EBA/CP/2023/19

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Consultation Paper

Draft Regulatory Technical Standards

on extraordinary circumstances for continuing the use of an internal model or discarding certain back-testing overshootings under Article 325az(9) CRR

Contents

1. Responding to this consultation

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

Comments are most helpful if they:

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

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by **3 November 2023**. 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

Article 325az(9) of Regulation (EU) No 575/2013 ('CRR') mandates the EBA to specify the extraordinary circumstances under which competent authorities may soften or waive the application of certain requirements for the use of internal models for market risk.

These draft RTS as presented in this consultation paper establish a high-level framework for identifying a situation of extraordinary circumstances, setting out conditions that need to be met and indicators that could support the identification of extraordinary circumstances.

More specifically, these RTS set out that only a situation of cross-border financial market stress, or a regime shift, can qualify as a situation of extraordinary circumstances, and only subject to the additional condition that this stress or regime shift impacts the validity of the results of the back-testing or the PLAT.

In order to assess whether the two conditions mentioned in the previous paragraph are met, these draft RTS specify that, among other factors and indicators reflective of the nature of the stress or regime shift, the levels of volatility should be assessed. These RTS also require taking into consideration, how quickly the financial stress manifested or the regime shift happened.

Next steps

The EBA will assess the feedback received during the public consultation, before submitting the final draft to the Commission.

3. Background and rationale

1. Article 325az(9) of Regulation (EU) No 575/2013 ('CRR') mandates the EBA to specify the extraordinary circumstances under which competent authorities may permit an institution to:

    - continue using their alternative internal models for the purpose of calculating the own funds requirements for the market risk of a trading desk that does not meet the back-testing requirements any longer or fails the profit and loss attribution test, and/or
    - limit the add-on to the one resulting from overshootings under back-testing hypothetical changes.

2. It should be noted that, as part of the on-going legislative process for amending the CRR (CRR3 revisions), the co-legislators proposed an amendment that would introduce the possibility to exclude overshootings resulting from the back-testing of hypothetical or actual changes from the calculation of the add-on as referred to in Article 325bf(6) CRR (addition of a point (c) to Article 325az(9)). If that amendment becomes part of the final CRR3 text, the provisions of these RTS will also be relevant to determine the circumstances under which that discretion can be used by the competent authority.

3. The tool provided for in Article 325az(9) CRR enables competent authorities to waive the application of certain requirements of the regulatory framework, or to soften the rules, where, and to the extent that, the full application of the framework in extraordinary circumstances (e.g. an extraordinary stress situation) is considered to subject institutions to regulatory requirements that may not be appropriate in those extraordinary circumstances. Such a tool avoids the need to make cumbersome changes to the legislative framework, like the changes to the Prudent Valuation framework made[1], or the temporary possibility to exclude certain overshooting introduced[2], during the COVID-19 crisis, every time a situation is deemed to be too extraordinary to continue applying the regulatory requirements in full.

4. If permissions to derogate from the regulatory framework were granted frequently, the substance of that regulatory framework would be undermined, and the framework would no longer serve its purpose. The Basel Committee on Banking Supervision (BCBS) specified in its standards for market risk[3], that a derogation should only be granted in most extraordinary, systemic circumstances, that affect several institutions. In line with the principle stipulated by the BCBS, these draft RTS as presented in this consultation paper foresees that extraordinary circumstances could be recognised only, where there is a situation of significant cross-border

[1] See EBA statement on the application of the prudential framework on targeted aspects in the area of market risk in the COVID-19 outbreak and Regulation (EU) 2020/866

[2] Article 500c CRR, introduced by Regulation (EU) 2020/873 ('CRR quick fix')

[3] MAR 32.45

financial market stress, or a major regime shift associated with a similar level of stress (e.g. a liquidity crisis), that are capable of rendering the outcome of the back-testing and profit and loss attribution requirements inappropriate.

