EBA/CP/2024/04

1 February 2024

Consultaton Paper

Draft Regulatory Technical Standards on the exemption from the residual risk add-on own funds requirements for certain type of hedges under Article 325u(4a) of Regulation (EU) No 575/2013 (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 03.05.2024. 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

One of the pillars of the standardised approach (SA) under the new fundamental review of the trading book (FRTB) framework is the residual risk add-on. It is calculated for all those instruments the risk of which is not sufficient covered by the sensitivity-based method (SbM) and the default risk charge (DRC) – the other two building blocks of the FRTB-SA. CRR2 provisions as well as the EBA RTS specifying technical details on the RRAO[1] provide guidance on the RRAO calculation.

As part of the CRR3 package, the co-legislators introduced a provision in the RRAO framework allowing the exemptions from the RRAO charge for those instruments bearing residual risks taken as a hedge for hedging instruments bearing residual risks too. What is subject to the exemption is just the hedge, i.e. the hedged position must always be capitalised with an RRAO charge.

Along with such provision, the co-legislators mandated the EBA to develop RTS specifying when an instrument qualifies as a hedge for the purpose of the exemption and when not. The mandate has been accordingly included in the EBA roadmap on Basel 3 implementation[2], and this consultation paper (CP) is a first step towards delivering that mandate.

The RTS proposed consultation require institutions to identify whether the RRAO charge for which the institution seeks the exemption relates to a risk factor that is not shocked in the SbM (i.e. non-SbM risk factor), or it is due to other reasons.

When the RRAO relates exclusively to a non-SbM risk factor, the RTS envisage conditions aiming at assessing that as a result of the hedge, the sensitivity towards the non-SbM risk factor is significantly reduced – CMS spread plain vanilla options are expected to fall under this case[3]. To ensure a fair application of the exemption, the RTS also require institutions to have in place a detailed internal policies setting out the details of the hedging strategy, as well as its expected effectiveness in terms of sensitivity against the non-SbM risk factor.

Instead, where the RRAO charge is due to other reasons than the presence of a non-SbM risk factor, the RTS allow the hedging instrument to be recognised as hedge, and as such exempted from the RRAO charge, only if it completely offsets the RRAO risk stemming from the hedged instruments.

Given the importance of the exemption in terms of capital requirements, the RTS proposed for consultation also include a revision of the fulfillment of the conditions set out in the RTS from an independent reviewer.

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1 https://www.eba.europa.eu/regulation-and-policy/market-risk/regulatory-technical-standards-residual-risk-add#pane-new-7bdd87fb-e02f-492a-99d6-129449e3cf9d

2 See EBA Roadmap on strengthening the prudential framework_1.pdf (europa.eu)

3 CMS spread options are typically hedged by other CMS spread option. The exemption from the RRAO charge is expected to be mostly (if not only) triggered in the context of CMS spread option.

The CP includes several questions for consultation, aiming at understanding those cases where institutions intend to use the exemption provided in CRR, and assess whether the provisions proposed in the RTS address those cases in a suitable manner.

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. In the past years, the EBA has developed several RTS implementing in EU law the fundamental review of the trading book (FRTB) framework. This followed the approach set out in the EBA roadmap on FRTB[4] and allowed credit institutions to prepare for the implementation of the FRTB in EU in accordance with the recently agreed CRR3 package. This package transformed the FRTB reporting requirements into own funds requirements and transposed in EU law the building blocks of the so-called Basel III reforms.

2. Among others, the EBA developed RTS specifying technical details on the residual risk add-on (RRAO) framework[5], i.e. one of the three pillars of the FRTB standardised approach introducing a specific capital charge for those instruments bearing residual risks.

3. As part of the CRR3 package, the co-legislators introduced a provision in the RRAO framework allowing the exemptions from the RRAO charge for those instruments bearing residual risks taken as a hedge for hedging instruments bearing residual risks too. What is subject to the exemption is just the hedge, i.e. the hedged position must always be capitalised with an RRAO charge.

4. Along with such provision, the co-legislators mandated the EBA to develop RTS specifying when an instrument qualifies as a hedge for the purpose of the exemption and when not. The mandate has been accordingly included in the EBA roadmap on Basel 3 implementation, and this consultation paper (CP) is a first step towards delivering that mandate.

