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From:	Presidency
To:	Working Party on Financial Services (Risk Reduction Measures)
Subject:	Counterparty Credit Risk: Proportionality & RTS Mandates

Delegations will find attached a Presidency non-paper for the 30/31 March meeting

30 & 31 March 2017
Working Party Financial Services (RRM)

Counterparty Credit Risk: Proportionality & RTS Mandates

Background

Further to the Presidency non-paper WK 1288/2017 INIT, the Council Working Party on Financial Services (RRM) discussed, on 16th of February 2017 (the 5th WP), the Commission's amendments to the CRR in particular Article 273a concerning the conditions for using simplified methods to calculate the exposure value as well as a number of questions presented in the non-paper.

Feedback provided by Member States

Member States welcomed the introduction of the SA-CCR. However, some Member States requested a limited number of adjustments to the SA-CCR. Concerns were also raised with respect to the proposed requirements being more prescriptive than the Basel standard.

The majority of Member States welcomed the proposed proportionality rules. However, concerns were raised with respect to (i) the thresholds set in Article 273a for using the OEM and the simplified SA-CCR; (ii) the calculation of the size of the derivative business, in particular whether netting would be allowed; (iii) the level of application (ie solo or consolidated) of the eligibility criteria for using the OEM and the simplified SA-CCR and the impact of the proposed changes since the simplified approaches have not been tested yet.

Member States welcomed the retention of the OEM. With respect to the simplified SA-CCR, while Member States generally did not raise any strong objections, a few Member States expressed their preference to retain the Mark-to-Market Method (MtM).

Feedback provided by EBA

During the Working Party on Financial Services held in Brussels on 15-16 February, the EBA presented its views on the proposed RTS mandates included in the SA-CCR sections. Specifically, the EBA proposed:

- an amendment to the RTS mandate set out in Article 279(4)(b) to allow more flexibility in determining whether a position is long or short with respect to the primary risk driver;
- the deletion of the RTS mandate set out in Article 280e(3) to determine what constitutes a large and concentrated commodity derivative portfolio in order to apply the discretion given to competent authorities in the same paragraph.
- some clarifications on the intention and scope of application of the RTS mandate set out in Article 277 to determine the primary and other material risk drivers of a position.

Main issues:

Proportionality:

- the level of the threshold to use the OEM;
- the definition of the size of derivative business;
- the deletion of the MtM method;
- the level of application for the eligibility to use the OEM and the simplified SA-CCR.

RTS mandates:

- the restriction of the RTS mandate set out in Article 279(4)(b)
- the relevance of the RTS mandate set out in Article 280e(3)
- the intention and scope of application of the RTS mandates set out in Article 277

Suggested way forward:

I. Proportionality

- With respect to applying the principle of proportionality in the CCR framework, the alternative simplified approaches that have been proposed instead of using SA-CCR for institutions with small- and medium-sized derivatives portfolios – respectively the revised OEM and the simplified SA-CCR – are overall well accepted by Member States. A few Member States expressed their concern regarding the removal of the MtM method as an alternative approach to SA-CCR since this approach is currently used by the majority of their institutions in their jurisdiction. These Member States believe that the MtM method would be more suitable for their institutions (although they recognise that some of its assumptions may need to be revised) and that the eligibility criteria to use the proposed alternative simplified approaches, especially the OEM, would be too strict to capture most of these institutions.

  As demonstrated by the comparison of the assumptions of the revised OEM and the MtM method in the below table, it is worth noting that the revised OEM that has been proposed in the CRR review is actually very similar to the MtM method although it does not contain the main drawbacks[1] of the MtM method.

[1] These drawbacks include: (i) outdated calibration; (ii) no differentiation between unmargined and margined transactions; (iii) inadequate capture of future funding benefits.

Table 1: Comparison between the assumptions behind the MtM method, the revised OEM as per the Commission's proposal and the revised OEM as per the Presidency's compromise proposal.

