULATE THE EXPOSURES ARISING FROM DERIVATIVE CONTRACTS LISTED IN ANNEX II CRR AND CREDIT DERIVATIVE CONTRACTS, WHERE THE CONTRACT WAS NOT ENTERED INTO WITH A CLIENT BUT THE UNDERLYING DEBT OR EQUITY INSTRUMENT WAS ISSUED BY THAT CLIENT
CRR
Has the institution entered directly into a derivative/credit derivative contract with its client?
Yes
Calculate the exposure as per Art 390(4) CRR
No
Has the client issued the debt or equity instrument underlying a derivative/credit derivative contract entered into by the institution although not directly with that client?
No
END
Yes
Where the indirect exposure values are to be assigned to the unknown client, as laid down in Articles 6(2)& 6(3) as per Reg. 1187/2014, and where the indirect exposure values are negative, the institution shall set to zero those indirect exposure values before counting them towards the exposures to the unknown client - Art 6(3)
Is the underlying of the contract constituted by a single reference name?
No
Calculation of indirect exposures arising from derivative and credit derivative instruments with multiple underlying reference names – Art. 6
Yes
Is a (partial) look through of the multi-underlying components possible?
Yes
Calculate the variation in the price of the derivative in case of default of those reference names – Art. 6(1) & Art. 6(2)(a)
Assign that exposure value to an identified client, a separate client or the unknown client as per Reg. 1187/ 2014 (Art. 6(1) & 6(2))
No
Calculate the variation in the price of the derivative in case of default of all those reference names – Art. 6(2)(b)
Assign that exposure value to a separate client or the unknown client as per Reg. 1187/ 2014 (Art. 6(3))
Yes
Indirect exposure = difference between the current market value of the derivative/credit derivative contract and the amount that the institution would receive/give If default of underlying's issuer
1) For options on debt and equity instruments – Art. 3
2) Credit derivative contracts – Art. 4
3) Other derivative contracts where the underlying asset is a debt or equity instruments – Art. 5
For call options: absolute value of the option's market value – Art. 3(2)
For put options: difference of the option's market value and its strike price – Art. 3(3)
Short position - the indirect position is negatve
Long position - the indirect position is positive
Short position – the indirect exposure is positive
Long position – the indirect exposure is negative
Amount due or expected in case of default of the issuer of the underlying debt instrument. This needs to be the market value of the credit derivative contract reduced (or increased) by the amount owed by (or due to) the counterparty' – Art. 4(1)
Can it be decomposed in individual legs? – Art. 5(1)
No
Maximum loss that could occur following the default of the issuer of the underlying to which the derivative refers – Art. 5(3)
Yes
Default risk?
No
END
Yes
Exposure value to be calculated as if the institution had a position in those legs – Art. 5(2)
For put options not having a strike price available at transaction date but available at a later stage, the expected modelled strike price used for the calculation of the fair value of the option shall be used – Art 3(4)
Where the market value of the option or credit derivative is not available on a given date, institutions shall take the fair value of the option or credit derivative on that date; or the most recent of the market value or the fair value. If neither is available at any date, institutions shall take the value at which the option or credit derivative is measured with the applicable accounting framework – Art. 3(5) and Art. 4(2), respectively
Where the derivative and credit derivative contracts are allocated to the non-trading book and where, following the calculation of the indirect exposure values to a client arising from those contracts, the indirect exposures have a negative value, institutions shall set to zero those exposure values before counting them towards the exposures to that client – Art 1(4)
Where the derivative and credit derivative contracts are allocated to the trading book, following the calculation of the indirect exposure values to a client arising from those contracts, institutions shall include those exposure values into the exposures to that client in the trading book. After aggregation, negative net exposures to the client shall be set to zero – Art 1(3)

4.3 Feedback on the public consultation

The EBA publicly consulted on the draft technical standards.

The consultation period lasted for 3 months and ended on 23 October 2020. Three responses were received, which were all published on the EBA website.

This paper presents a summary of the key points and other comments arising from the consultation and the analysis and discussion triggered by these comments and the actions taken to address them if deemed necessary.