5. When developing these RTS, the EBA considered that based on the feedback received to its consultation paper on instruments subject to RRAO, the material case to be addressed by this provision is that relating to constant maturity swap (CMS) spread options. For other instruments, it appears that institutions do not use instruments bearing residual risks to hedge instruments bearing residual risks too.

6. The RTS therefore distinguish between cases where the residual risk linked to a financial instrument:

    a. Exclusively relates to risk factor that is not shocked in the SbM (i.e. non-SbM risk factor). Simple CMS spread options are expected to fall under this case, given that they bear an additional correlation risk factor that is not shocked as part of the sensitivity-based method.

    b. Relates to other reasons than the one stated in point a. For example, digital options or barrier options trigger the RRAO for their complex pay-off, or for the path dependent

[4] https://www.eba.europa.eu/eba-publishes-its-roadmap-for-the-new-market-and-counterparty-credit-risk-approaches-and-launches-consultation-on-technical-standards-on-the-ima-under

[5] https://www.eba.europa.eu/regulation-and-policy/market-risk/regulatory-technical-standards-residual-risk-add#pane-new-7bdd87fb-e02f-492a-99d6-129449e3cf9d

nature of the derivative. It should be noted that under this case, also instruments characterized by an exotic underlying fall. Accordingly, an exotic underlying is not treated as a non-SbM risk factor in the sense of point a.

7. In both cases, it is important to stress that:

   a. The instrument must act as a hedge for the source of risk that triggered the RRAO charge. For example, in case the hedged position is a CMS spread option, the hedging instrument must hedge the correlation risk (i.e. the course of RRAO risk).

   b. What is subject to the exemption is the RRAO charge as the source of risk is hedged. However, the SbM-charge and the default risk charge for the hedging instrument must always be capitalised. Furthermore, the RRAO charge is waived only for the hedging instrument – it is not waived for the hedged instrument.

The RRAO charge exclusively relates to the presence of one or more non-SbM risk factor

8. When the RRAO charge of a financial instrument exclusively relates to a non-SbM risk factor, the RTS proposed for consultation aims at ensuring that the financial instrument actually reduces the sensitivity towards that non-SbM risk factor. In particular, the RTS require the following:

   a. First, the institution needs to identify the above-mentioned non-SbM risk factor, and after having done so, it must map to that non-SbM risk factor the positions being hedged. The objective is to assess that the non-SbM risk factor in the instrument taken as a hedge has a clear relationship with the RRAO risk factor of the hedged instrument. The term “clear relationship” signals that the risk factors do not need to be exactly the same but that they need to be strongly correlated. Requiring the hedging risk factor and the hedged risk factor to be exactly the same would risk excluding from the regulatory treatment those instruments bearing risk factors that slightly differ, for example, in the maturity dimension only.

   b. Second, the instrument taken as a hedge must not bear other RRAO risk factors other than that it aims at hedging. This to avoid that instruments that are subject to exemption, while hedging some risks, they do not create other RRAO risks that are not capitalised.

   c. Third, the instrument taken for hedging significantly reduces the sensitivity towards the non-SbM risk factor for which it is intended as a hedge. This to ensure that the primary purpose of the instrument is to hedge. The RTS require the level of the assessment (of the sensitivity reduction) to be consistent with the level at which the hedging is performed in accordance with the internal policy of the institution. The CP consults on whether this requirement should be further framed by introducing a percentage level (50%) constituting a floor of what can be considered as a “significantly reduced sensitivity”.

It should be stressed that the wording used here above refers to a “non-SbM risk factor”. The legal text of the RTS however acknowledges that there could be cases where the hedging instrument attracts more than one non-SbM risk factor. That instrument could still qualify for the exemption, as long as the sensitivity towards all those risk factors is reduced when entering in the hedge.

9. The provisions above are completed by a requirement for the institution to have in place an internal policy setting out several aspects relating to the hedging, such as the hedging strategy, the level at which such hedging is performed, which are the trading desks involved, how the bank identifies and distinguishes the hedge from the hedging instrument. Furthermore, considering that the provision may have a material impact on banks’ own funds requirements, the RTS require that the fulfillment of the conditions for being recognised as a hedge are also subject to an independent review.