		Current MtM method	Revised OEM	
			Initial proposal	Compromise proposal
Features	**Replacement cost**	Included	Included (same than MtM method for uncollateralised transactions, simpler for collateralised transactions)	Included (same than MtM method for uncollateralised transactions, simpler for collateralised transactions)
	Specific treatment for collateralised transactions in replacement cost	Yes (collateral can reduce directly the exposure)	Yes (simpler than in the current MtM method)	Yes (simpler than in the current MtM method)
	Specific treatment for collateralised transactions in potential future exposure	No	Yes (fixed scaling factor applied to PFE, not present in current MtM method)	Yes (fixed scaling factor applied to PFE, not present in current MtM method)
	Scope of applicability	All derivatives	Interest rate, foreign exchange and gold derivatives	All derivatives
	Definition of notional amounts	Few specific rules but banks shall define discretionarily the majority of these amounts	Harmonised explicit rules	Harmonised explicit rules
	Level of supervisory add-on in PFE	Calibration from Basel I which uses the market conditions from the end of 1980	Calibration in line with SA-CCR which uses the market conditions from the recent financial crisis (2007-2009)	Calibration in line with SA-CCR which uses the market conditions from the recent financial crisis (2007-2009)
	Future netting benefits	Yes (collateral can reduce directly the exposure)	No (simpler that MtM method due to the impossibility to capture future netting benefits in a simple fashion)	No (simpler that MtM method due to the impossibility to capture future netting benefits in a simple fashion)

It is being proposed that the concerns raised by Member States that would like to keep the MtM method in the CRR be addressed by (i) making further adjustments to the revised OEM in order to make it even closer to the MtM method and (ii) allowing its use to more institutions. In this case, more institutions that are currently using the MtM method would be eligible to use the revised OEM and little effort and costs would be required for them to implement the revised OEM.

The abovementioned adjustments could be (i) a widening of the scope of the revised OEM to cover all asset classes (instead of just interest rate and foreign exchange derivatives); and (ii) an increase in the eligibility threshold set out in Article 273a(2) from EUR 20 million to EUR 100 million.

As a consequence of the increase in the eligibility threshold of Article 273a(2) would also justify an increase in the eligibility threshold of Article 273a(1) for the use of the simplified SA-CCR from EUR 150 million to EUR 300 million.

In addition, to address comments from Member States regarding the clarity of the definition of the size of an institution's derivative business, which is used in the assessment of an institution's eligibility to the proposed alternative simplified approaches, we could clarify that netting is not allowed between long and short positions. This would be consistent with the definition of the size of trading book business for the purpose of Article 94 of the CRR and would follow the recommendation made by the EBA in its response to the Commission's Call for Advice.

With respect to the level of application of the threshold for using the proposed alternative simplified approaches, the Commission's proposal is clear: to be eligible for those approaches at consolidated (solo) level, the eligibility criteria have to be met at consolidated (solo) level. Based on that, a situation where a subsidiary would exceed the threshold at solo level (because it has a large number of intragroup transactions with its parent), but the group to which the subsidiary belongs would not exceed it at consolidated level. A way to address this issue would be to introduce a test at consolidated level: if at consolidated level the derivatives business does not exceed the threshold for using one of the simplified approaches, then all institutions within the group would be allowed to use those approaches. Conversely, if the threshold is exceeded at consolidated level, the more complex approach (either SA-CCR or simplified SA-CCR, as applicable) would need to be used at consolidated level while at solo level individual institutions could still use one of the simplified approaches, to the extent they would not exceed the corresponding thresholds.

Finally, the proposed alternative simplified approaches have been built on sound theoretical assumptions derived from a number of simplifications to the assumptions of SA-CCR with rather conservative effects. To address some concerns about the impacts of these approaches, a new mandate to EBA in Article 514 of the CRR could be introduced to monitor and report to the Commission those impacts at the latest two years after the date of application of the new counterparty credit risk rules (Article 514 of the CRR was used in the current CRR to review the OEM).

Question 1: Would Member States agree on the above compromise proposal for proportionality measures in the Counterparty Credit risk framework based on the below amendments to the Commission proposal?

The proposed Article 273a of CRR could be amended as follows:

1. *An institution may calculate the exposure value of derivative positions in accordance with the method set out in Section 4, provided that the size of its on- and off-balance sheet derivative business 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 ~~150~~ 300* million;

   ~~For the purposes of this paragraph, institutions shall determine the size of their on- and off-balance sheet derivative business on a given date by including all their derivative positions except credit derivatives that are recognised as internal hedges against non-trading book credit risk exposures.~~

2. *An institution may calculate the exposure value of ~~interest rate, foreign exchange and gold~~ derivative positions in accordance with Section 5, provided that the size of its on- and off-balance sheet derivative business is equal to or less than the following thresholds on the basis of an assessment carried out on a monthly basis:*

   (a) *5 % of the institution's total assets;*

   (b) *EUR ~~20~~ 100* million;

   ~~For the purposes of this paragraph, institutions shall determine the size of their on- and off-balance sheet derivative business on a given date by including all their derivative positions referred to contracts in paragraphs 1 and 2 of Annex II;~~

3. *For the purposes of paragraphs 1 and 2, institutions shall calculate the size of their on- and off-balance sheet derivative business on a given date in accordance with the following requirements:*

   (a) all their derivative positions shall be included, except credit derivatives that are recognised as internal hedges against non-trading book credit risk exposures.

