

EBA/CP/2020/14

23 July 2020

Consultation Paper

Draft Regulatory Technical Standards

on the determination of indirect exposures to underlying clients of
derivatives and credit default derivatives under Article 390(9) CRR2

Contents

1. Responding to this consultation	3
2. Executive Summary	4
3. Background and rationale	6
4. Draft regulatory technical standards	16
5. Accompanying documents	26
5.1 Draft cost-benefit analysis / impact assessment	26
5.2 Overview of questions for consultation	31
5.3 Annex I	33

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. *[The part of the phrase from ‘and in particular’ onwards to be added only if, as the case may be, specific questions are provided in the CP].*

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 23 October 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 (EU) 1725/2018 of the European Parliament and of the Council of 23 October 2018. Further information on data protection can be found under the Legal notice section of the EBA website.

2. Executive Summary

As part of the “Risk Reduction Measures Package” adopted by European legislators in May 2019, CRR2¹ has updated the large exposures framework. The amendments ensure greater alignment with the Basel standard (LEX).²

With regard to derivative contracts listed in Annex II of the CRR and credit derivative contracts the requirement to take indirect exposures into account was taken up. A derivative contract can give rise to a direct credit exposure and an indirect credit exposure. Pursuant to paragraph 5 of Article 390 of Regulation (EU) No 575/2013 (CRR), as amended by Regulation (EU) 2019/876, institutions shall add to the total exposures to a client the exposures arising from derivative contracts and credit derivative contracts, where the contract was not directly entered into with that client but the underlying debt or equity instrument was issued by that client. Under paragraph 9 of the same Article, the EBA is mandated to develop draft regulatory technical standards (RTS) to determine the indirect exposures arising from such contracts.

For large exposures purposes, an institution shall calculate the exposures to a client or group of connected clients by adding the direct and indirect exposures in the trading book and in the non-trading book. The indirect exposure towards the issuer of the underlying instrument of a derivative contract shall be calculated as the loss that would result from the default of the issuer itself.

The draft RTS propose a methodology for the calculation of exposures under Part four of the CRR for different categories of derivative contracts and credit derivative contracts with a single underlying debt or equity instrument, namely: options on debt and equity instruments, credit derivative contracts, and other derivatives having as underlying a debt or equity instrument. Only derivative and credit derivative contracts where the underlying of those instruments entails a default risk of the underlying reference names should be relevant for the calculation of the indirect exposures set out in these RTS. In addition, the draft RTS provide a separate methodology for the calculation of exposures stemming from contracts with multiple underlying reference names. In each case, a general methodology as well as a fallback approach is provided.

In order to ensure consistency through the different pieces of the regulatory framework, these draft RTS build on the Basel LEX with the intention to be consistent with market risk rules for the calculation of exposures from (credit) derivatives, complemented where needed by specificities or objectives stemming from the large exposures framework.

These RTS are part of the roadmap previously published by the EBA.³

¹ Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 – Capital Requirements Regulation (CRR)

² BCBS Supervisory framework for measuring and controlling large exposures. <https://www.bis.org/publ/bcbs283.pdf>.

³ <https://eba.europa.eu/eba-publishes-its-roadmap-risk-reduction-measures-package>.

Next steps

This consultation paper is issued for a consultation period of three months. The final draft RTS will be subsequently submitted to the Commission for endorsement before being published in the Official Journal of the European Union.

3. Background and rationale

3.1 Changes to the European Large Exposures framework to align with the new Basel LEX Standard

1. An institution with a strong capital ratio may fail if it experiences significant losses on large exposures in the event of a sudden failure of a counterparty or a group of connected counterparties ("a single counterparty"). The risk of large losses associated with the failure of a single counterparty was not captured by the risk-based capital standards of the Basel Committee on Banking Supervision (BCBS).
2. In April 2014, the BCBS introduced a new standard with the aim of ensuring that internationally active banks' exposures to single counterparties are appropriately monitored and limited.⁴ Banks are exposed to different types of concentration risk, such as sectoral and geographical concentration of asset exposures. The scope of the large exposures framework is limited to losses incurred due to a default of a single counterparty. The new Basel standard came into force on 1 January 2019.⁵
3. Furthermore, the BCBS published in December 2019 a consolidated chapter LEX Large exposures, Exposure measurement (LEX 30) which describes the value of exposures to counterparties used in the large exposures framework, including those for which a specific treatment is deemed necessary. The BCBS also published a LEX 30 version reflecting the new market risk requirements.⁶ That version will become effective as of 1 January 2023.⁷
4. In October 2016, the EBA issued an opinion in response to a European Commission call for advice, setting out its views on the review of the European large exposures regime.⁸ In that opinion, the EBA called on the EU institutions to introduce some amendments with a view to (a) aligning the CRR with the Basel standard on large exposures, (b) removing some exemptions and (c) improving some technical details.
5. As part of the Risk Reduction Measures (RRM) package adopted by the European legislators in May 2019, the Capital Requirements Regulation (CRR) was amended.⁹ The amended CRR

⁴ Supervisory framework for measuring and controlling large exposures. April 2014. See here: <https://www.bis.org/publ/bcbs283.pdf>.

⁵ See here: http://bis-org.com/basel_framework/standard/LEX.html.

⁶ See here: http://bis-org.com/basel_framework/chapter/LEX/30d6df.html?inforce=20220101. LEX 30 – Exposure measurement.

⁷ The Governors and Heads of Supervision announce deferral of Basel III implementation to increase operational capacity of banks and supervisors to respond to Covid-19 (<https://www.bis.org/press/p200327.htm>).

⁸ The EBA's response to the European Commission's call for advice, EBA-OP-2016-17 of 24 October 2016.

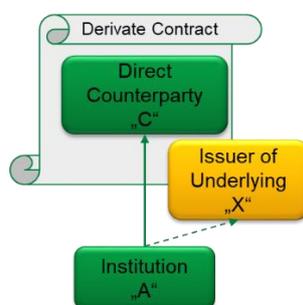
⁹ See Regulation (EU) 2019/876 of 20 May 2019 ("CRR2") (<https://data.consilium.europa.eu/doc/document/ST-6288-2019-INIT/en/pdf>), amending Regulation (EU) No 575/2013.