In many cases, several industry bodies made similar comments, or the same body repeated its comments in its response to different questions. In such cases, the comments and the EBA's analysis are included in the section of this paper where the EBA considers them most appropriate.

Changes to the draft RTS have been incorporated as a result of the responses received during the public consultation.

Summary of key issues and the EBA's response

Overall, the respondents agreed in general with the principles underlying the draft RTS. In particular, the respondents supported the focus of the draft RTS which is to help institutions with the identification of and the calculation method for indirect exposures arising from derivative and credit derivative contracts.

There was strong support by the respondents for the three proposed categories of derivatives and the methodologies proposed for the calculation of the indirect exposure values of these derivatives.

Some respondents pointed out the interaction between the jump-to-default (JTD) framework under the FRTB and these draft RTS, and encouraged the EBA to consider those. Also, the need for sufficient time for implementation of these draft RTS was raised by stakeholders, in particular due to other operational CRR projects and the COVID-19-pandemic, they asked for the draft RTS not to enter into force before 1 January 2022.

Furthermore, some technical issues were raised in response to the questions in the consultation paper.

EBA response

EBA welcomes the support for these draft RTS and agrees that it is important to ensure consistency, where possible between this draft RTS and the JTD framework under the FRTB due to the overlap in the key aspects of the requirements. As such, the proposed approaches were designed to be compatible with the JTD framework now and in the future.

These draft RTS need to be submitted to the Commission for adoption. Following submission, the RTS will be subject to scrutiny by the European Parliament and the Council before being published in the Official Journal of the European Union and coming into force in the EU. The EBA believes this timeframe provides institutions sufficient time to implement the draft RTS.

A more detailed presentation of the comments received and of the EBA response is included in the table set out below.

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
General comments			
Interaction with JTD framework	Two respondents pointed out that the interaction with the JTD framework under the FRTB needs to be carefully considered. In particular, early adoption of the approaches proposed in this technical standard has limited benefits if the methodology will be amended by the JTD framework in 2023.	In the EBA's view, the proposed approaches in these draft RTS were designed to be compatible with the JTD framework now and in the future. However, the EBA will monitor this point and, if necessary, revisit these RTS at a later stage.	None.
Transition period	One respondent reported that due to the COVID-19 pandemic and the ongoing implementation of CRR projects, institutions are already strained. He suggests that the RTS should come into effect on 1 January 2022 at the earliest.	The draft RTS needs to be submitted to the Commission for adoption. Following submission, the RTS will be subject to scrutiny by the European Parliament and the Council before being published in the Official Journal of the European Union and coming into force in the EU. The EBA believes this timeframe provides institutions sufficient time to implement the RTS.	None.
Group of connected clients	One respondent proposed clarification that where the counterparty risk exposure and the issuer risk exposure stemming from the same derivative contract form a group of connected clients (GCC), only the higher of the two exposure values is to be counted against the GCC's large exposure limit. The respondent provides the following example: *Institution A invests in a credit-linked note with a volume of EUR 5 million issued by institution B; the underlying reference asset is a bond issued by institution C* Institution C is a subsidiary of institution B.	The question relates to a specific case relating to a direct exposure and indirect exposures to a group of connected clients and not solely to the client, therefore it goes beyond the scope of the draft RTS. However, in general, as per Delegated Regulation No 1187/2014, in the overall exposure to a particular obligor that results from the institution's exposures to a transaction with underlying assets, the exposure value should be first identified separately for each of these exposures. The total exposure value should then be determined by the aggregate of these exposures, but should not be larger than the exposure value of the exposure formed by the	None.

