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WORKING PAPER

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From:	Presidency
To:	Delegations
Subject:	Articles 94, 102 to 106, 325 to 325bq, 501b, 519a CRR 'Market risk'

Delegations will find attached Presidency non-paper for the 15/16 February 2017 meeting.

15 & 16 February 2017
Working Party Financial Services (RRM)

Articles 94, 102 to 106, 325 to 325bq, 501b, 519a CRR - 'Market risk'

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Background

The market risk section of the CRR review transposes the new Basel market risk standard.

In Title I -General requirements, valuation and reporting

Article 94 sets out the revised conditions to benefit from the derogation for institutions with small trading book business, under which the own funds requirements for the credit risk of banking book positions may replace the own funds requirements for the market risk. Articles 102 and 103 clarify the general requirements for trading book positions. Article 104 and 104a clarify the criteria to assign positions to the trading book and the conditions for reclassifying a trading book position as a banking book position and vice versa. Article 104b defines the new concept of trading desk. Article 105 sets out the prudent valuation rules. Article 106 describes the recognition and treatment of trading book positions that hedge banking book positions.

In Title IV - Chapter 1 – General provisions

Article 325 describes the different approaches that can be used by institutions to compute own funds requirements for market risk as well as the conditions for their use and how their use may be combined. Article 325a specifies the eligibility criteria to use the simplified standard approach for institutions with medium-sized trading book business. Article 325b lays out the conditions under which market risk exposures can be netted between different legal entities within a group. Article 325c specifies the conditions under which the positions entered into in order to hedge against the adverse effect of changes in exchange rates on the institution's own funds ratios can be exempted from the market risk requirements.

Chapter 1a – The standardised approach

Section 1 (Article 325d) describes the different components of the standardised approach. Section 2 and 3 (Articles 325e to 325u) describes the functioning of the first component, the sensitivities-based method. Section 4 (Article 325v) describes the functioning of the second component, the residual risk add-on. Section 5 describes the functioning of the third component, the default risk charge. Section 6 (Articles 325af to 325az) provides the risk weights and correlations that must be used to determine own funds requirements for market risks under the standardised approach.

Chapter 1b – The internal model approach

Section 1 (Articles 325ba and 325bb) specifies the conditions under which institutions are allowed to use internal models and how own funds requirements for market risk must be calculated for trading desks that benefit from this permission. Section 2 (Articles 325bc to 325bl) describes how expected shortfalls and liquidity horizons must be used in the calculation of own funds requirements for market risk, the requirements that internal models must meet in terms of back testing, P&L attribution, internal validation as well as more general qualitative and risk measurement requirements, and the stress scenario risk measure that must be calculated for the non-modellable risk factors. Section 3 (Articles 325bm to 325bq) describes how the default risk charge must be calculated.

Chapters 2, 3 and 4 – The simplified standardised approach

These chapters reflect the simplified standardised approach under the revised market risk framework. These rules already existed in the current market risk framework and remain unchanged. When the proposed Regulation becomes applicable, only institutions that fulfil the eligibility criteria set out in Article 325a will be able to use the simplified standardised approach.

Part Ten – Transitional provisions (phase-in), reports, reviews and amendments

Article 501b describes how own funds requirements for market risk will be phased-in. Article 519a mandates the EBA to review important technical elements of the revised market risk framework no later than 3 years after the entry into force of this Regulation. The Commission may make proposals to change the related rules in light of the EBA conclusions.

Feedback provided by Member States

Most Member States reserved their comments on the technical aspects of the proposed standards pending further analysis, other than some preliminary comments as discussed below. Feedback focused mainly on the transitional provisions and proportionality-enhancing measures.

Transitional provisions (phase-in)

Member States welcomed the idea of a phase-in period but views diverged on the length and nature of the phase-in period and the calibration of the market risk requirements during the phase-in period, amongst other issues.

On the length of the phase-in period, certain Member States seemed contrary to giving the Commission the power to prolong the proposed three year period through a Delegated Act.

On the nature of the phase-in, some Member States were concerned that the proposal did not provide an adequately smooth transition over time, producing instead a cliff effect at the end of the transitional period between and the fully-fledged future market risk requirements and the discounted requirement (65%) applicable during the transitional period. On the other hand, a number of Member States noted that the 65% factor would actually reduce the market risk capital requirements for a number of institutions. A number of Member States proposed changing the 65% factor and instead increasing the % during a transition period to reach 100% at the end of the transitional period.

Proportionality (Article 94 and 325a)

Member States generally supported:

- The revision of the derogation for institutions with small trading books; and
- The Commission's proposal to use the existing Standardised Approach as Simplified Standardised Approach in the new framework.

