Comments

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

EBA/CP/2020/14

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General

In carrying out the mandate in Art. 390 (9) CRR II, the European Banking Authority (EBA) released on 23 July 2020 the "Draft Regulatory Technical Standards on the determination of indirect exposures to underlying clients of derivatives and credit default derivatives under Article 390(9) CRR2 (EBA/CP/2020/14)" for consultation. We welcome the opportunity to submit our comments on these draft regulatory technical standards (RTS).

Reasonable transition period needed – postponement by EBA not at the expense of the institutions

According to CRR II, a final draft of these RTS should have been submitted to the EU Commission by 28 March 2020. In the meantime, with EBA's road map, a postponement of working through the mandates was announced on 21 November 2019 and the presentation of a final draft for these RTS was moved back to December 2020.

The EBA mandate stems from the newly inserted Art. 390 (5) in CRR II. This in turn comes into effect on 28 June 2021. This means that for an implementation of the methodology to calculate risk exposure values on the basis of a final draft RTS the institutions and data processing centres will in a best-case scenario have a bare six months. This period will be further shortened if the required publication as an EU regulation is taken into account. The postponement of working through the mandates by the EBA cannot be to the detriment of the institutions and data processing centres. Due to the continuing COVID-19 pandemic and the ongoing implementation of CRR projects, the institutions' and data processing centres' resources are already considerably strained.

We therefore urge that these RTS come into effect on 1 January 2022 at the earliest.

Clarification of the relationship to Art. 390 (7) CRR in conjunction with Delegated Regulation (EU) No. 1187/2014 (see also Q11)

The basic interrelation between the original look-through requirements in Art. 390 (7) CRR in conjunction with Delegated Regulation (EU) No. 1187/2014 and the RTS under consultation needs to be clarified. According to Art. 390 (7) CRR, "other transactions where there is an exposure to underlying assets" fall under the look-through requirements for the large exposures regime. In line with the years-long supervisory and institutions' practice in Germany, included hereunder, are credit derivatives that refer to multiple underlying assets, particularly credit default swaps (CDS) and credit linked notes (CLN) or derivatives on indices. The risk from underlying assets is thus already taken appropriately into account for limiting large exposures. It should be clarified that in these cases the RTS do not apply.

Avoiding an overstatement of exposure if counterparty and issuer risk are vis à vis members of the same group of connected clients

The aim of the concept "group of connected clients" (GCC) pursuant to Art. 4 (1) no. 39 CRR is to capture a single risk. For purposes of the large exposures regime, the GCC is therefore regarded as one single borrower. Conceivable are constellations in which from one and the same derivative or credit derivative contract both a counterparty credit risk exposure vis à vis one member and also an issuer credit risk ex-

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posure vis à vis another member of the same GCC would have to be taken into account. Without special rules, the calculated exposure values would have to be added and set against the large exposure limit of the GCC, although the exposure can be outstanding against the GCC only once. This would lead to an overstatement of the exposure.

An Example to illustrate this:

Institution A invests in a CLN with a volume of EUR 5m EUR issued by institution B; the underlying reference asset is a bond issued by institution C
Institution C is a subsidiary of institution B.
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 matters, it is assumed that the exposure values for counterparty risk and issuer risk amount to EUR 5 m 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 10m, although the actual default risk amounts to only EUR 5m.

To reflect this properly, therefore, only EUR 5m should count against the GCC's large exposure limit (cf. EBA Q&A 2015_2116. Double counting for large exposures purposes would mean that the value of an exposure is assigned twice to the same client). It should be clarified that in cases in which there are counterparty risk exposures and issuer risk exposures from the same derivative or credit derivative contract against members of the same GCC only the higher of both exposure values is to be counted against the GCC's large exposure limit and accordingly only the higher exposure value is to be reported.

<u>Consultation questions</u>

Article 1
General rules for the calculation of 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 those were not directly entered into with that client
Question 1: What are your views on the three proposed categories of derivatives? Are they comprehensive?

It is basically understandable that with derivatives and credit derivatives in addition to counterparty risk also an issuer risk from the underlying/reference asset has to be taken into account. Here, we very much welcome the clarification that an "indirect exposure arising from those derivative contracts and credit derivative contracts for which the underlying asset does not entail a default risk of an indirect client shall not be considered by institutions".

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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 certain categories of derivative contracts? Please provide concrete examples and reasoning as well as suggested amendments to the methodology, if any.

The standardised calculation methods described in Art. 6 (1) and (3) of the draft RTS to determine the exposure value with multiple underlying assets are not compatible. While in Art. 6 (3) of the draft RTS the default of the respective ("that") issuer of the underlying asset is the determining factor, in Art. 6 (1) the default of ("any") issuer of underlying assets is relevant. In our opinion, the same calculation method should be applied in both cases and the determining factor should be on the default of the respective ("that") issuer. In this regard, the regulation in Art. 6 (1) should be aligned with the wording of Art. 6 (3).

Article 2
Allocation of the indirect exposures to categories of derivative contracts

Article 3
Calculation of the indirect exposure value for options on debt and equity instruments

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 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?

Options are – as far as is known, for reasons of hedging asset positions and in case of network-structured groups as part of brokering client business to the central institutions[1] – held in the non-trading book too. What is more, options can be part of a fund that is in turn held in the non-trading book. This does not give rise to problems for calculating the indirect exposure values.