The RRAO charge relates to other reasons than the presence of a non-SbM risk factor

10. Where the RRAO relates to other reasons than the presence of a non-SbM risk factor, it appears more difficult to objectively assess whether the hedging instrument actually hedges the source of risk generating the RRAO charge, e.g. how a barrier in a given option can be hedged (by means of another RRAO-bearing instrument). Most importantly, in this case, since there is not a risk factor, it is not possible to compute an ex-ante and ex-post sensitivity (i.e. prior and after the hedge has been taken).

11. Furthermore, as mentioned in paragraph 5, the EBA developed the proposal in the CP, considering that the material case to be addressed by these RTS is that of CMS spread vanilla options, which clearly fall in the category of instruments subject to RRAO exclusively because of the presence of non-SbM risk factors.

12. The CP therefore takes a particularly prudent stance to qualify an instrument as a hedge for an RRAO risk that does not relate to a non-SbM risk factor. In particular, the RTS requires the hedging instrument to completely offset the RRAO risk linked to the hedged instrument. For example, in case of a barrier option, it means that the hedging instrument de-facto removes the effect of the barrier. Not taking such prudent stance would risk seeing instruments that do not genuinely act a hedge to be recognised as such.

13. The CP includes consultation questions to understand if there are material cases of instruments triggering RRAO that are used to hedge other instruments triggering the RRAO that would fall in this category (i.e. that of instruments with a RRAO risk that does not relate to the presence of a non-SbM risk factor). Furthermore, the CP includes questions to assess whether there would be alternative ways to objectively assess whether in this circumstance, the instrument acts as a hedge.

4. Draft regulatory technical standards

COMMISSION DELEGATED REGULATION (EU) …/…

of XXX

supplementing [Regulation/Directive][serial number] of the European Parliament and of the Council with regard to regulatory technical standards [for/specifying]

(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[6], and in particular Article 325u(6) thereof,

Whereas:

(1) Instruments may be exposed to residual risks either because they bear a risk factor that is not captured as part of the sensitivity-based method or because of other reasons, including the presence of a complex pay-off. In the former case, it is possible to compute a sensitivity towards the risk factor corresponding to the residual risk and it can therefore be objectively assessed whether an instrument is hedging the open position to that risk factor. This is instead not possible to the same degree in the latter case. Accordingly, a different framework should apply depending on whether the residual risk borne by the instruments subject to the exemption exclusively relates to the presence of a risk factor that is not shocked as part of the sensitivity-based method.

(2) For instruments the residual risks of which do not exclusively relate to the presence of a risk factor that is not shocked as part of the sensitivity-based method, the residual risk cannot be measured by means of a sensitivity. To ensure a prudent application of the exemption from the residual risk add-on own funds requirements, an instrument should be recognised as a hedge only if such a hedge completely offsets the residual risk borne by other instruments in the institution's portfolio.

(3) For instruments the residual risks of which exclusively relate to the presence of a risk factor that is not shocked as part of the sensitivity-based method, requirements aiming at assessing that also the hedged instrument bears the same type of risk as of the hedging instrument should be envisaged. The aim is to ensure that the instrument that may be exempted from the residual risk add-on own funds requirement actually acts as a hedge. For the same reason, requirements ensuring that the sensitivity towards the relevant risk factor is significantly reduced as a result of the hedge should be laid down.

[6] OJ L 176, 27.6.2013, p. 1.

(4) Given the potential materiality of the exemption in terms of impact on the own funds requirements, prudential safeguards should be envisaged, including a requirement for an independent review that would provide certainty around the process establishing whether an instrument acts as a hedge or not.

(5) To further ensure a consistent application of the exemption by institutions and competent authorities, a non-exhaustive list of instruments should be specified, clarifying whether those instruments are considered to bear residual risks that exclusively relate to the presence of a risk factor that is not shocked as part of the sensitivity-based method, or not.