	Institution B and institution C form a GCC Institution A identifies two risks: a) Counterparty risk: institution B b) Issuer risk: institution C To simplify, it is assumed that the exposure value for counterparty risk and issuer risk amounts to EUR 5 million in each case. Since institution B and institution C form a GCC, the total amount to be set against the large exposure limit for the GCC would be EUR 10 million, although the actual default risk amounts to only EUR 5 million.	underlying asset itself (plus existing direct exposures to the underlying assets). If necessary, specific questions with regard to the overall exposure to a client or group of connected clients and aggregation of those exposures can be raised via the EBA Q&A tool.	
Responses to questions in Consultation Paper EBA/CP/2020/14			
Question 1. What are your views on the three proposed categories of derivatives? Are they comprehensive?	Two respondents stated that the proposed categories of derivatives are sufficiently clear and comprehensive. The other respondent welcomed the clarification that an indirect exposure arising from those derivative contracts for which the underlying asset does not entail a default risk of an indirect client shall not be considered by institutions.	The EBA welcomes the comments acknowledging the fact that the three proposed categories of derivatives are clear and comprehensive.	None.
Question 2. After considering the methodologies in Articles 2 to 6, could you please indicate if the described methodologies are sufficiently clear? Would you consider that the proposed methodologies might not comprehensively capture the exposures of	Regarding Article 6 (Calculation of the indirect exposure values arising from derivative contracts on indices or CIU or with multiple underlying reference names), one respondent noted some incompatibility between the method envisaged for derivative contracts written on indices or CIU (para. 1) and that envisaged for derivative contracts with multiple underlying reference names (para. 3). Specifically, the respondent suggested that in both methods, the calculation of the indirect exposure should be performed with reference to the specific	The EBA welcomes the comments acknowledging the fact that the methodologies described in Articles 2 to 6 are sufficiently clear and should be easy to implement. In the EBA's view, the calculation of the indirect exposure proposed in Article 6(1) and (3) of the RTS should be performed with reference to the specific underlying issuer. However, the EBA recognises that in the case of derivative contracts with multiple underlying reference names the allocation of indirect exposures could be to an identified client, a separate	Article 6(1) & CP version Article 6(3) were merged in Article 6(1).

certain categories of derivative contracts? Please provide concrete examples and reasoning as well as suggested amendments to the methodology, if any.	underlying issuer and not with reference to 'any' of them as suggested in Article 6(1). Two respondents deemed that the methodologies are clear and comprehensive. However, they also highlight that the approach proposed in Article 6 in the cases where no look-through is possible, is overly conservative. More generally, the two respondents noted that the implementation costs associated with the technical standard are significant, especially for institutions with limited derivative exposures (where the incremental impact from including indirect exposures will be negligible in the context of large exposures). Therefore, while recalling the proportionality principle, they propose the introduction of several thresholds for the applicability of the RTS. Finally, they also suggest updating the reporting templates for the purposes of the RTS.	client or the unknown client in a similar way as with an index or CIU or other multi-underlying derivatives, as such both Articles were merged. Moreover, for the sake of clarification, the word 'any' was replaced with 'each' in Article 6(1). The EBA agrees that the calculation of the indirect exposure should be performed with reference to the specific underlying issuer and not with reference to 'any' of them as was suggested in Article 6(1). As regards the overly conservative treatment envisaged in Article 6(2) of these RTS, see the EBA's answer to Question 11. Furthermore, the EBA believes that the proposed methodology and calculation is market standard and in line with the general market risk framework and includes fallback approaches. There is no need to provide for any thresholds in the RTS. Finally, future amendments on the reporting templates will depend on the policy impact of these draft RTS.	
Question 3. Do you consider that the treatment for option contracts specified in Article 3 is appropriate and sufficiently clear?	Two respondents noted that the methodology for options is sufficiently clear and conceptually sound. The other respondent did not answer.	The EBA welcomes the comments acknowledging the fact that the treatment for option contracts specified in Article 3 is appropriate and conceptually sound.	None.
Question 4. Having in mind that the treatment in Article 3 focuses on options allocated to the trading book, the EBA would like to understand whether	Two respondents stated that options may be held also in the banking book when used for hedging purposes or when embedded in other products. One also noted that the different allocation of the option does not give rise to problems for calculating the indirect exposure values.	The EBA notes that the approach proposed for options is also suitable for those allocated in the non-trading book and that it does not give rise to problems for calculating the indirect exposure values. In this regard, the EBA reiterates that no amendments related to question 4 are needed in Article 3.	None.

