

Industry Response to the EBA Consultation Paper on RTSs on SA-CCR

August 2, 2019

Executive summary

The Industry welcomes this opportunity to comment on the EBA's Consultation Paper relating to Draft Regulatory Technical Standards (RTSs) on mapping of derivative transactions to risk categories, on supervisory delta formula for interest rate options and on determination of long or short positions in the Standardised Approach for Counterparty Credit Risk¹.

In relation to the proposed mapping of derivative transactions to risk categories, the Industry supports an approach that allows for a qualitative assessment to identify transactions that have clearly only one material risk driver. In this respect, we support the use of Approach 1 and believe its use should be maximised, thereby minimising the number of trades that would otherwise need to be assessed through Approach 2. In order to maximise use of Approach 1, the Industry would encourage an expansion of the list to include other instruments² as well as maintaining the list as Guidelines³ rather than an RTS, thereby providing greater flexibility for the list to be updated more easily.

In addition, we propose an alternative to Approach 2 as the use of FRTB sensitivities at a trade level is a significant operational undertaking. It would produce unduly burdensome additional costs for banks in terms of operational processes and IT systems. We propose that firms and regulators leverage existing approaches, thereby easing implementation and retaining flexibility in the approach to ranking risk drivers.

In support of the industry recommendation we provide the following arguments:

- The use of an operationally burdensome methodology (Approach 2) is not justified for only the risk driver determination. Furthermore, the industry envisages that only a marginal percentage of the trade population will require allocation to a risk category outside of the prescribed list of products.

¹ Under Article 277(5) and Article 279a(3) of proposed amended Regulation (EU) No 575/2013.

² Common products include cross-currency swaps (see next section) but also government futures. The latter should be included in the rates category given that these products are generally risk managed as rates products.

³ Guidelines set the EBA view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area.

- Basel Standards⁴ and other local implementations⁵ are not prescriptive and allow banks the flexibility to determine how to map transactions to risk categories. This is particularly relevant for global consistency and we would therefore like to encourage the EBA to incorporate more flexibility into the standard.
- The supervisory objective of minimizing RWA variability in the SA-CCR calculation is primarily achieved through the use of the Approach 1 qualitative list. Any remaining variation in the practices of firms could be addressed in a simple and flexible way rather than a complex and computationally intensive quantitative approach.

In relation to the adjustment of the supervisory delta formula for interest options, the Industry prefers the adoption of a simple methodology in order not to introduce potential distortions in the valuation of the IR sensitivities. In this regard, we support the application of the smallest shift to lambda (1bp) and no adjustments in terms of volatility. Whilst an adjustment to the volatility would be required theoretically, it would add unintended consequences in terms of complexity, consequently, the Industry would prioritise simplicity provided that any distortions are kept within acceptable limits.

Cross Currency Swaps mapping

In the Basel SA-CCR text⁶, derivatives are mapped to the asset class of its primary risk driver⁷. Banks are required to use sensitivities and volatilities for the determination of the primary risk driver of complex trades that may have multiple risk drivers⁸. Only those complex trades designated by supervisors are to be mapped to more than one asset class.

In the consultation paper, it is stated⁹ that the method should be *“simple for all cases where the primary and only material risk driver of the transaction is immediately discernible from the nature of the transaction”*.

Consistently with the Basel Standards and European level 1 regulations (CRRII)¹⁰, it's crucial that cross currency swaps are considered under Approach 1 and the only material risk driver is FX rate. Indeed, the Basel SA-CCR text does not identify any additional risk factors (e.g. Cross Currency Basis) as separate risk

⁴ BCBS 279.

⁵ E.g. US NPR on SA-CCR: Standardized Approach for Calculating the Exposure Amount of Derivative Contracts; Notice of Proposed. Rulemaking, 83 Fed. Red. 64,660 (Dec. 17, 2018), available at <https://www.govinfo.gov/content/pkg/FR-2018-12-17/pdf/2018-24924.pdf>.

⁶ BCBS 279.

⁷ BCBS 279, Article 151.

⁸ BCBS 279, Article 152.

⁹ RTS draft Recital (1).

¹⁰ <https://data.consilium.europa.eu/doc/document/PE-15-2019-INIT/en/pdf>

factors¹¹. In addition, Annex II of the CRR also classifies cross-currency interest swaps as pure Foreign-exchange contracts.