5. The BCBS framework also clearly stipulates that extraordinary circumstances are meant to address situations of systemic stress, i.e. expected to have an impact on several types of portfolios. This is reflected in these draft RTS as presented in this consultation paper. In particular, these RTS' focus on financial market stress and major regime shifts ensures that the extraordinary circumstances framework cannot be triggered by the situation and specificities of a single institution.

6. Extraordinary circumstances may impact different institutions in a different manner and to a different extent. Once a situation of extraordinary circumstances was recognized in accordance with the provisions of the RTS, the competent authorities should, to the extent possible, analyse the impact on the different institutions under their supervision. Based on that analysis, a competent authority may, but does not have to, grant a permission to derogate from the existing regulatory framework to a particular institution. If the competent authority decides to grant such a permission, it should tailor the permission to the particular situation of that institution; among others, to ensure that known model deficiencies keep being accounted for, and continue to be remedied and/or capitalised.

7. These draft RTS as set out in this consultation paper establish a high-level framework for identifying a situation of extraordinary circumstances in the sense of Article 325az(9) CRR, setting out conditions that need to be met and indicators that could support the identification of extraordinary circumstances.

8. A situation associated with a degree of stress that is sufficiently extraordinary to consider softening or waiving the applicable requirements is one where, at the very least, the volatility observed in the market increases significantly. For that reason, these draft RTS envisage that one of the more important indicators to take into account when deciding whether there is a situation of extraordinary circumstance, are volatility indicators, including indicators of realised volatilities.

9. However, a significant increase of the volatility as such and on its own is not sufficient to declare a situation as severe and extraordinary; the boundary between increased volatility levels that can be expected and should, commonly, be accounted for in the normal course of business, and extreme volatility levels that characterize the situations a one of a crisis, is blurred. For that reason, a decision to trigger the 'extraordinary circumstances'-framework should also be based on other indicators and factors, that suitably reflect the source, nature and impact of the financial market stress or the regime shift. As the type and extent of stress and crises are commonly not predictable, this consultation paper does not specify in further detail what kind of indicators and factors could be considered.

10. Both the back-testing in accordance with Article 325bf CRR, and the profit and loss attribution test (PLAT) performed in accordance with Article 325bg CRR consider the period of 250 business days, and any development therein, preceding the reference date of the assessment. Thus, a period of stress, irrespective of its length, will impact the results of the back-testing and PLAT performed during the stress period itself and up to a year after the end of the stress period. In case of the back-testing, only relevant overshootings observed during the stress period itself should be possible candidates for exclusion in accordance with Article 325az(9), points (b) or (c) (if added in the CRR3), CRR. In case of the PLAT, the failure to meet the PLAT (i.e. having the desk classified as red or amber) at any assessment date during the stress period itself or the twelve month following it might be considered a possible case for granting a permission in accordance with Article 325az(9), point (a), CRR. In terms of time and duration of application, the competent authority's permission may thus also cover, to some extent, a period after the stress subsided.

11. In the light of this, these RTS defines a period of extraordinary circumstances a period, which may not cover just the stress period itself, but a combination of the stress period and the subsequent 'impact period' of up to 250 business days.

4. Draft regulatory technical standards

COMMISSION DELEGATED REGULATION (EU) …/…

of XXX

supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards specifying the extraordinary circumstances under which competent authorities may permit an institution to continue using its alterantive internal model for the purpose of calculatinghte own funds requirements for market risks or to discard certain back-testing overshootings

(Text with EEA relevance)

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 amending Regulation (EU) No 648/2012[4], and in particular Article 325az(9), third subparagraph, thereof,
Whereas:

(1) According to the standards for market risk set by the Basel Committee on Banking Supervision (BCBS), competent authorities may permit institutions to derogate from the compliance with certain requirements of the alternative internal models approach related to the back-testing and the profit and loss attribution test (PLAT). In line with the principle stipulated by the BCBS, extraordinary circumstances should therefore be recognised only, where there is a situation of significant cross-border financial market stress, or a major regime shift, that affects institutions all across the EU or EEA.