there are cases in which options are allocated also to the non-trading book. What are the reasons to have options allocated to the non-trading book? Would there be issues with the treatment proposed for those options?	The other respondent noted that its members generally do not have options allocated to the non-trading book.		
Question 5. If you have a different view with regard to the treatment for this type of derivative contracts, please provide an example where the calculation method would lead to an incorrect measurement of the indirect exposure or examples where you would not be in a position to perform the calculation under the method prescribed in this Article.	No answers.	None.	None.
Question 6. In your view, would there be an alternative method where in particular the market value of the option is not available? Please indicate if cases where the market value would not be available should be considered as more than rare cases, and please provide examples and reasoning.	Two respondents deemed that such cases (i.e. no market value available for option) will not be an issue. The concept of 'fair value' will be sufficient. No answer from the other respondent.	The EBA welcomes the comments acknowledging the fact that when the market value of an option is not available, the proposed approach based on the fair value and/or the value at which the option is measured in accordance with the applicable accounting framework is deemed appropriate and sufficiently clear.	None.

Question 7. Do you consider that the treatment for credit derivative contracts specified in Article 4 is appropriate and sufficiently clear?	Two respondents noted that the methodology is sufficiently clear and conceptually sound. One respondent shared the view that, from the perspective of the protection buyer, if the CDS is recognised as an eligible risk mitigation technique (CRMT) in conformity with Article 399 of the CRR, the indirect exposure value will accordingly be zero. However, the respondent points out that the wording of the explanatory text [22] is inaccurate because it should refer to the protection seller whereas it refers to protection buyer. The respondent also notes that if the institution is the protection seller, the methodology is not risk-adequate. In this case, the exposure value should be limited to the nominal value of the derivative, while the derivative's positive market value should be disregarded in order to avoid overstating the risk. The respondent highlights that otherwise the result obtained would be economically not reasonable: the more the credit derivative is – from the protection seller's perspective – in the money, the higher the market value of the derivative and therefore the exposure value would be; while the likelihood of payment from the protection seller would be increasingly low.	The EBA welcomes the comments acknowledging the fact that the treatment for credit derivative contracts specified in Article 4 is appropriate and conceptually sound. The EBA acknowledges that the explanatory text in the consultation paper should have referred to the protection seller. The explanatory text is, however, not part of the final draft-RTS. Furthermore, limiting the exposure of a CDS for which the institution is protection seller to the nominal value would not be sound. On the one hand, the EBA recognises that a positive market value for a CDS coincides with a lower implied probability of default for the referenced name (if compared to the implied PD at inception date), on the other hand, the large exposures framework is meant to capture the loss that the institution would suffer under a scenario of default. That loss for the abovementioned CDS would be the sum of the market value and the nominal value. Hence, the treatment laid down in the draft RTS is deemed appropriate.	None.
Question 8. The EBA would like to understand whether the	Two respondents stated that, in general, the calculation method of Article 4 (Calculation of the indirect exposure value for credit derivative	As mentioned in Article 1 (2) of these draft RTS *'By way of derogation from paragraph 1, where the underlying instruments are included in a debt, equity*	Replacement of Article 4(3) of the RTS with Article 1(3)

[22] *'On the contrary, when the credit derivative contract is assigned to the trading book or the non-trading book and is not considered as an eligible credit risk mitigation technique for large exposures purposes, as prescribed in Article 399, institutions have to reduce the indirect exposure to the reference name by the value of the credit protection and have to add the positive value of the indirect exposure to its exposure to the* ***protection buyer****'.*