(CRR2) retained some of the elements of the EBA’s opinion. These amendments ensure greater alignment with the Basel standard (LEX). For instance, the capital basis on which large exposures and large exposure limits are calculated will be restricted to Tier-1 capital and a tighter limit on exposures between global systemically important institutions (15% of Tier-1 capital) was introduced (as of 28 June 2021).

3.2 Large Exposure treatment of indirect exposures stemming from derivative contracts

General background and mandate

6. Article 390(9) CRR mandates the EBA to develop draft regulatory technical standards “to specify how to determine the exposures arising from derivative contracts listed in Annex II and credit derivative contracts, where the contract was not directly entered into with a client but the underlying debt or equity instrument was issued by that client for their inclusion into the exposures to the client”. The EBA shall submit those draft regulatory technical standards (RTS) to the Commission by 28 March 2020.¹⁰
7. A derivative contract can give rise to a direct credit exposure (i.e. the counterparty of the derivative contract) and an indirect credit exposure (i.e. the issuer of the underlying).



8. The direct credit risk exposure is the exposure of the institution A to the counterparty C of the derivative. The counterparty credit risk exposure captures the risk of a loss that an institution may suffer due to a default of the counterparty C. As this direct counterparty credit risk exposure is already captured in the large exposure framework, it is not relevant for the purpose of these RTS.
9. Instead, with regard to the wording “where the contract was not directly entered into with a client”, Article 390(9) CRR2 requires developing draft RTS to specify how institutions should determine the indirect exposure with respect to the issuer of the underlying instrument of a derivative (indirect client X). Once the value of the indirect exposure to the client X is

¹⁰ However, the EBA published on 21 November 2019 a roadmap on the risk reduction package, indicating in particular the planned timetable for delivering the regulatory deliverables according to the mandates given by the CRR2 to the EBA, including those on large exposures. According to the said roadmap, the mandate to submit draft RTS to the Commission under Article 390 (9) CRR should be delivered by December 2020.

calculated, it must be added to the other exposures, if any, of the institution towards the same client.

10. The indirect credit risk exposure is the one stemming from the issuer X of the underlying debt or equity instrument. This indirect exposure shall be considered for the large exposures framework because the default of the underlying client X affects the value of the derivative and, therefore, it affects the maximum loss that an institution could face in the event of X's default.
11. As a concrete example of the case in which the default of X leads to a loss, consider an institution A that has a long position on a call option - entered with counterparty C - on an equity issued by the client X. If X defaults, the option will expire worthless and the institution A will lose the current market value of the option.
12. If the issuer of the underlying instrument is a sovereign, such exposure would be exempted from the large exposure limits. However, an analysis of such exposures (and thus the correct calculation of the exposure value) is still required because the large exposures regime nonetheless applies to them (even though no upper limit is foreseen) – i.e., the institution is required to monitor and control if the value of any on- and/or off-balance sheet exposures reaches or exceeds 10% of its Tier 1 capital.
13. It should be emphasized that these RTS do not impact on the calculation of own fund requirements, their valuation or reporting. Especially, the indirect exposure values calculated on the basis of these RTS do not affect the size of the trading book or non-trading book. The RTS serve the sole purpose to specify the measurement methods for indirect exposures arising from derivative and credit derivative contracts for institutions to correctly identify and limit their large exposures.
14. The scope of the mandate of these RTS encompasses all derivative contracts as listed in Annex II of the CRR and credit derivatives contracts. As matter of example, embedded derivatives and credit-linked notes fall into the scope since, from an economic perspective, institutions could incur a loss when the underlying reference name of the embedded derivative defaults; therefore, an institution shall consider those indirect exposures in the calculation. The indirect exposure arising from those derivative contracts and credit derivative contracts for which the underlying does not entail a default risk of an indirect client X shall not be considered by institutions. Examples of such references of derivative contracts are commodities, interest rate benchmarks, interest rate curvature spreads, and exchange rates.

Calculation method for indirect derivative exposures

15. A derivative may be allocated to the non-trading book or the trading book. In particular, according to Article 104 CRR institutions must have clearly defined policies, procedures and documented practices in order to determine the correct allocation of derivative instruments to the trading book. The CRR strictly frames the ability of banks to move instruments between the trading book and the non-trading book restricting possible reclassifications to exceptional

circumstances as laid down in Article 104a(2) CRR. Indeed, Article 102 CRR regulates the requirements for the trading book, specifying that institutions are mandated to assign derivative instruments to the trading book in case those instruments are held for a short-term resale, profiting from short-term market value movements, looking at arbitrage or hedging risks that arise from those instruments. On the other side, institutions shall allocate derivative instruments to the non-trading book that do not qualify as trading book positions. In general, and as required by the CRR provisions on large exposures, for obtaining the total exposure to a client, it does not matter whether the indirect exposure is assigned to the non-trading book or the trading book, since an institution needs to calculate its overall exposures by adding those in the trading book and in the non-trading book.¹¹ In particular, the treatment of the indirect exposure value described in these RTS applies to derivative contracts and credit derivative contracts independently from the allocation of the instrument to the trading book or to the non-trading book.

16. Article 390(3) (a)-(b) CRR allows the offsetting between positive and negative exposures held in the trading book as long as some specific conditions are met.¹² Netting between positions held in the non-trading book and in the trading book is not allowed¹³ nor is netting between non-trading book positions.¹⁴ According to Article 390(5) CRR2, an exposure to the issuer of the underlying instrument of a derivative needs to be added to the total exposure to that issuer. Under the large exposures regime, the overall exposures to individual clients are relevant only when positive, i.e. an exposure leading to a loss following the client's default. Negative overall exposures shall be set to zero.
17. Institutions shall calculate the indirect exposure towards a client as the difference between the current market value of the derivative or credit derivative contracts and the amount that the institution would receive or give under the scenario of a default of the issuer of the underlying instrument when the settlement transactions take place – i.e., the indirect exposure towards a client shall be the loss that would result from the default of the underlying client of the derivative or credit derivative contract. Where the resulting exposure is negative, the client's default results in a gain for the institution (which shall be set to zero as not relevant for limiting large exposures).
18. Institutions shall calculate that indirect exposure with the following formula:

$$\text{Indirect exposure value} = \text{market value} + A_d - A_r$$

¹¹ Article 390(2) CRR.