(2) Extraordinary circumstances should also only be recognised to the extent that the consequences of not meeting the requirements of Article 325bf (back-testing) or 325bg (PLAT) of Regulation (EU) No 575/2013, are deemed inappropriate, considering that the results of those tests are triggered by events that are beyond the institutions' control.

(3) Both the back-testing and the PLAT take into account information about the 250 business days preceding the date where the respective test is performed. Thus, extraordinary circumstances should be recognised, where a period of financial market stress or of a regime shift fully or partially included in that 250 business days-interval produce inappropriate test results.

(4) The features of a crisis leading to financial market stress, or of a regime shift, are unique to every such crisis or regime shift. Therefore, ex ante, it would not be appropriate to lay out, in a prescriptive manner, an exhaustive set of indicators or factors, that would be deemed to always adequately capture the nature and intensity of the financial market stress or regime shift at hand. However, past experience shows

[4] OJ L 176, 27.06.2013, p. 1.

that there are common traits of situations that are understood to be crisis situations, or situations associated with a certain degree of stress: those common traits are mainly a significant increase of the level of volatility and the fact that the financial market stress or regime shift manifests very quickly and suddendly. Still, such a sudden increase of the level of volatility, on its own, may not be sufficient to characterise a situation as one of financial market stress or of a regime shift and should, therefore, not automaticaly entail the recognition of extraordinary circumstances as referred to in Article 325az(5) and Article 325bf(6), second subparagraph, of Regulation (EU) No 575/2013.

(5) This Regulation is based on the draft regulatory technical standards submitted to the Commission by the European Banking Authority.

(6) The European Banking Authority 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 advice of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council[5],

HAS ADOPTED THIS REGULATION:

Article 1

1. Whenever the compliance with the requirements set out in Article 325bf of Regulation (EU) No 575/2013 is being assessed or the profit and loss attribution test in accordance with Article 325bg of that Regulation is being performed, extraordinary circumstances shall be deemed to be in place, where the period of 250 business days that is considered in those assessments and tests includes a period where all of the following conditions are met:

   (a) a significant cross-border financial market stress has been observed or a major regime shift has taken place;

   (b) the financial market stress or major regime shift referred to in point (a) is likely to render the outcome of the back-testing performed in accordance with Article 325bf of Regulation (EU) No 575/2013 or of the profit and loss attribution test performed in accordance with Article 325bg of that Regulation inappropriate, including when those tests produce results that do not relate to deficiencies in the internal model.

2. In order to assess whether the conditions specified in paragraph (1) are met, factors and indicators that are representative of or reflect the nature of the stress or regime shift shall be taken into account, including all of the following:

   (a) the analysis of relevant volatility indices, and indicators of realised volatilities, deemed to be suitable to capture the nature of the financial market stress or regime shift;

[5] 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. 12–47.).

(b) the assessment of whether the financial market stress or major regime shift led to volatility levels that are comparable to, or exceed, those observed during the global financial crisis or the COVID-19 pandemic;

(c) the assessment of how quickly the financial stress manifested or the regime shift happened.

For the purposes of the first subparagraph, point (c), with regard to the back-testing performed in accordance with Article 325bf of Regulation (EU) No 575/2013, it shall be taken into particular consideration, whether and to which extent the statistical characteristics observed during the period of financial market stress or regime shift differ from the those observed during the reference period used for the calibration of the Value-at-risk-number in accordance with Article 325bf of that Regulation.

Article 2

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

Questions for consultation

Q1. Besides volatility indices like, for example, the VIX and VSTOXX, are there any other factors or indicators, in your view, that could be used to identify situations of significant cross-border financial market stress or of a major regime shift?

Q2. Do you agree with the approach presented in the RTS? If not, please clarify which alternative approach could be used or which additional aspects should be taken into consideration.