calculation method of Article 4 is deemed appropriate for all types of credit derivative contracts (where institutions act as sellers or buyers of credit protection) or whether there are contracts for which it would not be correct to apply this calculation method. Please provide a clear example where the calculation method would lead to an incorrect measurement of the indirect exposure arising from the specific credit derivative contract.	contracts) is appropriate. However, they suggest that it would be helpful if the EBA could specify whether CDS indices are in scope of this article, and if they are, detail their treatment. They would assume that there is no need to consider an indirect exposure where institutions act as buyer of credit protection because there would be no loss in the case that the CDS-underlying defaults. The other respondent deemed inappropriate the consideration of the nominal value of the credit derivative (provided no CRMT is applied) when calculating the indirect exposure towards the protection buyer. It suggests that the nominal value of the credit derivative (amount to be paid in the case of a credit event) should be taken into account as an indirect exposure by the protection seller against the underlying.	*or **credit default swap index** or a CIU, or where the derivative contracts have multiple underlying reference names, institutions shall determine the indirect exposure values to a client arising from the derivative contracts referred to in paragraph 1 and the contribution of that exposure to the exposure to a client in accordance with the methodology set out in Article 6.'* That said, in the EBA's view, the regulatory treatment proposed in Article 4 of these RTS would apply only to those credit default swaps with a single underlying. Moreover, as also mentioned in the Background section, in paragraph 16. Neither netting between positions held in the non-trading book and in the trading book nor netting between non-trading book positions is allowed.	& 1(4) to clarify the exposure value for positions held in the trading book (after aggregation) and for positions held in the non-trading book in the case of a negative exposure value.
Question 9. Do you consider that the treatment for other derivative contracts listed in Annex II specified in Article 5 is appropriate and sufficiently clear?	Two respondents reported that the methodology is clear but a more detailed description of the treatment of the most relevant types of derivatives would be helpful. The other respondent proposed the following alternative wording: '*For those transaction legs entailing default risk of the issuer of the underlying asset, institutions shall calculate their indirect exposure value as if they were positions in those legs'.*	The EBA has taken note of the request from the industry for an alternative wording in Article 5(2), which has thus been amended. As regards the proposal for a more detailed description of the treatment of the most relevant types of derivatives, the EBA reiterates that a more detailed description of the treatment of the most relevant types of derivatives (i.e. by giving examples) would not be appropriate for a level-1 legal text. If needed, the EBA stands ready to provide, through the Q&A process, further technical clarifications for the treatment of those types of derivatives that fall under Article 5.	Amendment to the wording in Article 5(2) of the RTS, in order to specify that only those transaction legs entailing default risk *of the issuer of the underlying instrument* should be taken into account.
Question 10.	Two respondents pointed out that the fallback approach appears to be equivalent to the	In the EBA's view, Article 5(3) is required because the regulatory treatment proposed in this paragraph	None.

The EBA would like to receive feedback with regard to situations, as explained above or otherwise, where a fallback approach might be necessary. Equally, the EBA would like to understand whether, for such situations, the calculation method of Article 5 is deemed appropriate or whether there could be a more suitable alternative. Please give your reasons and explain what the alternative calculation could be.	decomposition approach in Article 5, at least for the relevant instruments in their portfolio. The other respondent noted that according to Article 3 of the CRR, it is always possible for institutions to recognise more conservative amounts against the large exposure limits than would otherwise be necessary under the respective regulation. Therefore, it deems that the explicit inclusion of a fallback provision is not needed.	would apply also to those derivative and credit derivative contracts for which decomposition is not applicable. As regards the proposal for excluding the fallback approach, the EBA maintains that the provisions in Article 5(3) of these draft RTS do not conflict with Article 3 of the CRR. Moreover, in the EBA's view, paragraph 3 of Article 5 ensures the completeness of these RTS.	
Question 11. Do you consider that the treatment for derivative contracts with multiple underlying reference names constituting a structure, as detailed in paragraphs 1 and 2 of Article 6, is sufficiently clearly described? In addition, do you consider that it represents an adequate approach to the calculation of indirect exposure value arising from each reference name?	Two respondents highlighted that although the treatment is conceptually sound, the practical implementation of the look-through (LT) approach in the case of indices/CIU is challenging and brings limited benefits (e.g. an OTM option on a diversified index will result in negligible incremental indirect exposures but will pose significant data and processing requirements). The LT approach is likely to result in a multitude of individually insignificant exposures, potentially to counterparties with whom the organisation does not have any direct exposures. They point out that the LT approach is more suited to instruments with a limited number of underlyings as detailed in Article 6(3). Furthermore, they say that when the LT is not possible or impractical, the fallback approach is overly conservative. Specifically, the requirement that the exposure should be quantified assuming all underlying names default simultaneously is not realistic, especially for diversified indices or CIU.	The EBA believes that the proposed approach in Article 6 of these RTS is deemed appropriate and easy to implement. However, in order to allow more flexibility to institutions, in Article 6(2)(a) of this Regulation, the EBA has included the possibility of also performing partial look-throughs only on those underlying instruments where it is not unduly burdensome to do so. That said, as specified in Article 6(2)(b) of these RTS, in cases where the look-through approach is not possible or is unduly burdensome for the institution, as in the case of MSCI and/or diversified indices, an institution should still calculate the indirect exposure value by looking at the variation of the price of the derivative in the event of default for all the underlying names in the index or CIU. Furthermore, if underlying instruments are assigned to the unknown client, it would not be prudential to use negative exposure values to offset positive	Article 6(2) was amended by introducing subparagraphs: (a) in order to allow institutions to also perform a partial look-through on certain underlying instruments. A new Article 6(3) was included to ensure that in cases where underlying instruments are assigned to the unknown client, negative exposure

