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Consultation Paper

Draft Regulatory Technical Standards on the treatment of non-trading book positions subject to foreign-exchange risk or commodity risk under Article 325(9) of Regulation (EU) No 575/2013 (Capital Requirements Regulation 2 - CRR2)

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1. Responding to this consultation

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 10.04.2020. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EC) N° 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the EBA in its implementing rules adopted by its Management Board. Further information on data protection can be found under the Legal notice section of the EBA website.

2. Executive Summary

Regulation (EU) No 575/2013 (the Capital Requirements Regulation 2 – CRR2) implement in EU legislation, inter alia, revised requirements to compute own funds requirements for market risk. Institutions are required to calculate own funds requirements for market risk for:

- Positions held in the trading book;
- Positions held in the banking book (i.e. non trading-book) bearing foreign-exchange (FX) or commodity risk.

In line with Article 325(9), the EBA is mandated to develop draft regulatory technical standards to specify how institutions should calculate the own funds requirements for non-trading book positions that are subject to foreign exchange risk or commodity risk in accordance with the alternative standardised approach (SA), and the alternative internal model approach (IMA).

The draft RTS specify:

- (i) The value of non-trading book positions that institutions should be allowed to use where computing the own funds requirements for market risk for those positions. In this respect, the draft RTS require that institutions should use either the last available accounting value or last available fair value for positions attracting foreign-exchange risk. For positions attracting commodity risk, a daily fair-valuation must performed. In addition, although institutions are not requested to perform a daily valuation of non-trading book positions attracting foreign-exchange risk, they are required to reflect on a daily basis changes in the foreign-exchange component;
- (ii) The treatment for non-monetary items held at historical cost that may be impaired due to changes in the relevant exchange rate. In this respect, the draft RTS identify a specific methodology that institutions should use where capitalising the foreign-exchange risk stemming from those items under the standardised approach, while they require institutions to directly model the risk of an impairment due to changes in the relevant exchange rate where the institution capitalises the foreign-exchange risk of those positions using the internal model approach;
- (iii) A specific treatment with respect to the calculation of the actual and hypothetical changes for the purpose of the backtesting and the profit and loss attribution requirements to address the issue of jumps in the value of the portfolio. Without adjustments, that may lead to over-shootings in the backtesting (or misalignment with the theoretical changes in the P&L attribution tests), although not due to changes in the foreign-exchange risk component of the price.



3. Background and rationale

Regulation (EU) No 575/2013 (the Capital Requirements Regulation 2 – CRR2) implements in EU legislation, inter alia, the revised requirements to compute own funds requirements for market risk. Institutions are required to calculate own funds requirements for market risk for:

- Positions held in the trading book;
- Positions held in the banking book (i.e. non trading-book) bearing foreign-exchange (FX) or commodity risk.

In article 325(9), the EBA is mandated to develop draft regulatory technical standards to specify how institutions should calculate the own funds requirements for non-trading book positions that are subject to foreign exchange risk or commodity risk in accordance with the alternative standardised approach (SA), and the alternative internal model approach (IMA).

3.1 Feedback received from the Discussion Paper

In December 2017, the EBA published a Discussion Paper (DP) on EU implementation of market risk and counterparty credit risk revised standards. The paper discussed some of the most important technical and operational challenges for the purposes of implementing the FRTB and SA-CCR in the EU. The DP gave also the possibility to stakeholders to provide early input. The consultation ran until 15 March 2018, and a public hearing took place on 5 February 2018. The EBA received eight public responses to the DP as well as six confidential responses.

One of the implementation issues the EBA identified as potentially having a significant impact on institutions is the treatment of non-trading book positions subject to FX and commodity risk. In the DP, without pre-empting any conclusion, preliminary views were provided on how the implementation issues could be addressed. Three main aspects were discussed:

1. The identification and valuation of FX/COM non-trading book positions;
2. The structure and composition of notional trading desks;
3. The application of the quantitative IMA requirements to notional trading desks.

In the following sub-sections a summary of the feedback received is presented for each of the three aspects.



Identification and valuation of FX and commodity non-trading book positions

With respect to the identification of non-trading book positions with FX or commodity risk, the EBA DP highlighted that institutions are already supposed to identify such non-trading book positions since those risks are captured by the capital requirements for market risks under the Basel 2.5 framework. However, feedback was sought to understand whether institutions were experiencing any problems in identifying those positions. In particular, the DP highlighted that it may be difficult for institutions to identify non-trading book positions with FX risk.

In the feedback on the DP, respondents clarified that they did not face any issue in identifying non-trading book positions with FX risk or with commodity risk. In addition, it was highlighted that the identification under the FRTB rules would be the same as in the current Basel 2.5 framework.

With respect to the valuation of those positions, the EBA DP highlighted that the capital requirement for market risk is based on estimating a potential loss in the market value of a position subject to market risk due to changes in risk factors. In addition, it was pointed out that for non-trading book positions, it may be more complicated to estimate this loss if the valuation is not based on fair value but on another accounting treatment.

In general respondents highlighted that:

- Only a small portion of positions held in the banking book (BB) are treated as fair valued.
- All banking book instruments are fair valued for disclosure purpose. Respondents clarified that in general such exercise is performed on a quarterly basis, although it appears that for internal purposes some institutions are fair valuing those instruments more often.
- The revaluation process is mainly driven by accounting requirements.

