French Banking Federation comments on EBA consultation on Non-Delta Risk of Options (EBA/CP/2013/16)

- As per articles 329(3) 352(6) and 358(4) of regulation 575/2013, EBA shall develop and submit draft regulatory technical standards to the Commission, in order to define the capital requirement for other risks (apart from delta risk) of options and warrants.
- Please find hereby our responses to your questions. In summary, we are deeply concerned that the draft RTS departs from current Basel rules in some critical aspects. In particular, the overly conservative treatment proposed for non-continuous options and the contemplated option to require the use of a single method within any single legal entity are likely to undermine the level playing field with Basel compliant banks. Last but not least, we would like to remind that regulators and banks have engaged a deep review of trading book prudential rules that will among other address the shortcomings of the current standardized method. Requiring banks to implement interim rules that are not compliant with the Basel standards seems counterproductive.

Q1. Do you agree with the choice to refer to the Basel Framework? Are there other approaches that can effectively be used for the puposes of this RTS? Which ones? Explain your reasoning?

In France, the Basel Framework has been the reference since 1996 and we favour maintaining such reference. Furthermore given that Basel has launched a “Fundamental review of the trading book” that might be implemented in a rather short term (within a few years), it does not sound reasonable to introduce now new concepts that would only produce temporary volatility in the market risk requirements.

Q2. Do you prefer the first option (exclusion of a combination of methods within a single institution) or the second option (exact definition of the scope of the scenario approach)? If you prefer the second option, what additional conditions and controls should be established?

We find that the proposal should be more precise. Under the Basel Framework, the choice of the model is to be specified according to the strategy: an institution that pursues different strategies (e.g. one strategy for FX activities and another one for equity activities, or one strategy for liquid underlyings and another strategy for illiquid underlyings…) is entitled to use one approach with respect to each strategy. If this case falls under option 2 then this is the option we recommend as this is the one consistent with the current Basel rules.

Q3. Do you believe that it is useful to implement the simplified approach established in the Basel text?

As French banks are generally not using the simplified approach, we do not fully embrace the impact of the removal of this option and do not feel able to comment.

Q4. Do you agree with this prudential treatment, not contemplated in the Basel Framework, for non-standard option?

First, we find that the question is a bit ambiguous: it refers to “non-standard options” when article 4(3) mentions “non-continuous options”.

We find the issue is not very clear:

- It seems to us that this discontinuity is already handled by risk management principles:
  - Either the market is very liquid (FX options, precious metal options) and the absence of continuity is tradable and easily hedgable: digital risk limits oblige the trading teams to sell back this specific risk to the market
  - Or the discontinuity is smoothed through “bending” or “call-spreading” technics using vanilla options (IR options, equity options...) in order to price and hedge the product in a conservative way
- The proposal, as it is, creates a disconnection in the capital treatment of non-continuous options on one side and the capital treatment of their vanilla hedges on the other side making the hedges inefficient in terms of capital relief and hence disincentivizing banks from hedging such strategies.
- The new formulas are very conservative and introduce an asymmetric treatment between buyers and option sellers. This choice is certainly based on the infinite capacity of losses for sellers without taking into account the hedges. In practice this kind of strategies use option spreading technics to hedge volatility or digital options, spreading strategies which incorporate selling options. Also, since the market is very liquid, penalizing short positions may create squeeze. This last remark is important for avoidance of pro-cyclical stance.
- In practice, as this discontinuity criterion is either sold back to the market to remain within limits or managed through bending and call-spreading technics, the positions are considered as for standard option in risk management system. In addition, supposing such instrument would be identified specifically, there should also be a distinction between Long and Short positions (selling Autocalls differ in this sense from financing with Put Down and In) and between American and European barriers.

Lastly, as mentioned earlier we do not find it is productive to change the market risk rules within the transition period before the implementation of a whole new standard framework. This will be time consuming and all new developments will be short lived.

For all these reasons we urge the EBA to stick with Basel current Framework until the new rules are set up.

Q5. Do you agree that the RTS should require that the conditions of Articles 318(1), 341(1) and 347(3) of the CRR are met for the calculation of gamma and vega?

We were under the impression that this was already the case in the regulation. If EBA finds that this point is not clear for all jurisdictions or that it is not consistently implemented across jurisdictions, we fully support EBA proposal to clarify this point.

Q6. Do you think that the unified treatment of interest rate risk is sound? Could there be difficulties in implementing it in practice?

We support this proposal for a unified treatment of bond options and interest rate options, given it is what is done for a risk management perspective. We do not foresee any implementation issue.

Q7. How many hybrid options does your portfolio account for in terms of number of options and notional amounts (i.e. options which can be assigned to more than one underlying type as defined above)? Should the BTS specify the treatment of these hybrid options?

It is difficult to answer given that the definition is quite subjective. However, this kind of products is only a marginal portion of our standard perimeters.

Once again, we believe it is worthwhile waiting for the implementation of the new Basel rules with the “Fundamental review of the trading book”.

Q8. Do you agree with the rationale behind the exclusion of this provision contemplated in the Basel accord in the RTS? If not, please provide arguments in favour of its implementation?

We only see impacts on the higher/lower cost and workload depending of the number of calculation required.

We also reiterate our reluctance to diverge from the Basel Framework at this point in time.