	Therefore, they suggest an alternative approach, where, for example, only a certain percentage of the total value of the underlying is assumed to default, or where, for diversified indices/CIU, the 0.25 threshold for assigning to the unknown client is significantly increased. The other respondent pointed out that the Delegated Regulation (EU) No 1187/2014 applies to all transactions where there is an exposure to underlying assets. Therefore, the LT is already used for instruments such credit derivatives which refer to multiple reference assets (particularly CDS and CLN) or derivatives on indices. The respondent asks for clarification that in these cases the RTS do not apply. The same respondent also suggested that the wording in Article 6(1) and (2) should be amended in order to explicitly include structures with multiple underlying reference names: *'the scope of application of EU Regulation No 1187/2014 for assigning indirect exposure to a client extended more generally to structures underlying (credit) derivatives*.' Finally, the respondent – referring to Article 6(4) of the Delegated Regulation (EU) No 1187/2014 – proposes to use a monthly simulation on the level of the individual underlying reference. At the same time, they also point out that even for a monthly simulation, it is difficult to state with certainty whether it is technically possible given that some indices have several hundreds of underling reference name (e.g. MSCI World).	exposure values as such those that have been set to zero. As regards the overly conservative treatment envisaged in Article 6(2)(b) of these RTS (when no look-through is possible), the EBA believes that the proposed approach is appropriate because the large exposures framework will serve as a backstop. In particular, it would not be prudentially sound to consider the default of only a percentage of the underlying names of an index or CIU. Moreover, it should be noted that the look-through envisaged in Delegated Regulation (EU) No 1187/2014 can be used to assign the indirect exposure value, while the approach proposed in Article 6 of these RTS applies for the calculation of the indirect exposure value. As regard the suggestion to amend the wording in Article 6(1) and (2) of these RTS in order to explicitly include structures with multiple underlying reference names, it should be noted that indices and CIU represent a structure. Moreover, the language used is in line with Delegated Regulation (EU) No 1187/2014 that would apply for the allocation of those indirect exposures that fall under Article 6(1) and 6(2) of this Regulation.	values cannot offset any positive values. Recital 6 was amended accordingly.
Question 12. In the case of derivative contracts with multiple	Two respondents deemed that the proposed approach is best suited to underlying reference names which do not constitute a structure.	The EBA welcomes the comments acknowledging the fact that the proposal is clear and is suited to	None.

underlying reference names that do not constitute a structure, is the calculation as established in paragraph 3 sufficiently clear? Does it represent an appropriate methodology?	The other respondent noted that Article 6 (4) applies to embedded derivatives only if the embedded derivative is based on multiple underlying reference names that do not constitute a structure.	underlying reference names which do not constitute a structure. In the EBA's view, the proposed approach in Article 6(1) has been designed to be simple to implement and applicable also for embedded derivatives (see example in paragraph 39 of the Background section). Moreover, the EBA reiterates that no definition of embedded derivative is provided in the CRR.	
Question 13. The EBA would like to understand whether the draft cost-benefit analysis / impact assessment is deemed appropriate and sufficiently clear. Please fill the table in page 30 which allows a measure to be made of the indirect exposure arising from the derivative and credit derivative contracts that will be affected by this RTS.	No answers provided.	None.	None.