




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

Public hearing

Paris – October 6, 2020

Suggestions for an efficient session

- Should you need **assistance** or would like to **intervene**:
 1. **write on WebEx chat** to any of the hosts or publicly;
 2. or, **raise your hand on WebEx**.
- **To avoid background noise**, please **stay muted**  unless you take the floor.
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- For the **Q&A session**, please **write on the WebEx chat** to any of the **hosts for taking the floor** for a question.

1 Background and rationale

2 Treatment of indirect derivative exposures

Calculation method for indirect derivative exposures

- Derivative and credit derivative with a single underlying reference name
- Derivative and credit derivative with multiple underlying reference names

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Background and rationale



- In Oct. 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. 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;
 - c) improving some technical details.
- As part of the “Risk Reduction Measures Package” adopted by European legislators in May 2019, CRR2 has updated the large exposures framework retaining some of the elements of the EBA’s opinion. These amendments ensure greater alignment with the Basel standard (LEX).
- Article 390(9) CRR2 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”.
- These draft RTS build on the Basel LEX with the intention to be 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.

Treatment of indirect derivative exposures



- A derivative contract gives rise to a direct credit exposure (calculated acc. to Art. 390(4) CRR2) and an indirect credit exposure.
- The indirect exposure affects the maximum loss that an institution could face in the event of default of the underlying client.
- The scope of the mandate of these RTS encompasses all derivative contracts as listed in Annex II of the CRR and credit derivatives contracts.
- Derivative and credit derivative contracts for which the underlying does not entail a default risk of an indirect client shall not be considered by institutions (e.g. commodities, interest rate benchmarks, interest rate curvature spreads, and exchange rates) for the purpose of these RTS (calculation of indirect exposure).
- The treatment of the indirect exposure value described in these RTS applies to derivative and credit derivative contracts independently from the allocation of the instrument to the trading book or to the non-trading book.

Calculation method for indirect derivative exposures

Derivative and credit derivative contracts with a single underlying reference name



Institutions shall calculate the **indirect exposure** towards a client as the **loss that would result from the default of the underlying client** of the derivative or credit derivative contract.

Options on debt and equity instruments

▪ Call options

The indirect exposure value shall be equal to the value of the **market value of the option** (Long +/Short -)

▪ Put options

The indirect exposure value shall be the value of the **difference between the market value of the option and its strike price** (Long -/Short +)

For put exotic options, institutions shall use the expected modelled strike price used for the calculation of the fair value of the option.

Credit derivative contracts

▪ The indirect exposure value shall be calculated as the **sum of the current market value** of the credit derivative contract and the **amount owed to the counterparty** of the credit derivative contract **reduced by the amount owed to the institution** by that counterparty.

▪ Institutions shall set to **zero** the indirect exposure value corresponding to credit derivative contracts that have been used as **CRM technique** (Article 399 CRR).

Other Derivatives

1. Institutions shall **decompose** derivative contracts that constitute a combination of long and short positions into individual legs entailing default risk (e.g. swaps, futures or forwards) and apply the large exposure framework as if they had a position in those legs.
2. Fall-back: Where an institution cannot decompose the derivative, it shall determine the indirect exposure value 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.

- If market value is not available on a given date → **fair value** on that date.
- If neither market value nor fair value is available:
 - at **given date** → **most recent** of market value or fair value.
 - at **any date** → value at which the derivative is measured in accordance with the **applicable accounting framework**.

Calculation method for indirect derivative exposures

Derivative and credit derivative instruments with multiple underlying reference names



Derivatives having a structure as underlying (e.g. indices and CIUs)