¹² See also Basel Standards: The relevant conditions for netting between trading positions are provided by paragraphs from 30.23 to 30.31 of LE Basel standard.

¹³ See Basel standard on LEX 30.30 of the consolidated text effective as of December 2019.

¹⁴ Please note that for non-trading book positions only CRM techniques can be recognized in order to reduce the value of the exposure to the original counterparty. Article 399(1) CRR provides for a treatment of bought credit protection, thus where credit derivatives are entered into for CRM-purposes, the exposure value shall be set to zero.

Where “ A_d ” is the amount due to the counterparty of the derivative under the scenario of a default of the issuer of the underlying, and “ A_r ” is the amount received from the counterparty of the derivative under the same scenario.

19. According to Article 325v CRR, an institution has a short exposure (i.e. a negative exposure) where the default of an issuer or group of issuers leads to a gain for the institution, regardless of the type of instrument or transaction creating the exposure. On the contrary, an institution has a long exposure (i.e. a positive exposure) where the default of an issuer or group of issuers leads to a loss for the institution, regardless of the type of instrument or transaction creating the exposure. Thus, these RTS follow what is provided in the Article 325v CRR with respect to the terminology – i.e., where the calculations provided in these RTS lead to a negative (positive) indirect exposure, this would reflect a gain (loss) following a potential default of the issuer of the underlying instrument. Moreover, for the sake of clarity, for a short position the market value of the derivative or credit derivative contract has to reflect that the institution is acting as seller of the instrument, while for a long position, the institution is acting as the buyer; accordingly, for example, a short position in a put option does have a negative market value for the purpose of the formula in the previous paragraph.
20. Based on the EBA mandate, these RTS seeks to ensure consistency with the international standards for the calculation of indirect exposures to underlying clients of derivatives and credit derivatives for large exposures purposes. In particular, the EBA proposes methodologies that are based on the market risk framework used by institutions to measure the loss that would result from the settlement of these instruments under the scenario of a default of the underlying client. It is to be noted that some aspects of these RTS might be impacted in the future by the changes stemming from the Fundamental Review of the Trading Book.
21. In addition, these RTS build on aspects specific to the large exposures objectives and framework. This is in particular the case for aspects relating to the calculation of indirect exposures for contracts constituted with multiple underlying reference names. Indeed, while the calculation of the indirect exposure value relies on the market risk framework, the allocation of those exposures is based on Commission Delegated Regulation (EU) No 1187/2014 of 2 October 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council as regards regulatory technical standards for determining the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets.¹⁵

Calculation method for indirect exposures arising from derivative and credit derivative contracts with a single underlying reference name

22. In accordance with the proposed RTS, institutions shall distinguish between indirect exposures with single or multiple underlying reference names. For indirect exposures with single underlying reference name, and with a view to rationalizing the variety of derivatives and

¹⁵ See here: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014R1187>.

credit derivatives, the RTS divide them into three categories, following examples provided for in the LEX standard:

- i. Category 1: Options on debt and equity instruments;
- ii. Category 2: Credit derivative contracts; and
- iii. Category 3: Other Derivatives having as underlying a debt or equity instrument.

23. These RTS identify the methodology to calculate the exposure value for each of the three categories.

Category 1: Options on debt and equity instruments

24. Options are financial derivatives that give buyers (long position) the right, but not the obligation, to buy or sell an underlying asset (i.e. call and put options) at an agreed-upon price within a certain period or at a certain date. The option seller (short position) on the other hand has the obligation to deliver or buy the security if the option is exercised by the option buyer. One of the main feature of an option is its non-linear risk profile.

25. For options, to calculate the maximum loss it is necessary to consider changes in option prices that would result from a default of the respective underlying instrument (see Article 3 of these RTS). In particular, for call options, the indirect exposure value shall be equal to the market value of the option. Long call options would result in a positive exposure while for a short position (short call) the exposure would be negative. For put options, the indirect exposure value would be the difference between the market value of the option and its strike price. For a short position in a put option, the exposure would be a positive exposure while for a long position in a put option the exposure would be a negative exposure.

26. As matter of example, for a long call option, in case of default of the issuer of the underlying the loss, and thus the indirect exposure value, would be equal to:

$$\text{Indirect exposure value} = \text{market value}$$

Where “ A_d ” and “ A_r ” would be both zero because the institution would not use the option in case of default of the issuer of the underlying and the loss will be equal to the market value of the option. On the contrary, for a long put option, in case of default of the issuer of the underlying the loss, and thus the indirect exposure, would be equal to:

$$\text{Indirect exposure value} = \text{market value} - A_r$$

Where “ A_r ” would be equal to the strike price because the institution would use the option in case of default of the underlying and the profit will be equal to the market value reduced by the strike price. For a long put option “ A_d ” is zero.

Sign of the exposure / (Exposure value)	Call option	Put option
Long	+ / MV	- / (MV - X)
Short	- / - (MV)	+ / - (MV - X)

Notes: The table shows: i) the sign of the indirect exposure arising from long/short call and put options; and, ii) the exposure value. "MV" is the market value of the option and "X" is its strike price.

27. For put options not having the strike price available at transaction date but available at a later stage at any time (e.g. Asian option with a floating strike), the strike price should be set equal to the expected modelled strike price used for the calculation of the fair value of this option.
28. For options not having the market value available on a given date, the value of the option has to be measured at the fair value of the option. Where the market value and fair value of an option are not available on a given date, institutions shall take the most recent of the market value or fair value. Finally, if the market value and the fair value are not available, institutions shall use the value at which the option is measured with the applicable accounting framework.