In addition, the majority of respondents specified that it would not be appropriate (and even operationally too burdensome) to increase the valuation of BB-position to a daily frequency. However, some respondents specified that they are revaluing the FX component of BB-positions on a daily basis; in other words, while the positions are not revalued daily (i.e. the value in the currency of denomination is not updated daily, e.g. to capture changes the credit risk component of the item), the value of such positions in the reporting currency is adjusted daily to consider the effect of the fluctuation of the exchange rate between the reporting currency and the currency of a particular transaction.

On the valuation of commodity positions, respondents did not provide any detailed feedback. However, it was mentioned that the own funds requirements due to commodity risk are relatively immaterial.



Structure and composition of notional trading desks

With respect to the structure and composition of notional trading desks (i.e. desks that are managing BB positions subject to market risk own funds requirements), the EBA DP highlighted that in the FRTB, it is not clarified how many desks are to be allowed. In particular, it was stressed this number may vary depending on which of the trading desks requirements are applied to notional trading desks.

The feedback on the DP has been critical with respect to the possibility of introducing qualitative requirements to notional trading desks. In particular, it was highlighted that the requirements that are included in article 104b of the CRR2 are meaningful only for 'classical' trading desks, i.e. trading desks managing trading book positions. Precisely, it was pointed out that:

- Banking book businesses with FX/Commodity positions do not have a dedicated trader, instead the risk-management would generally be carried out by traders from FX/Commodity trading businesses;
- Enforcing the one trader/head trader per desk rule would not be proportionate to the scale and the nature of the risks being run in the banking book;
- Business strategy, annual plan and regular management information systems would not be meaningful for FX and commodity exposure in isolation, whilst risk limits would not be set at this level.

Accordingly, the majority of respondents proposed to not further expand on the requirements for notional trading desks beyond the generic description included in the FRTB.

In the DP the EBA discussed the possibility of introducing requirements related to the number of notional trading desks. In general respondents did not agree with the inclusion of any minimum or maximum number of notional desks. However, some respondents agreed that a minimum of one notional trading desk for commodity positions and one notional trading desk for FX-position would be meaningful.

Application of the quantitative IMA requirements to notional trading desks

Respondents have been in general critical with respect to the possibility of introducing quantitative requirements, i.e. backtesting and PLA requirements in the context of the notional trading desks.



3.2 Valuation of non-trading book positions attracting FX-risk for the purpose of standardised approach

Article 325q of the CRR2 defines the risk factors for foreign exchange risk for the standardised approach, while Article 325r(5) outlines how institutions should calculate the delta foreign exchange risk. Accordingly, the CRR already sets all key aspects that institutions should follow for the purpose of computing the own funds requirements for foreign-exchange and commodity risk using the standardised approach.

Article 105 requires institutions to revalue trading book positions at fair value at least on a daily basis. However, it does not set any specific requirements with respect to the valuation of banking book positions in the context of the calculation of the own funds requirements for market risk associated to those positions.

Accordingly, as discussed in its Discussion Paper, the EBA deems opportune to set which are the values of non-trading book positions that institutions are allowed to consider when calculating e.g. the own funds requirements for foreign-exchange risk.

As highlighted by respondents to the EBA Discussion Paper, positions in the banking book are in general not fair valued; however, institutions may for disclosure purposes - depending on the accounting standards implemented in the institution's jurisdiction - fair value all banking positions e.g. on a quarterly basis.

The EBA acknowledges that requiring a fair-valuation of all banking book positions just for the purpose of computing the own funds requirements for market risk would be overly burdensome compared to the benefits that may come from such potential requirement. Accordingly, the draft RTS propose the following treatment:

- Institutions should use the accounting value of banking book positions as a basis for calculating the relevant risk-measures that are needed for obtaining the own funds requirements for market risk. In other words, the accounting value should be considered as representing the market value for the purpose of article 325r(5).
- Institutions that are fair-valuing all banking book positions at least on a quarterly basis may use the fair-value instead of the accounting value as a basis for computing the own funds requirements for market risk. This should be done consistently overtime, i.e. the institution cannot switch from accounting to fair-value (or vice versa).

Accordingly, institutions should consider the same value for a non-trading book position as a basis for computing the own funds requirements within e.g. a quarter (i.e. until the non-trading book position is fully revalued). However, in line with the international standards, institutions should be required to update on a daily basis the FX-components of non-trading book positions. The EBA expects that the risk management of the foreign-exchange risk stemming from banking book positions is performed consistently with the value that is chosen for computing the own funds



requirements (e.g. if the institution calculates the own funds requirements for foreign-exchange risk using the accounting value as a basis, then the risk-management should be performed on that basis).

As a result, for example, an institution that for disclosure purpose is fair valuing its banking-book positions on a quarterly basis will be allowed to consider the fair value computed for such exercise as a basis, and fair value the FX-component on a daily basis for computing the own funds requirements for foreign exchange risk.

It should be noted that regardless of whether the institution uses the fair value or the accounting value, it must be able to identify the FX-component in such value; i.e. the institution must be able to explicitly express the pricing function used to determine the accounting value (or the fair value) with respect to the relevant exchange rate, and accordingly to calculate e.g. the delta risk in a meaningful way.