Q3. What kind of regime shifts would you expect to render the outcome of the back-testing/PLAT inappropriate?

Q4. How do you expect the PLAT results to be affected or to deteriorate during a period of financial stress or a regime shift, and what are the reasons for your expectation?

5. Accompanying documents

5.1 Draft cost-benefit analysis / impact assessment

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

This analysis presents the IA of the main policy options included in this Consultation Paper on these Draft Regulatory Technical Standards on extraordinary circumstances for continuing the use of an internal model under Article 325az(9) CRR ('these draft RTS'). The analysis provides an overview of the identified problem, the proposed options to address this problem as well as the potential impact of these options. The IA is high level and qualitative in nature.

A. Problem identification and background

To calculate their market risk own funds requirements for the portfolio of some or all positions assigned to trading desks, institutions may use, subject to a permission from their respective competent authorities, an internal model approach as described in Part Three, Title IV, Chapter 1b of the CRR. Competent authorities shall grant permission to those institutions to use their internal model approach, provided that requirements stipulated in Article 325az of the CRR are met. Amongst those requirements, there are a back-testing ('BT') and a profit and loss attribution test ('PLAT') requirement[6]. Where a trading desk of an institution does not meet the BT or PLAT requirements, the own funds requirements for that desk have to be calculated on the basis of the Standardised Approach set out in Part Three, Title IV, Chapter 1a, CRR; where the institution or a desk meets the BT requirements, but does not perform well, it is subject to possibly significant add-ons to their own funds requirements for market risk. However, Article 325az(9) foresees the possibility that competent authorities may permit an institution, under extraordinary circumstances, to continue using its internal model for the purpose of calculating the own funds requirements for the market risk of a trading desk that does not meet either one or both of those two requirements in that period, or to benefit from a derogation that effectively reduces the capital add-on. Moreover, Article 325az(9) mandates the EBA to develop draft regulatory technical standards to specify the extraordinary circumstances under which competent authorities may give the above mentioned permission.

[6] Currently, in accordance with Article 325az CRR, the PLAT is not a requirement that institutions have to meet. They are only required to report those results. However, for simplicity and consistency with the wording included in Article 325az(9), the draft of the impact assessment already reflects a scenario where institutions are required to meet the PLAT requirements for using the internal model approach.

B. Policy objectives

The Draft Regulatory Technical Standards on extraordinary circumstances for continuing the use of an internal model under Article 325az(9) CRR aim to support for the identification of a situation of extraordinary circumstances.

C. Options considered, assessment of the options and preferred options

Section C. presents the main policy options discussed and the decisions made by the EBA during the development of the draft RTS. Advantages and disadvantages, as well as potential costs and benefits from the qualitative perspective of the policy options and the preferred options resulting from this analysis, are provided.

Extraordinary circumstances criteria

As mentioned above, the EBA is mandated to specify elements – indicators and conditions - that would allow the identification of exceptional circumstances. Such indicators and conditions could be derived from the principles established by the BCBS, which state that *'There may, on very rare occasions, be a valid reason why a series of accurate trading desk level models across different banks will produce many backtesting exceptions or inadequately track the P&L produced by the front office pricing model (for instance, during periods of significant cross-border financial market stress affecting several banks or when financial markets are subjected to a major regime shift)'*. As such, the EBA leveraged on the BCBS principles and states in the draft RTS that extraordinary circumstances shall be deemed to be in place where the period of 250 business days preceding the observation date comprises a significant cross-border financial market stress or a major regime shift which are likely to render the outcome of the tests underpinning the BT or the PLAT inappropriate. Nonetheless, in order to facilitate, more concretely, the assessment of whether such a significant cross-border financial market stress or major regime shift occurred, the EBA considered two options:

Option 1a: Setting in the Draft RTS granular and quantitative criteria that would automatically trigger the recognition of the significant cross-border financial market stress or major regime shift.