Category 2: Credit derivative contracts

29. A credit derivative is a bilateral financial contract whose pay-off is linked to a credit event (e.g. the cash flow of a CDS is triggered only in case of a default event). The purpose of a credit derivative is to transfer credit risk and all or part of the income stream in relation to the borrower without transferring the asset itself. A credit derivative serves as a sort of insurance policy allowing an originator or buyer to transfer the risk stemming from a credit asset (of which he may or may not be the owner) to the seller(s) of the protection or counterparties (i.e. Credit Default Swaps or Total Return Swaps). Credit default swap options are credit derivatives but are excluded from this category because they are options and thus fall under Category 1.
30. According to Article 4 of these RTS, the indirect exposure underlying a credit derivative contract is equal to the market value of the credit derivative adjusted by the amount due or expected to be received in case of default of the issuer of the underlying instrument.
31. It should be noted, however, that the protective effect of a credit derivative for which the institution is a protection buyer, may have been already recognised as a credit risk mitigation technique in accordance with Article 399 of the CRR. Thus, in order to avoid double counting the protective effect arising from those credit derivative contracts, the RTS require institutions to set their indirect exposure values to zero.
32. For credit derivative not having the market value available on a given date, institutions shall take the fair value of the credit derivatives on that date. Where the market value and fair value of the credit derivative are not available on a given date, institutions shall take the most recent

of the market value or fair value. If the market value and the fair value are not available, institutions shall use the value at which the credit derivative contract is measured with the applicable accounting framework.

Category 3: Other Derivatives having as underlying a debt or equity instrument

33. This category covers all other derivatives not belonging to the previous categories, i.e. those which are neither options nor credit derivatives. In this case, to determine the indirect exposure value of underlying debt or equity instruments, institutions shall treat those indirect exposures as positions in debt and equity instruments. Institutions shall decompose derivative contracts that constitute a combination of long and short positions into individual transaction legs and apply the large exposure framework as if they had a position in those legs. Only the transaction leg(s) with default risk, where institutions have a risk of a loss in case of default, should be relevant for the calculation of the indirect exposures set out in this Regulation.
34. As matter of example, a forward contract on a listed stock is composed by two transaction legs, which are two agreements to exchange short and long position in opposing directions. In this case, a forward contract has both the strike leg and the stock leg. Both legs are towards the same client. Institutions shall apply the large exposures framework considering a short cash position with the counterparty (i.e. the strike leg), and a long stock position with the counterparty (i.e. the stock leg). Only the leg associated with default risk of the issuer of the underlying (i.e. the stock leg) should be taken into account – i.e. the exposure value should be calculated as if the position of the institution was a long position in the stock.
35. However, there might be cases for which the decomposition in individual transaction legs cannot apply. For those cases, the RTS include, in paragraph 3 of Article 5, a fallback calculation based on the maximum loss that could occur following the default of the underlying client to which the derivative refers.

Calculation method for indirect exposures arising from derivative and credit derivative instruments with multiple underlying reference names

36. Institutions shall calculate exposures also stemming from derivatives having a structure as underlying – i.e. where the derivative contract is written on debt, equity or credit default swap indices or CIUs. Furthermore, institutions shall calculate also the exposures stemming from derivatives with multiple underlying clients even where those exposures are not entered via a structure, e.g. Best-Of Call option.¹⁶ In particular, for those instruments having multiple underlying reference names that do not constitute a structure, institutions should calculate the indirect exposure value by looking at the variation in the price of the derivative assuming the default of any reference names and assign such exposure value to each identified client as specified in Article 6(3) of the proposed RTS.

¹⁶ A best-of option is a derivative instrument whose payoff at maturity is equal to whichever is higher of two values: zero or the maximum return obtained from an asset belonging to a basket of assets minus the option's strike price.

37. In order to determine the exposure value of derivative contracts written on bond or credit default swap or equity indices or CIUs, where an institution can look through all the components constituting the underlying of the derivative contract, the indirect exposure value shall be calculated by looking at the variation in the price of the derivative assuming the default of any of the underlying reference names in the multi-underlying instrument. Then, the rules laid down in Articles 6(1) and 6(2) of Commission Delegated Regulation (EU) No 1187/2014 shall apply. In particular, for each underlying exposure for which the issuer can be identified, an institution shall add this exposure value to the other exposures the institution has towards the same client. If an institution cannot identify the issuer of the underlying exposure, the indirect exposure value shall be assigned to:
- a) a separate client if the exposure value does not exceed 0.25% of the institution's Tier 1 capital or exceeds 0.25% of its Tier 1 capital and the institution can ensure, by means of the transaction's mandate, that the underlying exposures of the transaction are not connected with any other exposures in its portfolio or
 - b) to the unknown client in other cases.
38. Only where an institution is not able or it would be unduly burdensome for the institution itself to perform a look-through, the indirect exposure value shall be calculated by treating the exposure as a direct exposure towards the whole underlying reference names of the derivative – i.e., by looking at the variation of the price of the derivative assuming a default of all the reference names of the structure. Then, the rules applicable to direct exposures as laid down in the Article 6(3) of the Commission Delegated Regulation (EU) No 1187/2014 shall be applied. In particular, the exposure to the whole structure shall be assigned to a separate client if the whole exposure is below or equal to 0.25% of the institution's Tier 1 capital or to the unknown client if the whole exposure is above 0.25% of its Tier 1 capital.
39. For those derivative and credit derivative contracts having multiple underlying reference names that do not constitute a structure (e.g. Best-Of Call option), institutions should calculate the indirect exposure value by looking at the variation in the price of the derivative assuming the default of any reference names and assign such exposure value to each identified client as specified in Article 6(3) of the proposed RTS. This article would include also the case of embedded derivatives. As matter of example, considering a structured bond with a redemption value that depends on the performance of the underlying stock on which the structured bond is embedded, banks shall identify the reference names of the direct exposure (i.e. the issuer of the structured bond) and of the indirect exposures (i.e. the issuer of the stock embedded to the structured bond). In this case, according to Article 6(3) of the RTS, the indirect exposure value would be equal to the variation in price of the structured bond due to the default of the issuer of the underlying stock on which the structured bond is embedded.

Additional aspects

40. According to the new version of LEX30 (effective as of January 2023) institutions shall use the gross jump-to-default amount ('JTD') under the Fundamental Review of the Trading Book in

order to identify the exposure values for trading book positions. The JTD approach applies to all trading book positions subject to credit risk and is aimed at covering the risk of a sudden default of the issuer of the instrument and applies to derivative contracts as well. However, as the new Basel standard is only applicable as of 1 January 2023 and, due to the interconnection that arises with the EBA mandate under Article 325w(8) CRR2 that requires the EBA to specify the JTD calculation method, these draft RTS do not provide for this approach for the identification and calculation of indirect derivative exposures. Where necessary, these RTS might be further reviewed and possibly amended following the finalisation of the EBA mandate under Article 325w(8) CRR2.