Example:

The institution computed the fair value of a loan at a given date for disclosure purpose. The fair value of the loan at such date was USD 110, while the FX rate was 1 USD = 0.9 EUR. Accordingly, where computing the delta sensitivity, in accordance with article 325r(5):

$$V(FX) = 110 * FX = 110 * 0.9 = 99 \text{ EUR}$$

$$\text{Delta} = (V(FX * 1.01) - V(FX)) / 0.01 = (110 * 0.9 * 1.01 - 110 * 0.9) / 0.01 = 99 \text{ EUR}$$

The day after the fair valuation, the loan itself is not fully fair-valued. The FX-rate has changed from 1 USD = 0.9 EUR to 1 USD = 0.8 EUR. Accordingly, where computing the delta sensitivity the day after the fair-valuation, the institution should keep the value as it was at fair-valuation date in the reporting currency, and update the FX component:

$$V(FX) = 110 * FX = 110 * 0.8 = 88 \text{ EUR}$$

$$\text{Delta} = 88 \text{ EUR}$$

Items at historical cost

Items in a foreign currency that are held at historical cost are subject to foreign-exchange risk as those items may be impaired due sharp movements in the exchange rate. In particular, article 325q(1) clarifies that the FX-charge applies to instruments that are sensitive to foreign-exchange; accordingly also those items are considered to be in the scope of instruments to which the own funds requirements for foreign-exchange risk applies.

In general, non-monetary items that are booked at historical cost do not change their balance sheet value with the movements in the exchange rates. However, in case of an indication of an impairment (due to a sharp move of the FX rate and/or due to other circumstances) the carrying amount of an asset is the lower of its carrying amount before considering possible impairment



losses (with the FX rate of the date of the transaction) and its recoverable amount (with the FX rate of the reporting date). Thus, in certain instances a movement of the FX rate may also lead to FX-related losses with respect to non-monetary items that are booked at historical cost.

The EBA acknowledges that sensitivity-based-method may not be fit for the purpose of calculating the own funds requirements for foreign-exchange risk stemming from non-monetary items that are held at historical cost. However, the EBA believes that it is important that the foreign-exchange risk of those items is captured under the Pillar I requirements; accordingly, as part of these draft RTS, the EBA proposes to treat items that are historical cost, as linearly dependent on the FX-rate (i.e. delta-1 product), and requires the institution to update the FX-component on a daily basis, as for all other instruments. Such treatment is deemed to be the least burdensome from an operational point view.

3.3 Valuation of non-trading book positions attracting commodity risk under the standardised approach

With respect to the valuation of banking book instruments that are attracting commodity risk, these draft RTS propose that the institutions should perform a daily fair-valuation of the corresponding instrument. This treatment ensures consistency with the international standards where institutions are required to compute the own funds requirements for market risk on a daily basis.

3.4 Valuation of non-trading book positions attracting foreign-exchange or commodity risk under the internal model approach

Considering that the standardised approach is designed to represent a fallback for desks moving from the internal model approach to standardised approach (e.g. because not meeting the backtesting requirements), it is desirable to have common provisions with respect to the valuation of non-trading book positions bearing FX-risk. Accordingly, the EBA proposes in these draft RTS that all provisions discussed in section 3.2 *Valuation of non-trading book positions attracting FX-risk for the purpose of standardised approach* and section 3.3. *Valuation of non-trading book positions attracting commodity risk under the standardised approach* are applicable also in the context of the internal model approach (IMA) with the exception of the treatment for non-monetary items at historical cost for which the EBA proposes a different treatment when they are capitalised under the IMA.

Items at historical cost

As previously mentioned, non-monetary items that are booked at historical cost do not change their balance sheet value where small movements in the exchange rates occur. However, in case of an indication of an impairment (due to a sharp move of the FX rate and/or due to other circumstances) the carrying amount of an asset is the lower of its carrying amount before considering possible impairment losses (with the FX rate of the date of the transaction). Thus, in certain instances a movement of the FX rate may also lead to FX-related losses with respect to non-monetary items that are booked at historical cost.



On this basis, the draft RTS specify that where institutions opt for capitalising the foreign-exchange risk stemming from non-monetary items at historical cost with the internal model approach (pending permission of the competent authority), then they should do it by modelling the risk that such items would be impaired due to changes in the relevant exchange rate.

3.5 Other specifications on the treatment of banking book positions under the internal model approach

Limitation of the use of the internal model approach to positions assigned to classical trading desks

As mentioned in *3.1 Feedback received from the Discussion Paper*, three main aspects were discussed:

1. The identification and valuation of FX/COM non-trading book positions;
2. The structure and composition of notional trading desks;
3. The application of the quantitative IMA requirements to notional trading desks.

The concept of notional trading desk has been included in the final FRTB standards. Although a specific definition of notional trading desks was not provided in the Basel standards, they can be understood as sets of banking book positions subject to commodity or foreign-exchange risk for which the institutions seek the permission to calculate the corresponding own funds requirement for market risk using the internal model approach.

Although part of the final Basel standards, the current wording of the CRR provides for certain requirements for all trading desks as laid down in Article 325az(2) without any specific regime or exceptions for notional trading desks for the purpose of computing the own funds requirements for market risk. Therefore only positions assigned to trading desk meeting all conditions set out in Article in 325az (i.e. also all conditions specified in article 104b need to be met) can be capitalised using the internal model approach.