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

(7) 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 109x/2010 of the European Parliament and of the Council[7],

HAS ADOPTED THIS REGULATION:

Article 1

Requirements for hedging instruments

1. Without prejudice to Article 2, hedging instruments shall be subject to the exemption laid down in Article 325u(4a) of Regulation (EU) No 575/2013 where all of the following conditions are met:

   (a) the instrument completely offsets the residual risk of the hedged instrument, and as a result, the combination of the hedging instrument and the hedged instrument replicates an instrument that would not be subject to the residual risk add-on own funds requirement;
   (b) the instrument is not exposed to any other residual risk other than that it aims at hedging;
   (c) the instrument is entered into in accordance with an internal policy of the institution that meets all the following conditions:

      (i) it specifies the instruments it intends to use to hedge other instruments, and substantiates the fact that those instruments when assessed together fulfill the conditions referred to in point (a);

[7] Regulation (EU) No 109x/2010 of the European Parliament and of the Council ...[+*full title*] (OJ L [number], [date dd.mm.yyyy], [p.].).

(ii) it lays down appropriate criteria for distinguishing the hedging instruments from the hedged instruments;

(iii) it ensures that the trading desks that carry out the hedging process monitor the evolution of the hedges during their lifetime, including the unwinding of the hedged instruments, and the net profit and loss of the combined positions;

(d) compliance with the conditions set out in points (a) to (c) is subject to the independent review referred to in Article 325c(4) of Regulation (EU) No 575/2013 [CRR3].

2. When setting out the criteria to distinguish the hedging instruments from the hedged instruments in accordance with paragraph 1, point (c)(iii), the internal policy shall consider all the following elements and shall require the trading desks that carry out the hedging process to document all of them:

(a) the identity of the counterparty;
(b) whether the trade was made in the interbank market;
(c) that the trade was done at arm's length;
(d) the rationale in choosing the counterparty.

Article 2

Requirements for instruments hedging non-SbM risk factors

1. By way of derogation from Article 1, hedging instruments meeting the conditions set out in Article 325u(2), point (b) of Regulation (EU) No 575/2013 exclusively because of their exposure to risk factors that are not included in the sensitivities-based method ('SbM') laid down in Part Three, Title IV, Chapter 1a, Section 2 of that Regulation ('non-SbM risk factors'), shall be subject to the exemption laid down in Article 325u(4a) of Regulation (EU) No 575/2013 where all of the following conditions are met:

(a) the institution maps the non-SbM risk factors of the hedged instruments to the non-SbM risk factors of the hedging instruments;

(b) the mapping referred to in point (a) shows a clear relationship between the non-SbM risk factors of the hedged instruments and the non-SbM risk factors of the hedging instruments;

(c) the hedging instrument is not exposed to any other residual risk other than those stemming from the non-SbM risk factors mapped in accordance with points (a) and (b);

Text for consultation
option A: (d) the institution's sensitivity towards the non-SbM risk factors is significantly reduced as a result of the hedge. The assessment of the achievement of such significant reduction shall be done at the level at which the hedge is performed in accordance with point (f)(iv);
option B: (d) the institution's sensitivity towards the non-SbM risk factors is reduced by at least 50% as a result of the hedge. The assessment of the achievement of such percentage shall be done at the level at which the hedge is performed in accordance with point (f)(iv);

(e) the remaining exposure towards the non-SbM risk factor is dynamically managed within a limit specific to that risk factor that is consistent with the limits set out in accordance with Article 103(2), point (b)(ii) of Regulation (EU) No 575/2013;

(f) the instrument is entered into in accordance with an internal policy of the institution that meets all of the following conditions:

(i) it specifies the risk management and hedging strategy, including the level of risk appetite in relation to the non-SbM risk factors;

(ii) the risk appetite referred to in point (i) is consistent with the position limits set out in accordance with Article 103(2), point (b)(ii) of Regulation (EU) No 575/2013;

(iii) it specifies the hedged instruments, the instruments that it intends to use as hedge, and their corresponding non-SbM risk factors;

(iv) it specifies whether the hedging is done at transaction, sub-portfolio, or portfolio levels and the designed duration of the hedge;

(v) where more than one trading desks are involved in entering the hedge and the hedged positions, it identifies the trading desks involved and specifies the role of each of them;

(vi) it lays down appropriate criteria for distinguishing the hedging instruments from the hedged instruments;

(vii) it lays down appropriate criteria for carrying out the mapping referred to in points (a) and (b);

(g) compliance with the conditions set out in points (a) to (f) is subject to the independent review referred to in Article 325c(4) of Regulation (EU) No 575/2013 [CRR3].