41. In order to facilitate the reading of the provisions of these RTS, a decision tree explaining the different cases and options is provided in [Annex I](#).

4. Draft regulatory technical standards

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

of **XXX**

[...]

supplementing Regulation (EU) No 2013/575 of the European Parliament and of the Council with regard to regulatory technical standards specifying how to determine the indirect exposures to a client arising from derivatives and credit derivatives contracts where the contract was not directly entered into with the client but the underlying debt or equity instrument was issued by that client

THE EUROPEAN COMMISSION,

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

Having regard to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) 648/2012¹⁷, and in particular third subparagraph of Article 390(9) thereof,

Whereas:

- (1) Only derivative and credit derivative contracts where the underlying entails a default risk of the underlying reference name should be relevant for the calculation of the indirect exposures set out in this Regulation.
- (2) The assessment of the indirect exposure values to a client arising from derivative and credit derivative contracts should differ from the calculation of the exposure value used for risk-based capital requirements set out in Regulation (EU) No 575/2013 because a default of the underlying instrument could lead to a profit instead of a loss. The indirect exposure value should therefore be dependent on the loss (i.e. positive exposure) or gain (i.e. negative exposure) that would result from a potential default of its underlying instrument. Under the large exposures regime set out in Regulation (EU) No 575/2013, in the case of exposures in the trading book, institutions may offset positive and negative exposures in the same financial instruments, or in different financial instruments, issued

¹⁷ OJ L 176, 27.6.2013, p. 1.

- by a given client. The overall net exposure to an individual client should be considered only if positive.
- (3) The indirect exposure value of options, regardless of whether allocated to the trading book or the non-trading book, should therefore depend on the change(s) in option prices that would result from a default of the respective underlying instrument, e.g. the option's market value for 'call' options and the market value of the option minus its strike price for 'put' options.
 - (4) The purpose of credit derivatives is to transfer credit risk in relation to borrowers without transferring the assets themselves. The role that institutions play as protection seller or protection buyer and the type of credit derivative they enter into should be taken into account for the determination of the indirect exposure value of the underlying instrument. The indirect exposure should be equal to the market value of the credit derivative contract which should be adjusted by the amount due to or expected to be received from the counterparty in the case of default of the issuer of the underlying debt instrument. To avoid double counting of an exposure, this Regulation should take into account that where credit derivatives are eligible and used as a credit risk mitigation techniques in accordance with Article 399 of Regulation (EU) No 575/2013, institutions should set the value of the indirect exposure arising from those credit derivatives to zero.
 - (5) For other types of derivative contracts that constitute a combination of long and short positions, institutions should decompose those derivative contracts into individual transaction legs. Only the leg(s) with default risk, where institutions have a risk of a loss in case of default, should be relevant for the calculation of the indirect exposures set out in this Regulation. However, where institutions cannot apply this methodology, they should be allowed to determine the indirect exposure value of the underlying instruments as the maximum loss that they could incur following the default of the issuer of the underlying to which the derivative refers.
 - (6) Derivatives can be written on instruments having multiple underlying reference names. For derivatives on indexes or CIUs, where an institution can look through to all the underlying reference names of the index or CIU, the indirect exposure value should be calculated by looking at the variation in the price of the derivative in case of default of any of the underlying reference names in the multi-underlying instrument. Articles 6(1) and 6(2) of Commission Delegated Regulation (EU) No 1187/2014 should apply to assign the exposures to the identified client, a separate client and/or the unknown client. This Regulation should take into account that institutions may not be able to apply a look-through approach and that a look-through approach to a derivative with multiple reference names can be unduly burdensome. For this reason, in such cases institutions should calculate the indirect exposure value by looking at the variation of the price of the derivative in case of default of all the underlying names. Article 6(3) of the Commission Delegated Regulation (EU) No 1187/2014 should apply to assign the exposure to a separate client and/or the unknown client. For derivatives having multiple underlying reference names that do not constitute a structure, institutions should look-through to all the underlying reference names of the derivative and calculate the exposure value as the variation in the price of the derivative in case of default of any of the names. The exposure value should be assigned to each of the identified names.

- (7) This Regulation is based on the draft regulatory technical standards submitted by the European Supervisory Authority (European Banking Authority) (EBA) to the Commission.
- (8) 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 1093/2010¹⁸.

HAS ADOPTED THIS REGULATION:

Article 1

General rules for the calculation of the indirect exposure value to a client arising from derivative contracts listed in Annex II of Regulation (EU) No 575/2013 and credit derivative contracts where those were not directly entered into with that client

1. Institutions shall determine the indirect exposure value to a client arising from derivative contracts listed in Annex II of Regulation (EU) No 575/2013 and credit derivative contracts, where the derivative contracts were not directly entered into with that client but the underlying debt or equity instrument was issued by that client, in accordance with the methodology set out in Articles 2 to 5.
2. By way of derogation from paragraph 1, where the underlying instruments are included in a debt, equity or credit default swap index or a CIU, or where the derivative contracts have multiple underlying reference names, institutions shall determine the indirect exposure values to a client arising from the derivative contracts referred to in paragraph 1 and the contribution of that exposure to the exposure to a client in accordance with the methodology set out in Article 6.

Explanatory text for consultation purposes

These RTS provide a methodology for the calculation of exposure values arising from derivative contracts and credit derivative contracts as detailed in Articles 2 to 5. In Article 6, a methodology is provided for exposures arising from derivative contracts with multiple underlying reference names.

The RTS try to be as comprehensive as possible, yet it might be the case that the methodologies provided in the provisions of the RTS would not cover appropriately certain derivative contracts.

In addition, for indirect exposures with single underlying components, the RTS is providing for 3 categories of derivatives, building on the LEX standard.

¹⁸ 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).