As a result:

- (i) If institutions want to include a banking book position in their IMA, they will have to manage the FX or commodity risk stemming from such position via 'classical trading desks' (that meet all criteria in 325az).
- (ii) These draft RTS do not include any specific provision related to notional trading desks.

It should be noted that the CRR3 is expected to fully implement the FRTB standards in the European Union. Accordingly, it is expected that the possibility foreseen in the Basel standards to constitute notional trading desks will be finally included as part of the level 1 text. As a result, should the



concept of 'notional' trading desk be finally included in the CRR, the EBA will subsequently consider the need to amend these RTS to include any specification, that may be needed for harmonising banking practises e.g. with respect to the constitution of such notional trading desks.

Specification on the HPL and APL for banking book positions

As specified, the proposed draft RTS do not require a daily fair-valuation of the instruments bearing FX-risk. Instead, for items bearing FX-risk, only a daily fair-valuation of the FX-component is required.

Accordingly, for example, an institution that is fair-valuing its banking book positions on a quarterly basis will observe bumps in the value of its portfolio at the fair-valuing date that are not triggered by FX risk factors.

It appears that a specific definition of hypothetical changes (HPL) and actual changes (APL) in the portfolio's value is needed to address the problem of having bumps that may lead to over-shootings in the backtesting although not due to changes in the foreign-exchange risk component of the price. Accordingly, these draft RTS propose that, if at the time t the institution is fair-valuing its banking book positions, then, where calculating the $APL/HPL = V_t - V_{t-1}$ for the purpose of backtesting VaR_{t-1} , the value of the portfolio in t , V_t , can be calculated ignoring that in t a complete fair-valuation of the banking book positions has been performed. Accordingly, where calculating V_t the institution should be allowed to take the last fair value of the banking book positions available (before t) as a basis and update the FX-component with the FX-rate in t . In this way, the fair-value basis over which the FX-component is updated will be the same, and any overshooting will be only due to changes in the FX-risk component.

The treatment described above for APL/HPL will also solve the distortion of the PLA test through bumps in the HPL, as the RTPL - due to its calculation in the VaR engine - only reflects changes in the FX-component of banking book positions. In this way, the same definition of HPL would be used in the context of the PLA and in the context of the backtesting.

For the purpose of backtesting VaR_t the next day, the value of the portfolio in t , V_t , (as well as the value of the portfolio in $t + 1$, V_{t+1} , for calculation of APL and HPL) should then be based on the updated fair value of the banking book positions in accordance with the usual process.



4. Draft regulatory technical standards on the treatment of non-trading book positions subject to foreign-exchange risk or commodity risk under Article 325(9) of Regulation (EU) No 575/2013

In between the text of the draft RTS that follows, further explanations on specific aspects of the proposed text are occasionally provided, which either offer examples or provide the rationale behind a provision, or set out specific questions for the consultation process. Where this is the case, this explanatory text appears in a framed text box.



COMMISSION DELEGATED REGULATION (EU) No .../..

of **XXX**

[...]

supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards on the calculation of the own funds requirements for market risk for non-trading book positions subject to foreign-exchange risk or commodity risk with the approaches set out in points (a) and (b) of Article 325(3)



THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 575/2013 of 26 June 2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, and in particular the third subparagraph of Article 325(9) thereof,

Whereas:

- (1) Both in the context of the alternative standardised approach and the alternative internal model approach, institutions compute the own funds requirements for market risk stemming from non-trading book positions on the basis of the value taken by such non-trading book positions. Given that there are different ways for valuing non-trading book positions, this regulation should specify whether institutions should use the accounting or the fair value.
- (2) Own funds requirements for market risk for non-trading book positions should be calculated considering the non-trading nature of the items from which those positions stem. Institutions should not be required to perform a daily valuation for non-trading book positions since the value of those positions is not only driven by market risk factors. Instead, institutions should be required to reflect on a daily basis only those changes which are associated with the market risk components of non-trading book positions.
- (3) Accordingly, where calculating the own funds requirements for foreign-exchange risk, institutions should be required to consider the most recent value of such non-trading book positions and update that value in relation to the exchange rate. Institutions should only be required to do the update in relation to the exchange rate with a daily frequency.
- (4) In order to limit the operational burden in implementing these standards, institutions should use the most recent accounting value of a non-trading book position as a basis for the purpose of computing the own funds requirement for foreign-exchange risk. However, institutions should be allowed to use the fair value instead of the accounting value if the fair value of all non-trading book positions is calculated at least quarterly, since then the fair value is deemed an appropriate basis for the calculation.
- (5) Considering the specificities characterising foreign-exchange positions stemming from non-monetary items that are held at historical cost a specific treatment for determining their value should be laid down in this regulation to harmonise practises where calculating the own funds requirements for foreign-exchange risk for those items.