   ~~(a)~~ (b) derivative positions shall be valued at their market ~~prices~~ values on that given date. Where the market value of a position is not available on a given date, institutions shall take the most recent market value for that position.

   ~~(b)~~ (c) the absolute market value of every long derivative positions shall be summed with the absolute value of every short derivative position~~s~~.

4. By way of derogation from paragraph 1 or 2, as applicable, where the derivative business at consolidated level does not exceed the thresholds set out in that paragraph, an institution which is included in the consolidation and which would have to apply the method set out in Section 3 or 4, as applicable, because it exceeds those thresholds at individual level, may instead choose to apply the method that would apply at consolidated level.

~~4.~~5. Institutions shall notify the competent authorities of the methods set out in Sections 4 or 5 of this Chapter that they use, or cease to use, as applicable, to calculate the exposure value of their derivative positions.

~~5.~~6. Institutions shall not enter into a derivative transaction for the only purpose of complying with any of the conditions set out in paragraph 1 and 2 during the monthly assessment.

<u>The proposed Article 282(4) of CRR could be amended as follows:</u>

~~6.~~4. Institutions shall calculate the potential future exposure referred to in paragraph 2 as follows:

(a) *the potential future exposure of a netting set is the sum of the potential future exposure of all the transactions included in the netting set, as calculated in accordance with point (b);*

(b) *the potential future exposure of a single transaction is its notional amount multiplied by:*

(i) the product of 0,5% multiplied by the residual maturity of the transaction for derivative contracts concerning interestrates ~~contracts~~;

(ii) the product of 6% multiplied by the residual maturity of the transaction for derivative contracts concerning credit instruments;

~~(ii)~~(iii) 4% for derivative contracts concerning foreign-exchange rates ~~contracts~~;

(iv) 18% for derivative contracts concerning ~~gold contracts~~ commodities other than electricity;

(v) 40% for derivative contracts concerning electricity.

(vi) 32% for derivative contracts concerning equities;

(c) the notional amount referred to in point (b) shall be determined in

accordance with points ~~(a) and~~ (b) and (c) of Article 279b(1) for the transactions referred to in points (iii) to (vi) of point (b) of this paragraph and with Article 279b(2) and (3) for all transactions, as applicable;

(d) the potential future exposure of netting sets referred to in point (a) of paragraph 3 shall be multiplied by 0,42.

For calculating the potential exposure of derivative contracts concerning interest-rates ~~contracts~~ in accordance with points (i) and (ii) of point (b)~~(ii),~~ an institution may choose to use the original maturity instead of the residual maturity of the contracts.

<u>Article 514 of CRDIV could be amended as follows:</u>

"Article 514

~~Counterparty Credit Risk and the~~
Original Exposure Method and Simplified Standardised Approach for Counterparty Credit Risk

1. EBA shall, by [four years after the entry into force of this Regulation], report to the Commission on the impact and the relative calibration of the approaches set out in Sections 4 and 5 of Chapter 6 of Title II of Part Three to calculate the exposure values of derivative transactions.

2. On the basis of the EBA report, the Commission shall, where appropriate, submit a proposal to amend the approaches set out in Sections 4 and 5 of Chapter 6 of Title II of Part Three.

II. RTS mandates

- With respect to reflecting EBA suggestions on the scope of RTS related to SA-CCR, more flexibility could be given to EBA in Article 279(4)(b) to determine whether a transaction is long or short in a risk driver by not limiting the approach developed by EBA to the identification of information about the structure and the intend of the transaction. In addition, the mandate could reflect the fact that the approach developed by EBA would be used not only for the primary risk driver of a transaction but for all its material risk drivers in case it has more than one. As a consequence of the above amendment, the last subparagraph of Article 279(2) would also need to be changed.