Questions for consultation

Question 1: *What are your views on the three proposed categories of derivatives? Are they 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 of derivative contracts? Please provide concrete examples and reasoning as well as suggested amendments to the methodology, if any.*

Article 2

Allocation of the indirect exposures to categories of derivative contracts

For the purposes of this Regulation, institutions shall allocate the indirect exposures referred to in Article 1(1) to one of the following categories of derivative contracts:

- (a) Options on debt and equity instruments;
- (b) Credit derivative contracts;
- (c) All other derivative contracts listed in Annex II of Regulation (EU) No 575/2013 having as underlying asset a debt or equity instrument and which are not included in the categories referred to in points (a) and (b).

Article 3

Calculation of the indirect exposure value for options on debt and equity instruments

1. As a general rule, and subject to paragraphs 2 to 4, the indirect exposure value for options referred to in point (a) of Article 2 shall be calculated as the sum of the current market value of the option and the amount owed to the counterparty of the option as a result of a potential default of the issuer of the underlying instrument reduced by the amount owed to the institution by that counterparty in that event.
2. For call options, the indirect exposure value shall be equal to the value of the market value of the option. For a long position in a call option, the indirect exposure value shall be positive while for a short position in a call option, the indirect exposure value shall be negative.
3. For put options, the indirect exposure value shall be the value of the difference between the market value of the option and its strike price. For a short position in a put option, the indirect exposure value shall be positive while for a long position in a put option, the indirect exposure value shall be negative.

4. By way of derogation from paragraph 3, for put options not having a strike price available at transaction date but available at a later stage, institutions shall use the expected modelled strike price used for the calculation of the fair value of the option.
5. Where the market value of the option is not available on a given date, institutions shall take the fair value of the option on that date; where neither the market value nor the fair value of an option are available on a given date, institutions shall take the most recent of the market value or the fair value. If neither the market value nor the fair value of an option are available at any date, institutions shall take the value at which the option is measured in accordance with the applicable accounting framework.

Explanatory text for consultation purposes

The methodology proposed for the calculation of indirect exposures arising from options applies independently from the allocation of those instruments to the trading book or non-trading book. The EBA does not see the need of introducing divergent approaches for trading book and non-trading book since the proposed methodology should allow institutions to calculate indirect exposures arising from options in both cases. In addition, the proposed methodology includes a cascading approach starting from the market value but imposing considering alternative values when the market value is not available on a given date.

Questions for consultation

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

Question 4: *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?*

Question 5: *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.*

Question 6: *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.*

Article 4

Calculation of the indirect exposure value for credit derivative contracts

1. The indirect exposure value to a client arising from credit derivative contracts referred to in point (b) of Article 2 shall be calculated as the sum of the current market value of the credit derivative contract and the amount owed to the counterparty of the credit derivative contract as a result of a potential default of the issuer of the underlying instrument reduced by the amount owed to the institution by that counterparty in that event.
2. Where the market value of the credit derivative is not available on a given date, institutions shall take the fair value of the credit derivative on that date; where neither the market value nor the fair value of the credit derivative are available on a given date, institutions shall take the most recent of the market value or the fair value. If neither the market value nor the fair value of a credit derivative contract are available at any date, institutions shall take the value at which the credit derivative contract is measured in accordance with the applicable accounting framework.
3. By way of derogation from paragraph 1, institutions shall set to zero the indirect exposure value corresponding to credit derivative contracts that have been used as credit risk mitigation technique to reduce exposure values for large exposures purposes in accordance with Article 399 of Regulation (EU) No 575/2013.

Explanatory text for consultation purposes

When credit derivative contracts are assigned to the non-trading book and are used as credit risk mitigation technique for large exposure purposes, as prescribed in Article 399 CRR, institutions shall set the value of such indirect exposure to zero. This Regulation shall take this into consideration in order to avoid a double counting of those exposures. On the contrary, when the credit derivative contract is assigned to the trading book or the non-trading book and is not considered as an eligible credit risk mitigation technique for large exposure purposes, as prescribed in Article 399, institutions have to reduce the indirect exposure toward the reference name by the value of the credit protection and have to add the positive value of the indirect exposure to its exposure toward the protection buyer.

Questions for consultation

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

Question 8: *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.

Article 5

Calculation of the indirect exposure value for other derivative contracts listed in Annex II of the Regulation (EU) No 575/2013

1. In order to calculate the indirect exposure value to a client arising from other derivative contracts referred to in point (c) of Article 2, such as swaps, futures or forwards, institutions shall decompose their multiple transaction legs into individual transaction legs.
2. For those transaction legs entailing default risk, institutions shall calculate their indirect exposure value as if they were positions in those legs.
3. Where an institution cannot apply the treatment provided for in paragraphs 1 and 2, it shall determine the indirect exposure value toward the issuer of the underlying instruments as the maximum loss that the institution would incur from a potential default of the issuer of the underlying instruments to which the derivative contract refers.

Explanatory text for consultation purposes

Article 5 provides a methodology for the calculation of the exposure value arising from other derivative contracts (except options and credit derivative contracts) not entered into directly with an institution's client but for which the underlying debt or equity instrument was issued by that client.

There might be cases where the methodology set out in paragraphs 1 and 2 might not be suitable because the derivative cannot be decomposed in legs and, at the same time, it would not fall in the option/credit derivative category. The EBA has decided to include, for consultation purposes, an alternative calculation of the exposure value arising of other derivative contracts, a "fallback approach". In accordance with the fallback approach, the value of the indirect exposure of the underlying instruments would be calculated as the maximum loss that could occur following the default of the underlying client to which the derivative refers.

Questions for consultation

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

Question 10: *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.*

Article 6

Calculation of the indirect exposure values arising from derivative contracts on indices or CIUs or with multiple underlying reference names

1. In order to determine the indirect exposure value to a client arising from derivative contracts written on debt, equity or credit default swap indices or CIUs, institutions shall look through to all the individual underlying instruments of the index or CIU and calculate their indirect exposure value as the variation in the price of the derivative contract in case of default of any of the underlying reference names included in the index or CIU. Institutions shall assign each indirect exposure value either to an identified client, a separate client or the unknown client, as laid down in Articles 6(1) and 6(2) of Commission Delegated Regulation (EU) No 1187/2014.¹⁹
2. Where the institution is not able to look through to all the individual underlying instruments of the derivative contract as provided for in paragraph 1 or where it would be unduly burdensome for the institution to do so, it shall calculate the indirect exposure value by looking at the variation of price of the derivative in case of default of all underlying reference names of the index or CIU. The indirect exposure value shall then be assigned either to a separate client or to the unknown client, as laid down in Article 6(3) of Commission Delegated Regulation (EU) No 1187/2014.
3. In order to determine the exposure value in case of derivative contracts with multiple underlying reference names that are not included in an index or CIU, an institution shall look through to all individual underlying instruments of the derivative contract and calculate the indirect exposure value to the issuer of each of those underlying instruments as the variation in the price of the derivative in case of default of that issuer. The exposure value shall then be assigned to each identified client.