- (6) The value taken by non-trading positions subject to commodity risk is driven by risk factors falling under the market risk scope. Accordingly, in line with the international standards institutions should be required to fair value on a daily basis non-trading book positions that are subject to commodity risk.
- (7) In relation to the alternative internal model approach, this regulation also specifies how institutions should calculate actual, hypothetical changes for non-trading desk positions assigned to trading desks in order to ensure that those changes only reflect changes driven by market risk factors.
- (8) This Regulation is based on the draft regulatory technical standards submitted by the European Supervisory Authority (European Banking Authority) (EBA) to the Commission.
- (9) EBA has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the opinion of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010¹,

HAS ADOPTED THIS REGULATION:

SECTION 1

CALCULATION OF THE OWN FUNDS REQUIREMENTS FOR MARKET RISK FOR NON-TRADING BOOK POSITIONS THAT ARE SUBJECT TO FOREIGN-EXCHANGE RISK OR COMMODITY RISK IN ACCORDANCE WITH THE ALTERNATIVE STANDARDISED APPROACH UNDER POINT a) OF ARTICLE 325(3) OF REGULATION (EU) No 575/2013

Article 1

Valuation of non-trading book positions subject to foreign-exchange risk

1. Where calculating the own funds requirement for non-trading book position subject to foreign-exchange risk under the sensitivities-based method in accordance with Section 2 of Part Three, Title IV, Chapter 1a of Regulation (EU) No 575/2013, institutions shall use the last available accounting value of a non-trading book position that is subject to foreign-exchange risk as a basis.
2. By way of derogation from paragraph 1, institutions may use the last available fair value of a non-trading book position that is subject to foreign-exchange risk, provided that the fair value of all non-trading book positions is calculated at least on a quarterly basis. Where an institution applies this paragraph it shall apply it to all non-trading book positions subject to foreign-exchange risk.

¹ Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).



3. Institutions shall update the last available value that is used as basis for computing the own funds for foreign-exchange risk in accordance with paragraph 1 and 2 on a daily basis in order to reflect changes in the value of the foreign-exchange risk factors.

4. For the purpose of computing the own funds requirements for foreign-exchange risk, institutions shall treat non-monetary items that are measured in terms of historical cost that are subject to the risk of impairment due to movements in the exchange rate between a foreign currency and the reporting currency, as denominated in that foreign currency.

5. The value of the sensitivity calculated in accordance with Article 325r(5) of Regulation (EU) No 575/2013 corresponding to the items referred to in paragraph 4 shall be equal to the value which those items have in the currency of denomination multiplied by the spot exchange rates between the currency of denomination and the institution's reporting currency.

Explanatory text for consultation purposes

The proposed draft RTS require institutions to use the last available accounting value. Alternatively the fair value may be used as a basis for computing the own funds requirements for market risk if certain conditions are met. In addition, institutions are required to update on a daily basis the foreign-exchange component of that value in order to reflect changes that are associated to market risk factors. Accordingly, the EBA seeks feedback on whether further specifications should be made around aspects related to the value that can be used as a basis for the computation of the own funds requirements and on the current risk-management practices of banking book positions.

Moreover, the proposed draft RTS identify a methodology that institutions should use where calculating the own funds requirements for foreign-exchange risk associated to non-monetary items held at historical cost under the standardised approach. In this respect, the EBA seeks feedback on the proposed methodology.

Questions for consultation

Q1. Do you agree with the approach in relation to the use of the accounting value and alternatively the fair value as a basis for computing the own funds requirements for foreign exchange risk, or do you think that institutions should be requested to use e.g. only the accounting value? Please elaborate.

Q2. Do you agree that institutions should be requested to update on a daily basis only the foreign-exchange risk component of banking book instruments? Please elaborate.

Q3. Could you please describe the current risk-management practices that institutions use for managing the foreign-exchange risk stemming from banking book positions, e.g. whether the accounting or the fair-value is used as a basis for determining the exposure in a currency, the



frequency at which banking book positions are fully revalued, the frequency at which the foreign-exchange component is updated?

Q4. Do you agree with the proposed methodology for capturing the foreign-exchange risk stemming from non-monetary items at historical cost under the standardised approach? Do you have any other proposal for capturing the foreign-exchange risk stemming from non-monetary items at historical cost that would be prudentially sound while fitting within the standardised approach framework? Please elaborate.

Q5. How are you currently treating, from a prudential perspective, non-monetary items at historical cost that may be subject to an impairment due to a sharp movement in the foreign-exchange rate? In which currency are those items treated from an accounting perspective?

Q6. Could you please provide an estimate of the materiality of non-monetary items that are held at historical cost for your institution (e.g. size of the non-monetary items at historical cost with respect to the institution's balance sheet)? Please elaborate.

Article 2

Valuation of non-trading book positions subject to commodity risk

Where calculating the own funds requirement for non-trading book position subject to commodity risk under the sensitivities-based method in accordance with Section 2 of Part Three, Title IV, Chapter 1a of Regulation (EU) No 575/2013, institutions shall use the latest available fair value of those positions as a basis. Institutions shall fair value those positions on a daily basis.

Explanatory text for consultation purposes

The value of positions attracting commodity risk is deemed to be driven only by market risk factors. Accordingly, in line with the international standards, the proposed draft RTS require institutions to fair value such positions on a daily basis. The EBA seeks feedback on whether there are some exceptional cases where institutions would not be able to perform a daily fair-valuation.

Question for consultation

Q7. Do you think there are any exceptional cases where institutions are not able to meet the requirement to daily fair-value commodity positions? Would these exceptional cases occur only for commodity positions held in the banking book or also for commodity positions held in the trading book?