Option 1b: Setting in the Draft RTS more general criteria that should be taken into account to recognize the significant cross-border financial market stress or major regime shift.

Granular and quantitative criteria that automatically trigger the recognition of the significant cross-border financial market stress or major regime shift would have the benefit of simplicity; competent authorities, institutions and any other interested party would only have to analyse the development of specified indicators, and would not have to analyse, beforehand, the suitability of existing, or defined new indicators, that enable a deeper tailored analysis. Such an 'automated', or 'quasi-automated approach' based on similar, if not identical, indicators used by competent authorities, would also have the benefit of harmonizing the recognition of significant cross-border financial market stress or major regime shift across the competent authorities of the European Union, and ultimately support the level playing field between institutions everywhere in the EU. For instance, quantitative volatility indicators could be identified, and thresholds set for them in the draft RTS, as a degree of stress that is sufficiently extraordinary to consider softening or waiving the BT or PLAT requirements is, at the very least, associated with high, significantly increased volatility levels.

On the other hand, elements of a crisis leading to financial market stress, or of a regime shift, are unique to every such crisis or regime shift and as such, it is not possible to specify, ex ante, a reliable and exhaustive list of suitable indicators or factors in the RTS, that adequately capture the nature and intensity of potential future financial market stress or regime shift. Establishing a meant-to-be-exhaustive, but, considering real developments, too narrow list of indicators and factors feeding into an automated mechanism may result in the extraordinary circumstances framework being triggered too frequently or prematurely, and may effectively undermine the existing prudential framework.

For these two reasons, it is not advisable to prescribe, which indicators or factors – and their levels – should serve as the basis for identifying a significant cross-border financial market stress or major regime shift. More general, and therefore more flexible, criteria would be more fit for purpose.

As regards the cost of compliance with the provisions of the RTS, it is not expected that institutions would incur significant costs with regard to either option. Competent authorities have to invest a bigger effort to make a tailored analysis in order to recognize – or not – a significant cross-border financial market stress or major regime shift, when the RTS only stipulate more general criteria, compared to applying concrete, predefined granular and quantitative criteria. However, the costs are not deemed to be material in either case and exceeded by the above-mentioned benefits.

On the basis of the above, **the Option 1b has been chosen as the preferred option** and the Draft RTS will set more general criteria that should be taken into account to recognize the significant cross-border financial market stress or major regime shift.

D. Conclusion

The Draft Regulatory Technical Standards on extraordinary circumstances for continuing the use of an internal model under Article 325az(9) CRR will support the identification of a situation of extraordinary circumstances. It sets a framework for recognising a period of significant cross-border financial market stress or of a major regime shift, which may qualify as situations of extraordinary circumstances. For the institutions, the draft RTS is not expected to trigger costs. For the competent authorities, the benefit of having the leeway to take into consideration indicators and factors that truly reflect the nature of the extraordinary circumstances – would exceed the costs of the implementation of the process of recognition of extraordinary circumstances based on the more general criteria. On a more general point of view, main benefit of the draft RTS will be to establish a framework for triggering specific derogations from applying the provisions for the calculation of own funds requirements for market risk in circumstances were this is deemed warranted. Overall, the impact assessment on the draft RTS suggests that the expected benefits are higher than the incurred expected costs.

5.2 Overview of questions for consultation

Q1. Besides volatility indices like, for example, the VIX and VSTOXX, are there any other factors or indicators, in your view, that could be used to identify situations of significant cross-border financial market stress or of a major regime shift?

Q2. Do you agree with the approach presented in the RTS? If not, please clarify which alternative approach could be used or which additional aspects should be taken into consideration.

Q3. What kind of regime shifts would you expect to render the outcome of the back-testing/PLAT inappropriate?

Q4. How do you expect the PLAT results to be affected or to deteriorate during a period of financial stress or a regime shift, and what are the reasons for your expectation?