Furthermore, cross currency swaps are a vanilla flow product, particularly important for commercial end users (e.g. corporates providing funding in various currencies). Potential inflation of the exposure amount of those transactions could force banks to increase the cost for clients of such products and may, eventually, deter some to hedge their FX risk. This is crucial especially in Europe given that many of international transactions are denominated in US dollars.

Considering all those facts, we strongly support the addition of a specific paragraph for the treatment of cross-currency swaps within the Article 1 of the RTS which would provide more clarity on the way banks should manage these instruments. Exposure for this vanilla product would be the same for every institution and it would ensure a level playing field. In particular, the Industry suggests adding the following paragraph to Article 1: *“For the purpose of this paragraph, institutions shall map cross-currency swap transactions to the foreign exchange risk category.”*

Question 1: which of the two options do you think is more appropriate as thresholds in Article 3(b) steps (v) and (vii) (option 1a: Y%=50% and Z%=25%, or option 1b: Y%60% and Z=30%)? Please provide the rational for the chosen option.

The industry preference is Option 1b: Y= 60% and Z = 30% since we believe that Y=60% is a more appropriate option for the first threshold and provides a better representation of the risks and 30% provides an adequate backstop to identifying significant risk drivers.

Question 2: what are your views about the general quantitative approach methodology, which hinges on FRTB SA sensitivities? Please provide examples of cases where computing FRTB SA sensitivities might raise some issues

The Industry believes that full reliance on FRTB SA sensitivities at trade level is not justified for the sole purpose of ranking risk drivers. We would argue for flexibility in the approach of ranking risk drivers and a way to leverage existing approaches considering the following four principles:

- Scope: The vast majority of transactions should be covered by approach 1 in order to minimize the scope of transactions subject to a quantitative analysis to determine the primary risk driver

¹¹ In detail Article 162, footnote 14 specifies that “derivatives with two floating legs that are denominated in different currencies (such as cross-currency swaps) are not subject to this treatment: rather, they should be treated as non-basis foreign exchange contracts”.

- Timing: Any quantitative analysis under approach 2 should not have to be performed more frequently than at inception or quarterly basis
- Granularity: Banks should not be required to perform the quantitative analysis at a trade level but should have the flexibility to make determination at a portfolio level of similar transactions
- Flexibility: if for operational reasons FRTB sensitivities at trade level are not easy to implement, banks should have the flexibility to use other sensitivities as long as the bank uses a consistent set of sensitivities that are derived from bank's independent process such as valuation or risk management.

Given that the scope of transaction that fall into Approach 2 should be kept small and that the quantitative information is only used for risk driver identification, the Industry believes such flexibility is justified.

In contrast, the quantitative methodology under Approach 2 proposed in the EBA Consultation Paper creates a clear dependency between the Market Risk framework and the Counterparty Credit Risk framework both in terms of methodology and IT systems. As such, depending on bank internal organization, using sensitivities for the identification of the most material risk driver may be burdensome and technically complicated. The Industry therefore urges the EBA to introduce appropriate flexibility also for Approach 2.

As mentioned in the executive summary, the Industry would encourage an expansion of the list for Approach 1, as well as maintaining the list as Guidelines rather than an RTS, thereby providing greater flexibility for the list to be updated more easily. With that goal in mind to expand transactions covered by Approach 1, the Industry recommends the removal of the following part of Article 1(1)(b): "where the currency of the underlying of the transaction is the same as the settlement currency of the transaction", since the FX risk concerned here is either not material or already captured.

Question 3: Do you have any views on the appropriateness, for smaller institutions, of the alternative SA-CCR and add-ons approach (Article 3(2)) in overcoming the issues (if any) raised by the general FRTB SA sensitivities approach?

We do not have specific views in relation to appropriateness of this alternative specifically applied to smaller institutions. However, as mentioned above, general principle should be to apply any quantitative methods to as marginal as possible list of trades and to leave banks an adequate discretion in choosing the most fit-for-purpose methodology (please refer to our response to question 2).

Question 4: Do you think the approach outlined here should be applied at currency level (option 3a) or transaction level (option 3b)?