SECTION 2

CALCULATION OF THE OWN FUNDS REQUIREMENTS FOR MARKET RISK FOR NON-TRADING BOOK POSITIONS THAT ARE SUBJECT TO FOREIGN-EXCHANGE RISK OR COMMODITY RISK IN ACCORDANCE WITH THE ALTERNATIVE INTERNAL MODEL APPROACH UNDER POINT b) OF ARTICLE 325(3) OF REGULATION (EU) No 575/2013

Article 3

Valuation of non-trading book positions subject to foreign-exchange risk

1. Where calculating the own funds requirement for non-trading book positions subject to foreign-exchange risk assigned to trading desks in accordance with the alternative internal model approach as set out in Chapter 1b of Part Three, Title IV, of Regulation (EU) No 575/2013, institutions shall use the last available accounting value of a non-trading book position that is subject to foreign-exchange risk method as a basis.
2. By way of derogation from paragraph 1, institutions may use the last available fair value of a non-trading book position that is subject to foreign-exchange risk as a basis for calculating the own funds requirements provided that the fair value of all non-trading book positions is calculated at least on a quarterly basis. Where an institution applies this paragraph it shall apply it to all non-trading book positions subject to foreign-exchange risk.
3. Institutions shall update the last available value that is used as basis for computing the own funds for foreign-exchange risk in accordance with paragraph 1 and 2 on a daily basis in order to reflect changes in the value of the foreign-exchange risk factors.
4. For the purpose of computing the own funds requirements for foreign-exchange risk, institutions shall treat non-monetary items that are measured in terms of historical cost that are subject to the risk of impairment due to movements in the exchange rate between a foreign currency and the reporting currency, as denominated in that foreign currency.
5. For items referred to in paragraph 4, institutions shall capture in their risk-measurement model the risk that those items are impaired due to changes in the relevant exchange rate.

Explanatory text for consultation purposes

The proposed draft RTS set a principle based requirement with respect to the computation of the own funds requirements for foreign-exchange risk associated to non-monetary items held at historical cost under the internal model approach. In this respect, the EBA seeks feedback on whether a more prescribing methodology (like the one identified in the context of the standardised approach) would be beneficial and on whether institutions are able to model the risk that those items are impaired due to changes in the relevant exchange rate in their risk-measurement model.

Question for consultation



Q8. Do you agree that, with respect to the valuation of foreign-exchange and commodity positions held in the banking book, the provisions applicable in the context of the alternative standardised approach (Article 1 paragraphs 1 and 2) should also apply in the context of the alternative internal model approach (Article 3 paragraphs 1 and 2)? Please elaborate.

Q9. Do you agree with the provision requiring institutions to model the risk that non-monetary items at historical cost are impaired due to changes in the relevant exchange rate or do you think that the RTS should be more prescribing in this respect? Please elaborate.

Q10. How institutions would capture the risk of an impairment in their risk-measurement model? Would the definition of impairment used in the internal model be identical to the one proposed in the accounting standards? Please elaborate.

Q11. Do you think that the requirement to capture the impairment risk in the risk-measurement model for institutions using the internal model approach is less or more conservative than the requirement proposed for institutions using the standardised approach? Please elaborate.

Article 4

Valuation of non-trading book positions subject to commodity risk

Where calculating the own funds requirement for non-trading book position subject to commodity risk assigned to trading desks in accordance with the alternative internal model as set out in Chapter 1b of Part Three, Title IV, of Regulation (EU) No 575/2013, institutions shall use the last available fair value of those positions. Institutions shall fair value those positions on a daily basis.

Article 5

Computation of the hypothetical and actual changes related to non-trading book positions subject to foreign-exchange risk

1. Where institutions compute the hypothetical and the actual changes in the portfolio's value referred to in Article 325bf and Article 325bg of Regulation (EU) No 575/2013, they shall calculate the value of a non-trading book position at the end of the day following the computation of the Value-At-Risk number referred to in Article 325bf of that Regulation by using the value of that non-trading book position at the end of the previous day and update its component reflecting the foreign-exchange risk.

2. Institutions shall apply paragraph 1 only to non-trading book positions that are included both in the portfolio on the day of the computation of the Value-At-Risk number referred to in Article 325bf of Regulation (EU) No 575/2013, and in the portfolio on the day following the computation of that Value-At-Risk number.

**Explanatory text for consultation purposes**

The draft RTS include a specific definition of hypothetical and actual changes in the portfolio's value deriving from non-trading book positions to address the problem of having bumps that may lead to over-shootings in the backtesting although not due to changes in the foreign-exchange risk component of the price. Accordingly, these draft RTS propose that if at the time t the institution is fair-valuing its banking book positions, then when calculating the APL/HPL = $V_t - V_{t-1}$ for the purpose of backtesting VaR_{t-1} , the value of the portfolio in t , V_t , can be calculated ignoring that in t a complete fair-valuation of the banking book positions has been performed.

Question for consultation

Q12. Do you agree with the definitions of hypothetical and actual changes in the portfolio's value deriving from non-trading book positions that have been included in the proposed draft RTS?

Article 6

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

*For the Commission
The President*

*[For the Commission
On behalf of the President*



5. Accompanying documents

5.1 Draft cost-benefit analysis / impact assessment

Article 325(9) of the CRR2 requires the EBA to develop draft RTS to specify the details on how institutions should calculate the own funds requirements for non-trading book positions that are subject to foreign exchange risk or commodity risk where using the FRTB – standardised approach (SA), and the FRTB – internal model approach (IMA).