Explanatory text for consultation purposes

The RTS include methodologies for the calculation of indirect exposures arising from multi-underlying derivative contracts, whether or not they constitute a structure.

Paragraph 1 details the methodology where institutions are able to perform the look-through towards all the reference names underlying the derivative contract. In this case, the indirect exposure values would be calculated as the difference in price due to the default of any of the

¹⁹ Commission Delegated Regulation (EU) No 1187/2014 of 2 October 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council as regards regulatory technical standards for determining the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets (OJ L 324, 7.11.2014, p.1).

underlying names. Thus, in the case of a derivative contract with "n" underlying names, institutions have to calculate "n" indirect exposures to any of the underlying names and then assign the exposure values to identified clients, separate clients and/or the unknown client following the rules laid down in Articles 6 (1) and 6 (2) of Commission Delegated Regulation (EU) No 1187/2014.

But there might be cases where institutions cannot look through all the components of the structure, or they would find it too burdensome to do so (e.g. for diversified indices). For such cases, and as detailed in paragraph 2, an institution shall calculate the indirect exposure treating the underlying instruments as a single instrument, that is, assuming that all the reference names of the underlying structure default. This value would then be considered as a direct exposure in the multi-underlying instrument. Thus, in the case of a derivative contract with "n" underlying names, institutions have to calculate a single direct exposure assuming the default of all the "n" names. Following this calculation, the institution would have to assign the exposure value to a separate client or to the unknown client pursuant to the rules laid down in Article 6(3) of Commission Delegated Regulation (EU) No 1187/2014.

Finally, Article 6 also takes into account the case of derivative contracts with multiple underlying reference names, yet not constituting a structure. In this case, the underlying reference names can always be identified, paragraph 3 provides that institutions shall look through all the reference names underlying the derivative contract and calculate the indirect exposure value to the issuer of each of those underlying clients as the variation in the price of the derivative in case of default of that client (therefore, no fallback approach is proposed).

Questions for consultation

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?*

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?*

Article 7

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*

[Position]

5. Accompanying documents

5.1 Draft cost-benefit analysis / impact assessment

Regulation (EU) 2019/876, amending the Capital Requirements Regulation (EU) No 575/2013, amended Article 390 CRR by introducing a new paragraph 5 requiring institutions to add to the total exposure to a client the exposures arising from derivative contracts listed in Annex II and credit derivative contracts where the underlying debt or equity instrument was not issued by the institution's direct counterparty. Furthermore, paragraph 9 mandates the EBA to develop draft regulatory technical standards *"to specify how to determine the exposures arising from derivative contracts and credit derivative contracts, where the contract was not directly entered into with a client but the underlying debt or equity instrument was issued by that client for their inclusion into the exposures to the client"*.

Article 10 paragraph 1 of the EBA founding Regulation (Regulation (EU) No 1093/2010) states that the Authority shall conduct open public consultations on draft regulatory technical standards and shall analyse the potential related costs and benefits. This analysis should provide an overview of the findings regarding the problem to be dealt with, the solutions proposed and the potential impact of these options.

The present analysis provides the reader with an overview of the findings as regards problem identification, possible options to remove problems and their potential impacts. Given the nature and the scope of the draft RTS, and pursuant to the principle of 'proportionate analysis', this analysis is high-level and qualitative in nature. A qualitative analysis is provided for the potential impact of the options; whereas a quantitative analysis is provided only for the potential perimeter on which this legislation would apply.

The qualitative analysis presents the advantages and disadvantages of different options. Moreover, the quantitative analysis relies on information available through the Supervisory Reporting Templates (i.e. COREP) and, in particular, it leverages only on data provided in the EBA sample. This way, it is not necessary to collect information from National Competent Authorities (NCAs) or directly from banks²⁰.

A. Problem identification and baseline scenario

An excessive concentration of exposures towards a single counterparty has long been recognised as a major threat for banks' stability. In 1991, the Basel Committee for Banking Supervision (BCBS) issued supervisory guidance on large exposures. However, until recent years no clear guidance was

²⁰ An Ad-hoc data collection is a costly and time-consuming process. For this reason it is preferable, whenever it is possible, to exploit data that are readily available from statistical agencies and databases.

available on how banks should measure their exposures to a single counterparty and, in particular, which factors they should take into account when considering whether separate legal entities form a group of connected counterparties. This has resulted in a considerable variation of practices across banks. The experience gathered during the 2008 financial crisis showed that banks did not always measure exposures to single counterparties in a consistent manner across their books and operations.

Beside direct exposures, indirect exposures can also arise through financial instruments like derivatives. Indeed, a derivative contract can give rise to an indirect credit exposure when the issuer of the asset underlying the derivative is not the counterparty of the derivative contract. Recognising these exposures is important to ensure an exhaustive evaluation of the concentration risk. However, given the technical aspects connected with these instruments, a considerable variation of practices across banks can be expected.

The baseline is represented by the definition of indirect exposures provided by Article 390(5) CRR: <<*Institutions shall add to the total exposure to a client the exposures arising from derivative contracts listed in Annex II and credit derivative contracts, where the contract was not directly entered into with that client but the underlying debt or equity instrument was issued by that client*>>

This definition does not provide practical indications as to how to measure the exposures and leaves unclear some aspects regarding the scope of application. For example, it is not specified whether it applies only to issuers that are already a client of the institution or it is sufficient that an institution is indirectly exposed to the issuer of an underlying to consider that issuer as a client. Moreover, since it is possible that the default of the issuer generates a reduction of the exposure (for example, in the case of a long position on a put option) it is not specified whether it is possible to account for this reduction and net the exposures.

