

---

22 April 2020

---

# Statement on the application of the prudential framework on targeted aspects in the area of market risk in the COVID-19 outbreak

---

In response to the global COVID-19 pandemic, the EBA has issued a number of statements on actions to mitigate its impact on the EU banking sector. In these statements, the EBA is providing clarity on the functioning of the prudential framework. This statement complements the existing guidance provided by the EBA in response to the COVID-19 outbreak by clarifying a number of aspects of the prudential framework in the area of market risk and proposing amendments to Delegated Regulation (EU) No 101/2016 on prudent valuation.

This statement covers four areas: i) prudent valuation; ii) FRTB-SA reporting requirements; iii) implementation of phase V and VI of the implementation of the Joint ESAs RTS on non-cleared OTC derivatives and iv) back-testing breaches on IMA models.

## **Mitigate the increase in aggregated amounts of additional valuation adjustments (AVAs) under the prudent valuation framework**

Under Article 105 of Regulation (EU) No 575/2013 ('CRR') institutions are required to prudently value their fair-valued financial instruments. Delegated Regulation (EU) No 101/2016 specifies how AVAs should be calculated for this purpose.

The expansion of the COVID-19 pandemic in the Union and across the globe has triggered levels of extreme volatility throughout financial markets affecting multiple asset classes, which has generated exceptional increases in asset price dispersion and bid-offer spreads, affecting exit costs. Prudent valuation being a point-in-time, forward-looking framework, an increase or decrease in market volatility can be expected to directly affect the calculation of AVAs. Although AVAs should, in general, mechanically adjust to fluctuating market conditions, the recent COVID-19 pandemic and the subsequent decisions by public authorities, in the EU and across the globe, to halt large parts of economic activity in their efforts to curb the development of the pandemic have triggered an unprecedented systemic shock and extreme levels of volatility, which have had an excessive impact on aggregated AVAs.

Delegated Regulation (EU) No 101/2016 currently allows institutions to follow two approaches for the calculation of AVAs: a core approach and a simplified approach. The core approach requires to compute, for market price uncertainty, close-out costs and model risk category level AVAs, individual AVAs for separate valuation exposures, which are then aggregated to provide total category level AVAs. In order to mitigate the excessive impact on AVAs of the recent COVID-19 pandemic, the EBA is proposing to amend Delegated Regulation (EU) No 101/2016 to increase the aggregation factor applicable to the core approach from 50% to 66% until 31 December 2020.

The draft RTS should be adopted by the Commission and published in the Official Journal of the EU (OJEU) as quickly as possible in order to allow, to the extent possible, for the application of the revised Delegated Regulation for the 30 June 2020 COREP reporting. The entry into force of the amendment will, however, depend on whether the amendments can be published in the OJEU before the 30 June 2020.

### **Postponement of the FRTB-SA reporting requirement under the CRR2**

European legislators agreed to implement in the EU the revised framework for market risk - i.e. the so-called Fundamental Review of the Trading Book (FRTB) – in the first instance as a reporting requirement. This will apply only to institutions whose trading book and business subject to market risk exceed certain thresholds. Institutions below the thresholds will only report on the size of the trading book and the business subject to market risk.

Due to the COVID-19 outbreak, the EBA considers that alleviating any potential operational challenges to institutions in preparing for the introduction of these reporting requirements is warranted. The FRTB reporting requirements in the EU, and in particular those on the FRTB standardised approach (FRTB-SA)<sup>1</sup>, were scheduled to apply from the first quarter of 2021. The EBA recognises that firms currently face increased operational challenges in the area of reporting in general. This is also acknowledged in the statement of 31 March 2020<sup>2</sup>. Those operational challenges are expected to present a particular impediment to the implementation of an entirely new market risk and reporting framework.