As per Article 10(1) of Regulation (EU) No 1093/2010 (EBA Regulation), any regulatory technical standards developed by the EBA shall be accompanied by an Impact Assessment (IA), which analyses ‘the potential related costs and benefits’.

This section presents the cost-benefit analysis of the main policy options included in the RTS described in this CP. Given the nature and the scope of the RTS, the IA is high-level and qualitative in nature.

A. Problem identification and Baseline scenario

Under CRR2, institutions are required to calculate capital requirements for market risk for:

- positions held in the trading book; and
- positions held in the banking book (i.e. non-trading book positions) subject to foreign exchange (FX) and commodity risk.

Article 105 requires institutions to revalue trading book positions at fair value at least on a daily basis. However, it does not set any specific requirements with respect to the valuation of banking book positions in the context of the calculation of the own funds requirements for market risk associated to those positions. The lack of such specification can result in an inconsistent implementation of the capital requirements for market risk for banking book positions subject to FX and commodity risks across institutions in the EU.

B. Policy objectives

The specific objective of the RTS is to establish common requirements on:

- the valuation of FX and commodity non-trading book positions;
- the specifications on the calculation of hypothetical and actual changes for the purpose of the backtesting and the profit and loss attribution test for positions in the non-trading book.



Generally, the RTS aim to create a level playing field, promote convergence of institutions' practices and enhance comparability of own funds requirements across EU. Overall, the RTS are expected to promote the effective and efficient functioning of the EU banking sector.

C. Options considered, Cost-Benefit Analysis and Preferred Options

This section presents the main policy options discussed during the development of the CP, the costs and benefits of these options, as well as the preferred options included in the CP.

Valuation of non-trading book positions attracting FX-risk

In general, positions in the banking book are not fair valued; however, institutions may for disclosure purposes - depending on the accounting standards implemented in the institution's jurisdiction - fair value all banking positions e.g. on a quarterly basis. Against this background, the following options were assessed regarding the valuation method that should be used when obtaining own funds requirements for foreign-exchange risk.

Option 1a: Institutions should fully revalue banking book positions at fair value on a daily basis and use that fair value as a basis for calculating the relevant risk-measures that are needed for obtaining the own funds requirements for foreign-exchange risk.

Option 1b: Institutions should use either the last available accounting value or fair-value of banking book positions as a basis for calculating the relevant risk-measures that are needed for obtaining the own funds requirements for foreign-exchange risk and update on a daily basis only the component of that position that is associated to market risk factor.

Option 1a would force institutions to fair value on a daily basis banking book positions, which they probably would otherwise not do, only for the purpose of calculating capital requirements. Although it would provide for a consistent procedure with trading book positions, it would be overly burdensome for institutions relative to the benefits that such potential requirement would bring. On the other hand, Option 1b allows institutions to use either the last available accounting value or fair-value as the basis for the calculation, while requesting to revalue the FX component of the banking book positions on a daily basis. In other words, the positions are not revalued daily (i.e. the value in the currency of denomination is not updated daily, e.g. to capture changes the credit risk component of the item), but the value of such positions in the reporting currency is adjusted daily to consider the effect of the fluctuation of the exchange rate between the reporting currency and the currency of a particular transaction. This option is more in line with institutions' current practices and is expected to reduce the operational burden, while still reflect daily the FX rate in the value of the positions.

Option 1b is preferred. In order to avoid any sort of regulatory arbitrage, the draft RTS propose that institutions should use the same kind of valuation (either accounting or fair value) for all banking positions. In addition, it is clarified that institutions are free to use the fair value as long as the fair valuing of banking book positions is performed at least on a quarterly basis. Finally, the same valuation treatment is prescribed for the standardised and internal model approach.



Non-monetary items at historical cost under standardised approach

In general, non-monetary items are booked at historical cost and do not change their balance sheet value with the movements in the exchange rates. However, in case of an indication of an impairment (due to a sharp move of the FX rate and/or due to other circumstances) the carrying amount of an asset is the lower of:

- its carrying amount before considering possible impairment losses (with the FX rate of the date of the transaction);
- its recoverable amount (with the FX rate of the reporting date).

Thus, in certain instances a movement of the FX rate may also lead to FX-related losses with respect to non-monetary items that are booked at historical cost.

The EBA acknowledges that the sensitivity-based-method may not be fit for the purpose of calculating the own funds requirements for foreign-exchange risk stemming from non-monetary items that are held at historical cost as it was not designed to capture this type of impairment risk. From a technical perspective, the delta risk of items that are held at historical costs is zero, as their balance sheet value does not change with fluctuations in exchange rates. As a result, the foreign-exchange risk associated to those items would not be capitalised under the standardised approach.