The lack of common criteria about these technical aspects could result in an inconsistent interpretation across banks.

B. Policy objectives

The rationale of Article 390(5) CRR stems from the fact that, whenever an indirect derivative exposure arises, the institution might incur a loss when the underlying client of the embedded derivative defaults. The objective of the RTS is to provide a harmonised approach to quantify the exposures arising from said financial instruments where the contract was not directly entered into with a client but the underlying debt or equity instrument was issued by that client. In this regard, the RTS defines the methods to quantify the exposure amount for different categories of derivatives contracts whether allocated to the trading or non-trading book.

Quantitative Analysis

The following table has been obtained by exploiting the information contained in the COREP templates. In particular, Article 390 paragraph 7 CRR requires that all institutions assess their underlying exposures taking into account the economic substance of the structure of the

transaction and the risks inherent in the structure of the transaction itself, in order to determine whether it constitutes an additional exposure. Column 180 of template C28 provides the amount of these exposures for the borrowers identified as large.

The sample is constituted by 129 banks - excluding subsidiaries - from 27 countries. The data are at consolidated level.

At end-2019, the amount of exposures recognized under Article 390(7) CRR amounted to EUR 85bn equivalent to 0.3% of the exposures towards borrowers identified as large. At bank-level, average values above 1% can be found in six countries (AT, DE, FI, FR, IT, PT). The highest value at bank-level is 11.4%. At single-borrower level, it is possible to observe some cases where this type of exposure represents a relevant portion of the total exposure.

Exposures recognized under Article 390 (7) CRR. Relative share of the Large Exposures, Dec. 2019.

Country	Average	Max at bank level	Max at borrower level
AT	0.70%	11.40%	100.00%
BE	0.00%	0.00%	0.00%
BG	0.00%	0.00%	0.00%
CY	0.00%	0.00%	0.00%
DE	0.50%	3.20%	100.00%
DK	0.00%	0.00%	0.00%
EE	0.00%	0.00%	0.00%
ES	0.00%	0.40%	3.40%
FI	0.70%	1.00%	38.50%
FR	0.60%	2.10%	100.00%
GB	0.00%	0.80%	100.00%
GR	0.00%	0.00%	0.00%
HU	0.00%	0.00%	0.00%
IE	0.00%	0.00%	0.00%
IS	0.00%	0.00%	0.00%
IT	0.10%	1.40%	100.00%
LT	0.00%	0.00%	0.00%
LU	0.00%	0.00%	0.00%
LV	0.00%	0.00%	0.00%
MT	0.00%	0.00%	0.00%
NL	0.00%	0.00%	0.00%
NO	0.00%	0.00%	0.00%
PL	0.00%	0.00%	0.00%
PT	0.50%	2.60%	84.40%
RO	0.30%	0.30%	94.70%
SE	0.00%	0.00%	0.00%
SI	0.00%	0.00%	0.00%

Source: Corep

The main conclusion of this analysis is that these RTS would likely affect about 1% of the Large Exposures reported at the end of 2019 at country-level. This result thus justifies the present simplified Impact Assessment.

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 retained in the CP.

Scope of the RTS

The common framework presented in these draft RTS ensures a harmonized identification and quantification of the exposures arising from financial instruments where the underlying debt or equity instrument was not issued by the direct counterparty of the contract. The draft RTS provide the methodologies to specify the exposures arising from derivative contracts as listed in Annex II of the CRR as well as credit derivative contracts, allocated to both trading and non-trading books. The draft RTS classify derivative contracts in three categories, following the Basel methodology, and set out the way to determine the exposures arising from each category.

The main disadvantage of any new regulatory product like RTS is that it increases the complexity of the Regulation and, potentially, increases the costs of compliance. However, given the technicality of the item, it is deemed that without the indications provided by the RTS, the application of Article 390(5) CRR could give rise to different interpretations across banks and jurisdictions, thus putting in jeopardy the identification of large exposures arising from derivative contracts and credit derivative contracts in the EU's internal market.

Scope of application

The main options considered as regard the scope of application are three:

1. In which cases it is not required to quantify the indirect exposures.
2. Whether to restrict the need to quantify indirect exposures only for issuers that are already clients of the bank or extend it to any issuer.
3. Whether to extend the need to quantify the indirect exposure also when the underlying reference of a derivative contract is an index.

Concerning the first point, an option considered during the discussions was to exclude from the scope of these draft RTS those derivatives where the underlying contracts cannot be issued by the client or where a contract does not entail default risk. This would have had the potential to simplify materially the operational burden.

Furthermore, by extending the scope of application of Article 390(5) CRR to issuers that are not already clients of the bank and also to derivatives referring to indexes, the draft RTS require to collect information about clients not already recorded in the bank's systems and to do a look-through analysis in case of indexes (based on Commission Delegated Regulation (EU) No 1187/2014 of 2 October 2014).

One of the disadvantages of such extensions of the scope of application is the necessity for institutions to collect the information needed to register additional clients in their databases.

However, to reduce the operational burden on institutions, a materiality threshold of 0.25% of the bank’s Tier 1 is foreseen. The RTS also clarify the approach when an institution is not able to distinguish the underlying exposures of a transaction. An additional possibility to reduce burden is that, in case the derivatives’ issuer is committed to substitute an asset which issuer is defaulted with an equivalent one, the bank would not be required to perform the look-through analysis.

Considering both the importance to obtain a comprehensive quantification of the exposures toward large borrowers and the provisions envisaged by the RTS to reduce the burden whenever the materiality of the exposure is limited, it is deemed that the benefits compensate the costs. An additional reason to catch non-existing clients is to prevent arbitrage, which could lead to an unlevelled playing field among institutions.

Questions for consultation

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

5.2 Overview of questions for consultation

Question 1: What are your views on the three proposed categories of derivatives? Are they 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 of derivative contracts? Please provide concrete examples and reasoning as well as suggested amendments to the methodology, if any.

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

Question 4: 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?

Question 5: 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.

Question 6: 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.

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

Question 8: 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.

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

Question 10: 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.

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?

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?

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 in page 30 which allows to measure the indirect exposure arising from the derivative and credit derivative contracts that will be affected by this RTS.

5.3 Annex I