However, some Member States proposed reviewing the thresholds for simplified methodologies, for larger banks with simpler trading book business to be able to use such simplified methodologies.

Preliminary technical comments

A number of Member States objected to the proposed requirement to characterise all "financial assets or liabilities measured at fair value" as trading book positions as per (Article 104(2)(e)). Member States argued that as drafted such a requirement would lead to an undue re-characterisation of certain banking book exposures as trading book positions apart from not being in line with Basel. The Commission acknowledged that this was not the intended outcome.

Some Member States also expressed their concern about the P&L attribution test. The Commission explained that the reason for proposing a mandate to the EBA was that some elements are too technical to be included in Level 1 text as well as because this would allow the possibility to take into account Basel developments on the matter.

Some Member States argued that the proposed market risk requirements for FX risk do not take sufficiently into account the liquidity horizon of the currencies in the ERM-II framework. The Commission noted that the proposal already includes these elements (Article 325aw (Standardised approach) and 325be (Internal Model approach).

Main issues

Transitional provisions (phase-in):

- The length of the phase-in period.
- The nature of the proposed phase-in and the calibration of market risk requirements during the phase-in period.
- The possibility for the Commission to prolong the phase-in period through a Delegated Act.

Proportionality:

- The calculation and level of the threshold for the derogation for institutions with small trading books.
- The calculation and level of the threshold to use the Simplified Standardised Approach.

Preliminary technical issues

- *Banking book vs.* trading book boundary issues in connection with Art. 104(2)(e);
- P&L attribution test;
- Market risk requirements for FX risks for currencies in the ERM-II framework.

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Questions:

Regarding the **phase-in** of the **calibration**:

Q1: Do Member States support the proposed phase-in approach for the market risk framework?

Q2: If not, how should the phase-in be designed to provide a smooth transition into the new framework and avoid cliff-effects? In particular, what are your views on:

(a) Length of the phase in period: should it be 3 years or longer (see Q4)?;

(b) should discount factors be applied in a step-up linear phase-in starting from 65% and up to 100%? Assuming a 3year phase-in: would you agree with the following implementation:

(i) 65% first year;

(ii) 80% second year;

(iii) 90% third year?

(c) Phase-in during which institutions may choose to use the current market risk framework or the new framework during the whole phase-in period. In case they would choose to use the new framework, no application of 65% discount factor would be allowed)?

(d) Another phase-in approach (please specify)?

Q3: Do Member States support the proposal to give a delegated act empowerment to the Commission to extend the phase-in period?

Q4: Do Member States support giving a mandate to the EBA to produce a report assessing the calibration of the new market risk?

Q5: In the absence of a Commission delegated act, would Member States be willing to extend the phase-in period beyond 3 years to enable the Commission to act upon the recommendations of the EBA report through a level 1 legislative proposal?

Regarding the **timing** of application of the new market risk framework:

Q6: Do Member States have any concern with the date of application of the new market risk framework, which would be 2 years after the date of entry into force? In particular, do you believe that it leaves sufficient time for supervisors to approve institutions' internal models for market risks? If not, what alternative would you favour?

Regarding **proportionality** in the new market risk framework:

Q7: Do Member States have any concerns with the definitions of the size of the "trading book business" and/or the proposed thresholds to use the derogation for small trading book business in Article 94? If yes, what are those concerns and how could they be addressed?

Q8: Do Member States have any concerns with the definitions of the size of the "business subject to market risks" and/or the proposed thresholds to use the Simplified Standardised Approach in Article 325a? If yes, what are those concerns and how could they be addressed?

Q9: Do Member States support the use of the existing Standardised Approach as Simplified Standardised Approach in the new framework? If not, what alternative would you favour (taking into account that the international standard on a new Simplified Standardised Approach is not finalised yet)?

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ANNEX I

NEW Article 501b CRR

"Article 501b

Own funds requirements for market risks

1. Until [date of application + 3 years], institutions that use the approaches set out in Chapters 1a and 1b, Title IV, Part Three to calculate the own funds requirement for market risks shall multiply their own funds requirements for market risks calculated under these approaches by a factor of 65%.

2. EBA shall monitor the appropriateness of the level of own funds requirement for market risks calculated in accordance with the approaches set out in Chapters 1a and 1b, Title IV, Part Three by institutions in the Union and report to the Commission on the opportunity to change the calibration of these approaches by [date of application + 2 years]. *This report shall at least assess:*

(a) for the most common financial instruments assigned to the trading book of institutions in the Union, whether the level of own funds requirements for market risks calculated by institutions in accordance with the approach set out in Chapters 1a, Title IV, Part Three is excessive as compared to the own funds requirements for market risks calculated by institutions in accordance with the approach set out in point (a) of paragraph 1 of Article 325.