Against this background, two options were considered on how to capture FX risk for historical cost positions:

Option 2a: Capture FX risk stemming from non-monetary items under Pillar 2 requirements (by setting a delta risk = 0 in the standardised approach)

Option 2b: Capture FX risk stemming from non-monetary items under Pillar 1 requirements, by treating those items as linear in the FX rate

Option 2a acknowledges that the FRTB-SA is not designed to capture the FX-risk stemming from non-monetary items (e.g. impairment risk) and proposes to capture such risks under Pillar 2. This could be considered as the most technically clean solution. However, from a prudential perspective, the EBA believes that it is important that the foreign-exchange risk of those items is captured under the Pillar I requirements (as this is the case for all other instruments). Accordingly, as part of these draft RTS, the EBA considered Option 2b, which treats items that are historical cost, as linearly dependent on the FX-rate (i.e. delta-1 product), and requires the institution to update the FX-component on a daily basis, as for all other instruments. Such treatment is deemed to be the least burdensome from an operational point view, and it still captures the FX risk stemming from these items under Pillar 1.

Option 2b is preferred. In addition, it should be noted that non-monetary items at historical cost are typically structural. Accordingly, the FX-risk position associated to these items may be waived as part of the structural FX provision (if the institution applies for the structural FX waiver).



Specification on the HPL and APL for banking book positions

As described in Option 1, the draft RTS do not require a daily fair-valuation of the instruments bearing FX-risk (and in some special cases, of the instruments bearing commodity risk). Instead, for items bearing FX-risk, only a daily fair-valuation of the FX-component is required. Accordingly, for example, an institution that is fair-valuing its banking book positions on a quarterly basis, will observe bumps in the value of its portfolio at the fair-valuation date that are not triggered by FX risk's factors. Consequently, these bumps may lead to over-shootings in the backtesting, which are unrelated to changes in the foreign-exchange risk component of the price.

The EBA has considered following options for clarifying the definition of hypothetical P&L (HPL) and Actual P&L (APL).

Option 3a: Do not consider a specific definition HPL, APL

Option 3b: Allow for a specific definition of HPL, APL to address the problem of having bumps in the value of the portfolio at the fair-valuation date

Under Option 3a, on the fair-valuation date, institutions could experience over-shootings in the backtesting which are unrelated to the changes in the foreign-exchange risk component of the price. Alternatively, Option 3b would allow institutions at the time t when the institution is fair-valuing its banking book positions to calculate the $APL/HPL = V_t - V_{t-1}$ for the purpose of backtesting VaR_{t-1} , using a value of the portfolio in t , V_t , which ignores that in t a complete fair-valuation of the banking book positions has been performed. Accordingly, when calculating V_t the institution should be allowed to take the last fair value of the banking book positions available (before t) as a basis and update the FX-component with the FX-rate in t . In this way, the fair-value basis over which the FX-component is updated will be the same, and any overshooting will be only due to changes in the FX-risk component. Option 3b provides for a practical solution to address the problem of artificial over-shootings on the date of fair-valuation.

Option 3b is preferred.



5.2 Overview of questions for consultation

Q1. Do you agree with the approach in relation to the use of the accounting value and alternatively the fair value as a basis for computing the own funds requirements for foreign exchange risk, or do you think that institutions should be requested to use e.g. only the accounting value? Please elaborate.

Q2. Do you agree that institutions should be requested to update on a daily basis only the foreign-exchange risk component of banking book instruments? Please elaborate.

Q3. Could you please describe the current risk-management practices that institutions use for managing the foreign-exchange risk stemming from banking book positions, e.g. whether the accounting or the fair-value is used as a basis for determining the exposure in a currency, the frequency at which banking book positions are fully revalued, the frequency at which the foreign-exchange component is updated?

Q4. Do you agree with the proposed methodology for capturing the foreign-exchange risk stemming from non-monetary items at historical cost under the standardised approach? Do you have any other proposal for capturing the foreign-exchange risk stemming from non-monetary items at historical cost that would be prudentially sound while fitting within the standardised approach framework? Please elaborate.

Q5. How are you currently treating, from a prudential perspective, non-monetary items at historical cost that may be subject to an impairment due to a sharp movement in the foreign-exchange rate? In which currency are those items treated from an accounting perspective?

Q6. Could you please provide an estimate of the materiality of non-monetary items that are held at historical cost for your institution (e.g. size of the non-monetary items at historical cost with respect to the institution's balance sheet)? Please elaborate.

Q7. Do you think there are any exceptional cases where institutions are not able to meet the requirement to daily fair-value commodity positions? Would these exceptional cases occur only for commodity positions held in the banking book or also for commodity positions held in the trading book?

Q8. Do you agree that, with respect to the valuation of foreign-exchange and commodity positions held in the banking book, the provisions applicable in the context of the alternative standardised approach (Article 1 paragraphs 1 and 2) should also apply in the context of the alternative internal model approach (Article 3 paragraphs 1 and 2)? Please elaborate.

Q9. Do you agree with the provision requiring institutions to model the risk that non-monetary items at historical cost are impaired due to changes in the relevant exchange rate or do you think that the RTS should be more prescribing in this respect? Please elaborate.



Q10. How institutions would capture the risk of an impairment in their risk-measurement model? Would the definition of impairment used in the internal model be identical to the one proposed in the accounting standards? Please elaborate.

Q11. Do you think that the requirement to capture the impairment risk in the risk-measurement model for institutions using the internal model approach is less or more conservative than the requirement proposed for institutions using the standardised approach? Please elaborate.

Q12. Do you agree with the definitions of hypothetical and actual changes in the portfolio's value deriving from non-trading book positions that have been included in the proposed draft RTS?