

The European Banking Authority
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Subject: Public consultation: on draft RTS on extraordinary circumstances for continuing the use of an internal model¹

The International Swaps and Derivatives Association ('ISDA') and the Association for Financial Markets in Europe ('AFME'), the 'Joint Associations' and their members ('the Industry') welcome the opportunity to comment on the EBA's draft RTS on extraordinary circumstances for continuing the use of an internal model or discarding certain back-testing overshootings under Article 325az(9) CRR.

It is important that the rules capture the cases where permissions should be granted in the interest of overall financial stability, without undermining the substance of the regulatory framework. Therefore, the industry believes that other extraordinary circumstances not mentioned in this RTS should be considered, such as local or regional economic or financial crises or deeper than expected cyclical downturns.

In terms of factors and indicators, there are volatility indicators such as the VIX and the VSTOXX indices that can be helpful for identifying situations of significant cross-border financial market stress or of a major regime shift. In addition, there are also symptoms of extraordinary circumstances that are more properly captured within other measures such as liquidity and correlation indicators.

We believe that the wording in this proposed RTS is very prescriptive and may not provide the right level of flexibility to counter future crisis situations and preserve market capacity to intermediate. Therefore, the industry recommends that the text should be modified to consider other extraordinary circumstances as well as additional indicators to identify periods of significant stress which would allow for continued use of the internal model for market risk capital requirements.

Should you have any queries regarding the response, please do not hesitate to contact us.

Yours sincerely,

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¹ <https://www.eba.europa.eu/calendar/consultation-draft-rts-extraordinary-circumstances-continuing-use-internal-model>

Definition of extraordinary circumstances

1. Recital 1 of the RTS states that *“In line with the principle stipulated by the BCBS, extraordinary circumstances should therefore be recognised **only**, where there is a situation of significant cross-border financial market stress, or a major regime shift, that affects institutions all across the EU or EEA”*. However, the BCBS standard mentions the significant cross-border financial market stress or major regime shift as possible examples of extraordinary circumstances, rather than the only circumstances that justify the derogation from compliance (MAR 32.45²: *“for instance, during periods of significant cross-border financial market stress affecting several banks or when financial markets are subjected to a major regime shift”*). Thus, we believe that the approach of the EBA RTS is stricter than that established by the BCBS Standards for the reasons described below.

2. Although we understand that a frequent grant of these permissions would undermine the substance of the regulatory framework, we believe there are other extraordinary circumstances not mentioned in the RTS that could justify the application of such permissions, such as local or regional economic or financial crises or deeper than expected cyclical downturns. Thus, we believe that the RTS wording should be modified to address potential disrupting and systemic causes beyond the two extreme cases foreseen in the draft RTS. This recital is very prescriptive, and we recommend that it should be revised to allow for other circumstances that temporarily can affect the PLAT and backtesting (BT) requirements to be addressed as and if required, while bearing in mind the overall principle that the circumstances need to be exceptional.

These systemic or extreme events or situations must be assessed on an individual basis by the supervisor, not only at the group-wide level but at entity level, to determine if the features and spirit of those events align with the BCBS Standards.

3. There are specific cases where banks due to their different subsidiary-branch structures may have different booking and risk management models for position netting or offsetting. In these cases, the applicability of the extraordinary circumstances framework will be limited, as it applies only to situations impacting the EU or EEA. This can have negative impact at trading desk performance for banks with material exposure to other geographies and markets, as different conditions and crises may apply. For EU-based banks that have trading desks located and trading in out-of-EU/EEA geographies, the use of IMA requires application to the competent authorities on a consolidated basis, despite operating out-of-EU jurisdictions. This limitation in the proposed scope of the exceptional circumstance provision impacting EU or EEA institutions would exclude situations impacting subsidiaries in 3rd countries.

As per question 2 of the consultation, VIX index, which is a volatility indicator for US markets, is allowed to be used to identify situations of significant crossborder financial market stress or of a major regime shift. Similarly, we believe that more flexibility is required in the wording of the RTS that when recital 1 mentions *“that affects institutions all across the EU or EEA”*, it covers those institutions whose trading desks also participate in the market (or product) where

² BCBS: Internal Model Approach:
https://www.bis.org/basel_framework/chapter/MAR/32.htm?inforce=20230101&published=20200327

the extraordinary circumstances are taking place, whether these are based on the EU/EEA or not, and that it is not interpreted as such circumstances affecting the EU in general.

4. Therefore, we propose that recital 1 (and pertinent articles of the RTS related to these comments) should be amended as follows:
 - a) the wording of “financial market stress or regime shift” should be replaced by a generic reference to a systemic or extreme financial, political, or economic event that caused such turmoil.
 - b) the wording at the end of the first paragraph “*that affects institutions all across the EU or EEA*” should be modified to align with the wording in the BCBS Standards (MAR 32.45): “*that affects accurate trading desk level-models across different banks*”.

We propose the final redaction to be: *“In line with the principle stipulated by the BCBS, extraordinary circumstances should therefore be recognised ~~only, such~~ where there is a situation of significant ~~cross-border~~ financial market stress, or a major regime shift, that **would affect institutions all across the model’s ability to pass PLAT and BT at trading desk level, across different banks** ~~the EU or EEA~~ irrespective of trading desks’ location. In these cases, the supervisory authorities should adopt a case by case assessment”*

Q1. Besides volatility indices like, for example, the VIX and VSTOXX, are there any other factors or indicators, in your view, that could be used to identify situations of significant crossborder financial market stress or of a major regime shift?

