POSITION PAPER

ESBG response to the EBA consultation on its RTS on derivatives indirect exposures

ESBG (European Savings and Retail Banking Group)
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Dear Sir/Madam,

The European Savings and Retail Banking Group (ESBG) and its members welcome the opportunity to contribute and comment on the European Banking Authority (EBA) draft Regularity Technical Standards (RTS) on derivatives indirect exposures. We would like to share with you some reflections that we believe will contribute to improve the RTS and, therefore, we hope will be considered by the EBA.

ESBG's comments:

Question 1: What are your views on the three proposed categories of derivatives? Are they comprehensive?

ESBG believes the proposed categories are sufficiently clear and comprehensive.

Question 2: After considering the methodologies in Articles 2 to 6, could you please indicate if the described methodologies are sufficiently clear? Would you consider that the proposed methodologies might not comprehensively capture the exposures of certain categories ofc derivative contracts? Please provide concrete examples and reasoning as well as suggested amendments to the methodology, if any.

The methodologies are clear and comprehensive, although in some cases overly conservative. Specifically, we believe the approach proposed in Article 6 in the cases where no look through to single underlyings is possible, is overly conservative.

At the same time, it has to be pointed out that the implementation costs associated with the technical standard are significant. Especially for institutions with smaller trading books and/or lesser involvement in derivatives trading with bond and equity underlyings, the incremental impact from including indirect exposures will be negligible in the context of large exposures. Such institutions, however, will have to bear the full implementation cost of the proposed methodology. In our view, for such institutions, thresholds for the applicability of this technical standard should be introduced. The thresholds can be based on a quantification of derivative indirect exposures on a periodic basis, e.g. a quantification methodology similar to the one followed by EBA in the cost-benefit analysis of the RTS can be adopted. Such an approach would alleviate the implementation efforts for institutions where indirect exposures are negligible and would be in line with the proportionality principle.

In addition, as pointed out in Paragraph 40 of the ITS and with reference to implementation costs, the interaction with the gross Jump-to-Default (JTD) framework under Fundamental Review of the Trading Book (FRTB) needs to be carefully considered. In our view, an early adoption of the approaches proposed in this technical standard has limited benefits if the methodology will be amended by the JTD framework in 2023.

Furthermore, it would be helpful if the relevant reporting positions in the Large Exposure templates C 28.00 and C 29.00 would be clearly defined for these indirect exposures.

Question 3: Do you consider that the treatment for option contracts specified in Article 3 is appropriate and sufficiently clear?

In our opinion, the methodology is sufficiently clear and conceptually sound.

<u>Question 4</u>: Having in mind that the treatment in Article 3 focuses on options allocated to the trading book, the EBA would like to understand whether there are cases in which options are allocated also to the non-trading book. What are the reasons to have options allocated to the non-trading book? Would there be issues with the treatment proposed for those options?

There might be several reasons to use options strategies to hedge banking books as several parts of the balance sheet contain embedded options (e.g. variable mortgages caps, interest rates driven prepayments).

<u>Question 5</u>: If you have a different view with regard to the treatment for this type of derivative contracts, please provide an example where the calculation method would lead to an incorrect measurement of the indirect exposure or examples where you would not be in a position to perform the calculation under the method prescribed in this Article.

N.A.

<u>Question 6</u>: In your view, would there be an alternative method where in particular the market value of the option is not available? Please, indicate if cases where the market value would not be available should be considered as more than rare cases, and please provide examples and reasoning.

Assuming that "market value" refers to the fair value, i.e. theoretical valuation based on models and non-observable risk factors is acceptable, we do not think such cases will be of practical consideration.

<u>Question 7</u>: Do you consider that the treatment for credit derivative contracts specified in Article 4 is appropriate and sufficiently clear?

ESBG believes the methodology is sufficiently clear and conceptually sound.

<u>Question 8</u>: The EBA would like to understand whether the calculation method of Article 4 is deemed appropriate for all types of credit derivative contracts (where institutions act as sellers or buyers of credit protection) or whether there are contracts for which it would not be correct to apply this calculation method. Please, provide a clear example where the calculation method would lead to an incorrect measurement of the indirect exposure arising from the specific credit derivative contract.

Generally, yes. It would be helpful if the EBA could specify if credit default swaps (CDS) indices are in scope of this article, and if yes, detail their treatment. We assume that institutions do not have to consider an indirect exposure where institutions act as buyers of credit protection. We do not see a loss (an exposure) in these cases if the CDS-underlying defaults.

<u>Question 9</u>: Do you consider that the treatment for other derivative contracts listed in Annex II specified in Article 5 is appropriate and sufficiently clear?

The methodology is clear but a more detailed description of the treatment of the most relevant types of derivatives (e.g. the once listed in Article 5(1) would be helpful.

<u>Question 10</u>: The EBA would like to receive feedback with regard to situations, as explained above or else, where a fallback approach might be necessary. Equally, the EBA would like to understand whether, for such situations, the calculation method of Article 5 is deemed appropriate or whether there could be a more suitable alternative. Please give your reasons and explain what the alternative calculation could be.

The fallback approach appears to be equivalent in quantitative terms to the decomposition approach in Article 5 for the relevant instruments in our portfolio.

Question 11: Do you consider that the treatment for derivative contracts with multiple underlying reference names constituting a structure, as detailed in paragraphs 1 and 2 of Article 6, is sufficiently clearly described? In addition, do you consider that it represents an adequate approach to the calculation of indirect exposure value arising from each reference name?

The proposed treatment is conceptually sound if lookthrough to individual positions in the index/CIU is possible, even if the practical implementation of the approach is challenging (e.g. an out of the money option on a diversified index will result in negligible incremental indirect exposures but will pose significant data and processing requirements). The approach is likely to result in a multitude of individually insignificant exposures, potentially to counterparties with whom the organization does not have any direct exposures.

In our view, the proposed approach is more suited to instruments with limited number of underlyings as detailed in Article 6(3). In the case where no lookthrough is available or practical, the proposed approach is overly conservative. In particular, the requirement that the exposure should be quantified assuming all underlying names default simultaneously is not realistic, especially for diversified indices or CIUs. The effect of this proposal is that exposures towards the unknown client would easily become material since they will reflect the full exposure against underlyings without lookthrough.

In our view, an alternative approach for handling these exposures is needed, e.g. an approach where a certain percentage of the total value of the underlying is assumed to default, or where for diversified indices/CIUs, the 0.25 threshold for assigning to the unknown client is significantly increased.

Question 12: In the case of derivative contracts with multiple underlying reference names that do not constitute a structure, is the calculation as foreseen in paragraph 3 sufficiently clear? Does it represent an appropriate methodology?

We believe that the proposed approach is best suited to underlying reference names which do not constitute a structure.

Question 13: The EBA would like to understand whether the draft cost-benefit analysis / impact assessment is deemed appropriate and sufficiently clear. Please, fill the table below which allows to measure the indirect exposure arising from derivative and credit derivative contracts that will be affected by this RTS.

Amount EUR % of Total LE % of LE at borrower level Q1 Q2 Q3 p90 Max

N.A.

About ESBG (European Savings and Retail Banking Group)

ESBG represents the locally focused European banking sector, helping savings and retail banks in 21 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 900 banks, which together employ more than 650,000 people driven to innovate at roughly 50,000 outlets. ESBG members have total assets of €5.3 trillion, provide €1 trillion in corporate loans (including to SMEs), and serve 150 million Europeans seeking retail banking services. ESBG members are committed to further unleash the promise of sustainable, responsible 21st century banking. Our transparency ID is 8765978796-80.

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