ON

Look-through to all components

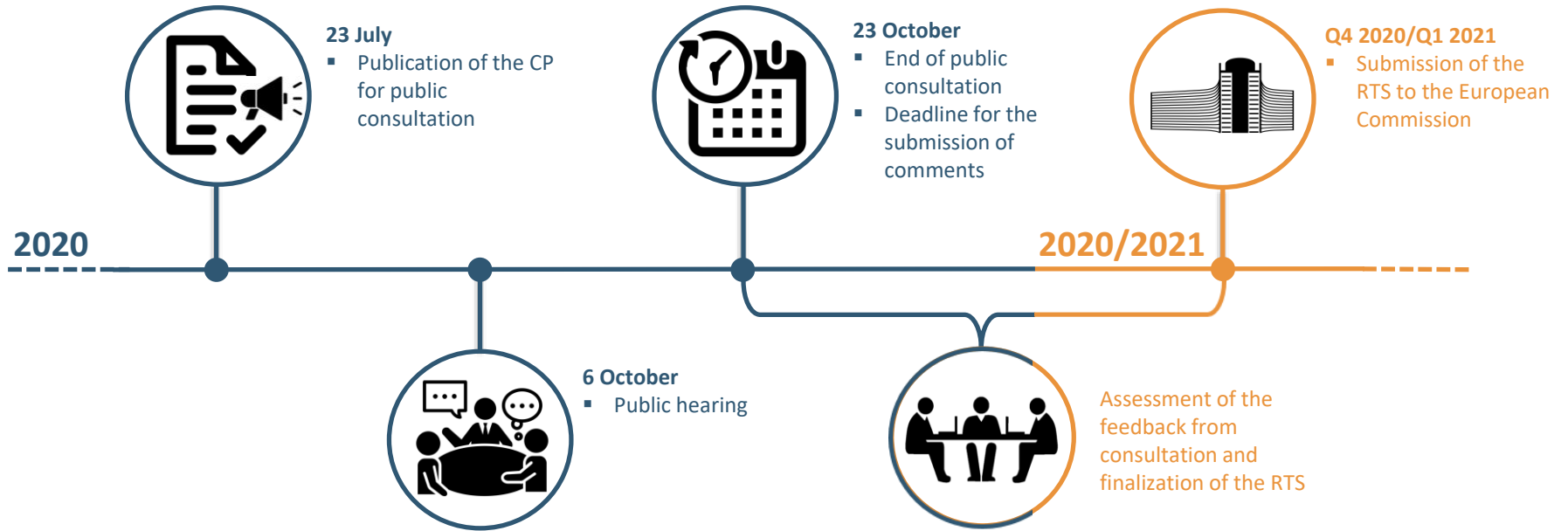


- The indirect exposure value shall be calculated by looking at the **variation in the price** of the derivative assuming the default of any of the underlying reference names.
- The exposure value is assigned to **each identified, separate** or the **unknown client** according to the rules laid down in Articles 6(1) and 6(2) of Commission Delegated Regulation (EU) No 1187/2014.
- The indirect exposure value shall be calculated by treating the exposure as a direct exposure towards the **whole underlying** reference names of the derivative.
- The exposure value is assigned to a **separate** or the **unknown clients** according to the rules laid down in the Article 6(3) of the Commission Delegated Regulation (EU) No 1187/2014.

Derivatives with multiple underlying reference names not entered via a structure (e.g. best-of call option)

- The indirect exposure value shall be calculated by looking at the **variation in the price** of the derivative assuming the default of any reference names.
- The exposure value is assigned to each identified client.

Next steps



Overview of questions for consultation (1)



Article	Question
1	<p>Q1: What are your views on the three proposed categories of derivatives? Are they comprehensive?</p> <p>Q2: 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.</p>
3	<p>Q3: Do you consider that the treatment for option contracts specified in Article 3 is appropriate and sufficiently clear?</p> <p>Q4: 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?</p> <p>Q5: 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.</p> <p>Q6: 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.</p>

Overview of questions for consultation (2)



Article	Question
4	<p>Q7: Do you consider that the treatment for credit derivative contracts specified in Article 4 is appropriate and sufficiently clear?</p> <p>Q8: 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.</p>
5	<p>Q9: Do you consider that the treatment for other derivative contracts listed in Annex II specified in Article 5 is appropriate and sufficiently clear?</p> <p>Q10: 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.</p>
6	<p>Q11: 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?</p> <p>Q12: 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?</p>



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