Article 4
Calculation of the indirect exposure value for credit derivative contracts

Question 7: Do you consider that the treatment for credit derivative contracts specified in Article 4 is appropriate and sufficiently clear?

It is understandable that using credit derivatives to hedge and, if the protection buyer has already taken this into account as a recognised credit risk mitigation technique (CRMT) in conformity with Art 399 CRR, the indirect exposure value according to Art. 4 (3) of the draft RTS will in these cases be set at zero. We would like to point out here that for this statement the wording in the explanatory text does not fit "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 toward the reference name by the value of the credit protection and have to add the positive value of the indirect exposure to its exposure toward the protection buyer". As we understand it, the last clause describes precisely the procedure in the event that a credit derivative is applied by the protection buyer as a CRMT (substitution for protection

[1] In these cases, for reporting purposes, the house bank represents the chain: client – house bank – central institution

seller). We assume that instead of “protection buyer”, it should then read “protection seller” and request clarification accordingly (see answer to Q 8).

Furthermore, if the institution is the protection seller, the methodology is not risk-adequate.

Indirect exposure value in the non-trading and trading book =
market value of the credit derivative (x) + amount to be paid to counterparty in case of default by the issuer of the underlying instrument (nominal value of derivative) – amount to be received from counterparty in case of default by the issuer of the underlying asset (0) = Nominal value of derivative + market value of the credit derivative x.

The more the credit derivative is, from the protection seller’s perspective, in the money, the higher the market value x and the higher the exposure value. Economically, this does not make sense because the payment by the protection seller will be increasingly unlikely. The exposure value should be limited to the nominal value of the derivative, so that the derivative’s negative market values properly reduce the exposure, but derivative’s positive market values are not additionally factored in because they overstate the risk.

Question 8: The EBA would like to understand whether the 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.

We do not follow why the nominal value of the credit derivative – for derivatives in the trading /non-trading book, provided no CRMT is applied – is taken into account as an indirect exposure towards the protection buyer (see Explanatory Text for draft RTS, p. 21). The nominal value of the credit derivative (= amount to be paid in case of a credit event) would have to be taken into account as an indirect exposure by the protection seller against the underlying. We request clarification (see also answer to Q 7).

Article 5
Calculation of the indirect exposure value for other derivative contracts listed in Annex II of the Regulation (EU) No 575/2013

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?

Based on our interpretation and the background and rationale in para. 34, Art. 5 (2) of the draft RTS should for the sake of clarity be worded as follows:
For those transaction legs entailing default risk <u>of the issuer of the underlying asset</u>, institutions shall calculate their indirect exposure value as if they were positions in those legs.

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Question 10: The EBA would like to receive feedback with regard to situations, as explained above or else, 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.

With reference to Art. 3 CRR, it is basically always possible for institutions to recognise more conservative amounts against the large exposure limits than would otherwise be necessary under the respective regulation. In this respect, the explicit inclusion of a fallback provision would be dispensable but could for the sake of clarification be conducive to understanding.

Article 6
Calculation of the indirect exposure values arising from derivative contracts on indices or CIUs or with multiple underlying reference names

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?

The basic interaction between the original look-through requirements according to Art. 390 (7) CRR in conjunction with the Delegated Regulation (EU) No. 1187/2014 and the RTS under consultation is open. According to Art. 390 (7) CRR, also "other transactions where there is an exposure to underlying assets" fall under the look-through requirements for the large exposures regime. In line with long-standing supervisory and institutions' practice in Germany, included hereunder, for example, are credit derivatives which refer to multiple reference assets, particularly credit default swaps (CDS) and credit linked notes (CLN), or derivatives on indices. The risk from underlying assets is thus already taken appropriately into account for limiting large exposures. It should be clarified that in these cases the RTS does not apply.

While the wording in Art. 6 (1) and (2) of the draft RTS refers expressly only to (credit) derivatives with an index or fund as an underlying asset, the tenor in the questions on Art. 6 (Q 11 and 12) and para. 39 "Background and rationale" is more general in terms of multiple underlying reference names in the form of a structure. We consider this too to be appropriate. In this regard, the wording in Art. 6 (1) and (2) of the draft RTS should be amended accordingly and 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.

Following on from Art. 6 (4) of the Delegated Regulation (EU) No. 1187/2014 regarding the look-through, we propose that a monthly simulation on the level of the individual underlying reference names should be sufficient. Even with a monthly simulation, moreover, the current state of the analyses cannot conclusively verify whether such a simulation including all kinds of underlying assets is even technically possible. This applies particularly to indices such as the MSCI World with more than 1,600 underlying reference assets.

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Question 12: In the case of derivative contracts with multiple underlying reference names that do not constitute a structure, is the calculation as foreseen in paragraph 3 sufficiently clear? Does it represent an appropriate methodology?

According to “Background und rationale” para. 39, Art. 6 (3) of the draft RTS should be applied also to “embedded derivatives”: “This article would include also the case of embedded derivatives”. We understand this as a (renewed) clarifying wording of para. 14 on the basic scope of application of the RTS. Art. 6 (3) of the draft RTS applies to embedded derivatives only if the embedded derivative is based on multiple underlying reference names that do not constitute a structure.

See also answer to Q 2.

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