We support alignment with the Basel FAQ¹² as a minimum standard, i.e., calibration of the shift at currency and bank level - based on each institution set of forwards/strikes in its own population of options. In particular, some IMM institutions might opt for this option as it could bring alignment/consistency with their IMM model and this choice would therefore be seen as operationally efficient. For greater consistency, banks should be allowed to use the same currency level shift for SA-CCR at as the one used for IMM.

However, whilst a shift at currency and bank level offers consistency across the portfolio, this may suffer of threshold effect in case of an option with a negative strike. As such, only one transaction may impact the figures of the whole portfolio. Thus, the Industry is of the opinion that the option to calibrate the shift at transaction level should be retained since we consider transaction-level calibration to be superior to current-level calibration in the following respects:

- Operational simplicity of implementation
- Minimum distortion introduced as no adjustment would be applied to options that do not require it under this approach
- With currency level calibration, the shift has a dependency on the option with the most negative strike. A single option could trigger a recalibration of the shift which is not desirable. This is not the case when the calibration occurs at transaction level which could imply unwarranted volatility on the outcomes across institutions and through time
- Consistency of the shift at transaction level across institutions. Indeed at a point in time, the same trade in portfolios of different institutions will result in the same SA-CCR exposure across institution, which might not be the case with alternative 3a) approach at currency level, where discrepancies between institutions could arise within the market quote retrieval process

We consider that a unique shift across all institutions would be operationally difficult to implement and note that it would have the undesirable consequence that a single option with a very low strike in one institution could trigger an immediate recalibration of shift across the entire Industry.

Question 5: Which one of the three options (option 4a: 1bp, option 4b: 0.1% or option 4c: 1%) do you think is more appropriate as a threshold? Please provide the rationale for the chosen option

The Industry strongly supports the adoption of option 4a which implies a threshold 1bp. Main rationales are:

¹² <https://www.bis.org/bcbs/publ/d438.pdf>. FAQ 2.6. Supervisory delta adjustments for negative interest rates

- The larger the shift introduced, the larger the shifted log normal distribution could move from log-normal to normal.
- As evidenced in the EBA CP, the necessary adjustment of volatility for larger shift could be particularly complex as it depends on the option details. The Industry is inclined to put forward simplicity: no volatility adjustment but with a shift as small as possible.
- A threshold of 1 bp combined with the most negative combination of strikes/forwards would pose no issue from a computational perspective as it would be well within the bounds of any machine precision.

Question 6: Please provide examples of cases where the possibility to set the shift λ according to the prevalent market conditions (option 4) might: a) provide some benefits b) raise some concerns

Setting the shift to prevalent market conditions would be operationally burdensome, in particular it would be extremely challenging to react sufficiently quickly to new options with negative strikes.

The potential benefits are not sufficiently clear to warrant operational difficulties. The Industry is strongly against the potential adoption of this approach.

Question 7: Do you consider necessary an adjustment to the supervisory volatility parameter δ as defined in Article 5? In the case an adjustment is considered necessary, how should it be carried out?

As evidenced by EBA CP, an adjustment of volatility is theoretically required to ensure that a shifted log-normal δ aligns with the corresponding log-normal δ with a volatility of 50% (when both are defined).

The size of this adjustment depends on the option details, and is practically complex to put in place.

We would favour simplicity and not adjust volatility while keeping the distortion as low as possible (via a threshold of 1bp, see response to question 5).

Question 8: Do you think the specified method for determining whether a transaction is a long or short position in a material risk driver is adequate? If not, please provide an explanation

The industry considers the definition provided in Regulation (EU) 2019/876, "CRR2" to be sufficiently clear. Where the relationship between risk driver and the derivative trade is one-to-one and a regulatory prescribed list is used to map trades to risk categories, the definition in "CRR2" will be used. However,

where sensitivities are used to assign trades to risk categories, sensitivities could be used to determine whether a transaction is long or short.

The method proposed by EBA for determining whether a transaction is a long or short position in the primary risk driver or in the most material risk driver in a given risk category shall allow the qualitative approach set out in Article 6(b) for transaction where the classification is done using article 1. The Industry suggests the removal of the following part of Article 6(b): « *where institutions apply the approach set out in Article 3(1)(a),* ».

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