- Furthermore, the RTS mandate set out in Article 280e(3) could be deleted. As a consequence, the discretion given to competent authorities to consider more attributes than the nature of the underlying commodity to establish commodity hedging sets would be maintained where the institution is significantly exposed to the basis risk of different positions within a certain commodity reference type in line with the Basel standards.

- Finally, the intention of the approaches set out in Article 277, including the scope of the RTS set out in 277(6), could be clarified. More specifically, the approach that would be developed by EBA in point (a) of Article 277(6) should apply to all positions that are subject to the own fund requirements for market risks and not only trading book positions. In addition, the scope of the RTS mandate would be extended to cover the application of the approach set out in paragraph 3 for positions subject the own funds requirements for market risks to since this approach raises a number of technical issues. Finally, it should be clarified that the derogation set out in Article 277(5) should apply to all the positions and is not limited to positions that are not subject to the own funds requirements for market risks.

Question 2: Would Member States agree on the below amendments to the RTS mandates proposed by the Commission on the SA-CCR sections based on the EBA suggestions?

The proposed point (b) of Article 279(4) of CRR could be amended as follows:

(b) ~~what objective information concerning the structure and the intend of a transaction institutions hall use to~~ a method for determininge whether a transaction that is not referred to in Article 277(2) is a long or short position in ~~its primary~~ a material risk driver;

The proposed Article 279(2) of CRR could be amended as follows:

2. For transactions referred to in Article 277(3), a long position is a transaction for which the sign of the sensitivity of the primary risk driver is positive and a short position is a transaction for which the sign of the sensitivity of the primary risk driver is negative. For transactions other than the ones referred to in Article 277(3), institutions shall determine whether those transactions are long or short positions in the primary risk driver ~~based on objective information about the structure of those transactions or their intend.~~

The proposed Article 280e(3) of CRR could be amended as follows:

3. By way of derogation from paragraph 2, competent authorities may require an institution which is significantly exposed to the basis risk of different positions sharing the same nature as referred to in paragraph 2 ~~with large and concentrated commodity derivative portfolios~~ to establish the commodity reference types for those positions using more characteristics than just the nature of the underlying commodity instrument. In this situation, commodity derivative transactions shall be assigned to same commodity reference type only where they share those characteristics.

~~consider additional characteristics other than the nature of the underlying commodity instrument to establish the commodity reference types of a commodity hedging set in accordance with paragraph 2.~~

~~EBA shall develop draft regulatory technical standards to specify in greater detail what constitutes a large and concentrated commodity derivative portfolio as referred to in the first subparagraph.~~

~~EBA shall submit those draft regulatory technical standards to the Commission by [15 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.~~

<u>The proposed paragraphs 2, 3, 5 and 6 of Article 277 of CRR could be amended as follows:</u>

2. Institutions shall conduct the mapping referred to in paragraph 1 on the basis of the primary risk driver of the transaction. ~~For transactions other than those referred to in paragraph 3, t~~The primary risk driver shall be the only material risk driver of a derivative position.

3. From [date of application of this Regulation], for a derivative transaction ~~allocated to the trading book~~ subject to the own funds requirements for market risks and for which an institution uses the approaches laid down in either Chapters 1a or 1b to calculate these own funds requirements ~~for market risk,~~ the ~~primary~~ only material risk driver of that transaction shall be the risk factor associated with the highest absolute sensitivity among all the sensitivities for that transaction calculated in accordance with Chapter 1~~b~~ of Title IV.

5. By way of derogation from paragraphs 2 and 3, institutions shall map derivative transactions that have more than one material risk driver to more than one risk category. Where all the material risk drivers of one of those transactions belong to the same risk category, institutions shall only be required to map one time that transaction to this risk category based on the most material of those risk drivers. Where the material risk drivers of one of those transactions belong to different risk categories, institutions shall map that transaction one time to each risk category for which the transaction has at least one material risk driver, based on the most material of the risk drivers in that risk category.

6. EBA shall develop draft regulatory technical standards to specify in greater detail:

(a) a method for identifying the only material risk driver of transactions other than those referred to in paragraph 3;

(b) a method for identifying transactions with more than one material risk driver and for identifying the most material of these risk drivers for the purposes of paragraph 3;

(c) a method to specify how the highest absolute sensitivity shall be determined for the transactions referred to in paragraph 3.