Therefore, the EBA intends to submit the ITS it is mandated to draft under Article 430b of the CRR to the European Commission with a starting date for the FRTB-SA reporting in Q3 2021 i.e. the first reference date will be set at 30 September 2021. This should allow institutions to focus on their core operations and should provide some operational relief, whilst not undermining the smooth implementation of the FRTB in the EU. However, the ITS will subsequently have to be adopted by the Commission.

---

<sup>1</sup> The FRTB-SA is called 'Alternative standardised approach' under the CRR2.

<sup>2</sup> See <https://eba.europa.eu/eba-provides-additional-clarity-on-measures-mitigate-impact-covid-19-eu-banking-sector>

Since the formal reporting obligation will be triggered by the Commission delegated act on market risk in accordance with Article 461a of the CRR, the EBA recommends the Commission to consider the same delay in the date of application of the delegated act.

### **Postponement of final two implementation phases of the margin requirements for non-centrally cleared derivatives**

BCBS/IOSCO<sup>3</sup> announced on 3 April its intention to allow a deferral of the final two implementation phases of the margin requirements for non-centrally cleared derivatives, in order to free up operational capacity for banks to respond to the COVID-19 crisis. In EU, the framework is implemented through the joint ESAs RTS on risk mitigation techniques for OTC derivatives not cleared by a central counterparty. These RTS will consequently need to be changed to implement the delay in EU law.

Under the current circumstances, EBA welcomes the measures taken and is consequently working closely with ESMA and EIOPA to implement the necessary changes in the RTS. These changes will postpone by one year the requirement to implement initial margins for counterparties above €50 bn (phase V - due to start Sept 2020) and for counterparties above €8bn (phase VI – due to start Sept 2021).

### **Increase in the Value-at-Risk (VaR) risk metrics and multiplication factors under the Internal Models Approach (IMA) for market risk**

Extreme volatility across financial markets has led to the increase in the VaR risk metrics used to calculate own funds requirements for market risk for institutions using the IMA. The progressive adjustment of the VaR to new market conditions is an intended consequence of the framework, as higher volatility should increase the market risk faced by financial institutions. In order to mitigate the procyclical effects of the market risk framework, while preserving a high degree of risk sensitivity to changes in market conditions, a Stressed VaR (SVaR) risk metric was introduced in the aftermaths of the 2007-2008 financial crisis. The SVaR is calibrated to historical data from a continuous 12-month period of significant financial stress relevant to the institution's portfolio, generally identified around the 2007-2008 financial crisis.

The current extreme volatility has caused an increase in VaR figures and, in some cases, the occurrence of a high number of back-testing overshootings, which have triggered an increase in the VaR backtesting multiplier add-on.

The EBA notes that CRR currently allows some flexibility to mitigate the above effects. Firstly, under Article 366(4) of the CRR competent authorities may in individual cases limit the VaR multiplier add-on to that resulting from overshootings under hypothetical changes, where the number of overshootings under actual changes does not result from deficiencies in the internal model. This

---

<sup>3</sup> See <https://www.bis.org/bcbs/publ/d499.htm>

provision would, however, not allow to disregard overshootings that materialise under hypothetical changes.

Secondly, where a value of the VaR multiplier greater than the minimum of 3 had been imposed by competent authorities under Article 366(2) of the CRR, competent authorities may also reduce the VaR multiplier to this minimum value. Reductions of the multiplier in this regard should, however, be carefully considered, as a multiplier greater than 3 would have been imposed by competent authorities to address deficiencies in the banks' internal models for market risk and as it might raise concerns about ensuring a level playing field vis-à-vis other institutions for which the multiplier was not increased.

Finally, EBA notes that the current market environment may trigger changes to the SVaR observation period as a result of expected reviews by institutions. Article 365(2) of the CRR requires that the choice of the SVaR observation period should be subject to at least annual review. While it is expected that institutions perform such annual review, the EBA is of the view, in light of the current circumstances, that the review of the SVaR observation period could be postponed to the end of 2020 and should not constitute a supervisory priority at the moment.