We believe that volatility indices such as the VIX in the US and the VSTOXX in Europe are natural indicators than can be used to identify situations of significant cross-border financial market stress or of a major regime shift. They could be naturally supported by other market implied volatility indices in Asia or linked to non-equity asset classes (e.g. market implied volatility indices for rates) or realised volatility indicators (although those indicators will identify these stress situations with some delay, by construct of the indicators that are computed as averages based on historical measure); measures are important indicators.

However, often there are symptoms of extraordinary circumstances that are more properly captured in metrics other than volatility measures. Below we outline indicators that should also be considered.

1. **Correlation indicators are very important.** Indeed, stress periods are characterised by markets dislocations, which are characterized by increased correlations and heightened systemic risk. In principle, higher implied correlations can be assessed for instance from the increase of index implied volatilities over individual constituents average implied volatilities. Alternatively, implied (credit) correlations could be assessed from the relative price of cash securitisation tranches, with equity or mezzanine tranche prices decreasing relative to the price of senior tranches;
2. **Liquidity indicators** (e.g. jump of risk free rates (RFRs)/overnight indexed swap (OIS) indicators) to identify a major regime shift associated with a level of stress similar to a situation of significant cross border financial market stress (e.g. a liquidity crisis);

3. **Unusual deviations in the markets:**

- i. Unusual spread deviations between safer and riskier assets. For example, a sharp widening of spreads between developed and emerging markets caused by a sudden flight to quality triggered by a country-specific or regional debt crisis.
 - ii. Unusual deviations between cash and derivatives markets. For example, credit spreads on bonds and CDS for same or similar reference entities may experience an unusual divergence (a symptom would be for example a sudden large deviation between the iBoxx EUR High Yield indices and the ITRAXX crossover index spreads). Another example would be large differences between spot and futures/forward prices.
4. **Restrictions on trading or delivery of financial instruments or commodities.** For example, restrictions on convertibility of a certain currency. In other example, the restrictions faced by the Russian ruble during the Russia-Ukraine war. Another example occurred during the COVID crisis on the ability to move gold across markets that triggered unusual differences of spot/futures prices across markets.
5. In addition, an unusual number of backtesting overshootings in a short period of time (eg, more than 2 overshootings in a monthly period) being notified by several banks as well as the volume of contracts referencing those indicators and / or their sudden moves could also naturally complete the indicators themselves;

Every crisis is unique and cannot be defined ex ante. Thus, we believe that the list of indicators should not be fixed nor exhaustive as they will naturally evolve through time.

Q2. Do you agree with the approach presented in the RTS? If not, please clarify which alternative approach could be used or which additional aspects should be taken into consideration.

We appreciate that Option 1b has been chosen as the preferred option and the Draft RTS will set more general criteria that should be taken into account to recognize the significant financial market stress or major regime shift. Nevertheless, the EBA RTS mentions precise indicators and factors that reflect the nature of the financial stress or regime shift whereas none of them are listed in the Basel text (MAR 32.45).

The industry recommends:

1. At the very least, to remove (b) of paragraph 2 of Article 1 as there should not be reference to absolute volatility levels observed during the global financial crisis or the COVID-2019 pandemic. Also, we note that a sudden jump of volatility after a long period of low volatility may reference a period of financial stress or regime shift (the level of which being in relative terms high compared to the low level volatility but not necessary as high in absolute terms compared to the reference of the global financial crisis or the COVID-2019 pandemic);

2. Ideally, we recommend removing the whole paragraph 2 of Article 1 to align with the Basel principle.

Besides, we understand that extraordinary circumstances are meant to address situations of systemic stress, i.e. expected to have an impact on several types of portfolios and several types of banks (whether using an internal model or not), and for those banks using internal models, this should not be dependent on the model used. This overarching principle should be more clearly addressed in the final RTS. Therefore, it should be clarified that what matters is the number of banks affected if they were using an internal model on typical portfolios rather than the number of affected banks. This clarification is important to be made, given the limited number of banks expected to have a validated internal model.

Q3. What kind of regime shifts would you expect to render the outcome of the backtesting/PLAT inappropriate?

1. A value at risk (VaR) measurement is likely to capture an extreme market shift with a time lag, as VaR is calibrated using 1y of the most recent historical data and would need some days to adjust to the new market conditions (i.e., there would need to be 2-3 extreme market observations for the shift to be incorporated in the 1% confidence interval metric). This time lag may lead to BT overshootings as, in contrast to VaR, the hypothetical and actual P&Ls capture an extreme market shift immediately.
2. PLAT failures could occur in periods of low volatility, mainly due to the Spearman correlation (as correlation assessment between the RTP&L and the HP&L is generally blurred in a situation of continuous low level of volatility).

Q4. How do you expect the PLAT results to be affected or to deteriorate during a period of financial stress or a regime shift, and what are the reasons for your expectation?

1. On PLAT, although this is more difficult to assess, during a financial stress period or a regime shift, the impact from some risks which are not in the model and are usually small can become much bigger and hence affect the PLAT. Therefore, more desks failing the PLAT can be expected during such periods;
2. As a side note, the US NPR³ provides a possibility to exempt events due to technical issues unrelated to the internal model (in the context of BT requirements at desk level). This flexibility is crucial in the European Regulation too, as resources tend to focus on other priorities (rather than remediating technical production issues) in period of financial stress, as it was the case during the COVID-19 pandemic. Hence, during such stressed periods, technical issues leading to BT overshootings shall not be treated as related to some flaws in the model but rather as a consequence of the extraordinary circumstances and hence discarded. Similarly, failing the PLAT as a result of technical issues during extraordinary circumstances should be disregarded as a consequence of the situation rather than a model deficiency.

³ US NPR- § __.204 Measure for market risk (page: 737)