(b) for the most common financial instruments assigned to the trading book of institutions in the Union, whether the level of own funds requirements for market risks calculated by institutions in accordance with the approach set out in Chapters 3, Title IV, Part Three is excessive as compared to the own funds requirements for market risks calculated by institutions in accordance with the approach set out Chapters 7, Title IV, Part 3.

(c) for the most common financial instruments assigned to the trading book of institutions in the Union, whether the level of own funds requirement for market risks calculated by institutions in accordance with the approach set out in Chapters 2, Title IV, Part Three is excessive as compared to the level of own funds requirement for market risks calculated by institutions in accordance with the approach set out in Chapters 3, Title IV, Part Three.

3. Within the three years after the date of application of the approaches set out in Chapters 1a and 1b, Title IV, Part Three , the Commission shall be empowered to adopt a delegated act in accordance with Article 462 of this Regulation to prolong the application of the treatment referred to in paragraph 1 or amend the factor referred to in that paragraph, if considered appropriate and taking into account the report referred to in paragraph 2, international regulatory developments and the specificities of financial and capital markets in the Union.

4. In the absence of adoption of the delegated act referred to in the previous subparagraph within the specified timeframe, the treatment set out in paragraph 1 shall cease to apply."

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Commission's amendments to Article 94 CRR

"Article 94

Derogation for small trading book business

"1. By way of derogation from point (b) of Article 92(3), institutions may ~~replace the capital requirement referred to in point (b) of Article 92(3) by a capital requirement~~ may calculate~~d in accordance with point (a) of that paragraph in respect of their trading book business,~~ the own funds requirement of their trading-book business in accordance with paragraph 2 provided that the size of the institutions' ~~their~~ on- and off-balance sheet trading-book business ~~meets both the~~ is equal to or less than the following ~~conditions~~ thresholds on the basis of an assessment carried out on a monthly basis:

(a) ~~is normally less than 5 % of the total assets and EUR 15 million;~~ 5% of the institution's total assets;

(b) ~~never exceeds 6 % of total assets and EUR 20 million.~~ €50 million.…"

NEW Article 325a CRR

"Article 325a

Conditions for using the Simplified Standardised Approach

1. An institution may calculate the own funds requirements for market risks with the approach referred to in point (c) of Article 325(1) provided that the size of the institution's on- and off-balance sheet business subject to market risks is equal to or less than the following thresholds on the basis of an assessment carried out on a monthly basis:

(a) 10 % of the institution's total assets;

(b) EUR 300 million."

Commission's amendments to Article 104 CRR

"Article 104

Inclusion in the trading book

"… 2. ~~Institutions shall have in place clearly defined policies and procedures for the overall management of the trading book. These policies and procedures shall at least address:~~ Positions in the following instruments shall be assigned to the trading book:

…(e) financial assets or liabilities measured at fair value;"

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NEW Article 325bh CRR

"Article 325bh

Profit and loss attribution requirement

1. For any given month, an institution's trading desk meets the profit and loss (P&L) attribution requirements for the purpose of Article 325ba(1) where that trading desk complies with the requirements set out in this Article.

2. The P&L attribution requirement shall ensure that the theoretical changes in a trading desk portfolio's value, based on the institution's risk-measurement model, are sufficiently close to the hypothetical changes in the trading desk portfolio's value, based on the institution's pricing model.

3. An institution's compliance with the P&L attribution requirement shall lead, for each position in a given trading desk, to the identification of a precise list of risk factors that are deemed appropriate for verifying the institution's compliance with the backtesting requirement set out in Article 325bg

4. EBA shall develop draft regulatory technical standards to further specify:

(a) in light of international regulatory developments, the technical criteria that shall ensure that the theoretical changes in a trading desk portfolio's value is sufficiently close to the hypothetical changes in the trading desk portfolio's value for the purposes of paragraph 2;

(b) the technical elements that shall be included in the theoretical and hypothetical changes in a trading desk portfolio's value for the purpose of this Article.

EBA shall submit those draft regulatory technical standards to the Commission by [six months after the entry into force of this Regulation].

Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulation (EU) No 1093/2010."

NEW Article 325be CRR

"Article 325be

Liquidity Horizons

"…4. Currency pairs that are composed by the EUR and the currency of a Member State participating in the second stage of the economic and monetary union shall be

included in the most liquid currency pairs subcategory in the foreign exchange broad risk factor category of Table 2…"

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