2. When setting out the criteria to distinguish the hedging instruments from the hedged instruments in accordance with paragraph 1, point (f)(vi), the internal policy shall consider all the following elements and shall require the trading desks that carry out the hedging process to document all of them:

(a) the identity of the counterparty;
(b) whether the trade was made in the interbank market;
(c) that the trade was done at arm's length;
(d) the rationale in choosing the counterparty.

3. For the purposes of this Regulation:

(a) the instruments listed in Annex 1 shall be considered as meeting the conditions set out in Article 325u(2), point (b) of Regulation (EU) No 575/2013 exclusively because of their exposure to non-SbM risk factors;

(b) the instruments listed in Annex II shall not be considered as meeting the conditions set out in Article 325u(2), point (b) of Regulation (EU) No 575/2013 exclusively because of their exposure to non-SbM risk factors.

Box for consultation

The proposed framework distinguishes between instruments bearing residual risks that are characterised by a non-SbM risk factor, and the rest of instruments. The EBA specifically seeks feedback on that distinction, and the treatment foreseen in the two cases (respectively included in Article 1 and Article 2). In addition, feedback is sought to understand whether the proposed framework addresses material cases where institutions hedge an instrument bearing residual risk with another instrument bearing residual risk.

Questions for consultation

Q1. Do you agree with the distinction between instruments with residual risks that are characterised by a non-SbM risk factor, and the rest of the instruments? Please elaborate.

Q2. Do you agree with the requirements set out in Article 2 for instruments with residual risks that are characterised by a non-SbM risk factor? What is your preferred option between option A and option B in point (d) of that Article? Please elaborate, highlighting operational challenges that you may face under the two options.

Q3. Do you agree with the requirements set out in Article 1 for instruments with residual risks that are not characterised by a non-SbM risk factor? In which cases, other than back-to-back positions, do you think hedging instruments would meet the conditions referred to in Article 1? Do you think there are alternative objective ways of assessing whether instruments currently falling under the treatment set out in Article 1 act as a hedge? Please elaborate.

Q4. What are your views in relation to the requirement to consider whether an instrument has been taken in the interbank market, as a way to distinguish the hedge from the hedged instrument? Which are the cases where the hedge is not performed with the interbank market? Please elaborate.

Q5. What are the material cases where institutions hedge an instrument with residual risks using other instruments with residual risks? Does the proposed regulation address those cases? If not, how can the assessment of the hedge be performed in those cases? Please elaborate.

Article 3

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

ANNEX I

1. multiunderlying options, including spread options and options with a basis as an underlying, which meet the following two conditions:

(i) the price of the option depends only on SbM risk factors and on the correlation between the underlyings;
(ii) the option does not fall in any of the categories listed in Annex II.

2. options not falling in any of the categories listed in Annex II and that are on an underlying denominated in one currency but whose pay-offs are settled in a different currency, with a predetermined exchange rate between the two currencies;

ANNEX II

1. options where the pay-offs depend on the path followed by the price of the underlying asset and not just its final price on the exercise date;

2. options that start at a predefined date in the future and whose strike price is not yet determined at the time at which the option is in the trading book of the institution;

3. options whose underlying is another option;

4. options with discontinuous pay-offs;

5. options allowing the holder to modify the strike price or other terms of the contract before the maturity of the options;

6. options that can be exercised on a finite set of predetermined dates;

7. options subject to behavioural risk.

5. Accompanying documents

5.1 Draft cost-benefit analysis / impact assessment

Article 325u(6) of the CRR mandates the EBA to develop a draft RTS to specify when an instrument qualifies as a hedge for the purpose of the exemption from the RRAO charge.

Article 10(1) of Regulation (EU) No 1093/2010 (EBA Regulation) provides that any RTS developed by the EBA should be accompanied by an analysis of the potential related costs and benefits. This analysis should provide an overview of the findings regarding the problem to be dealt with, the options proposed and the potential impact of these options.

This section presents the cost-benefit analysis of the main policy options included in the draft RTS. The analysis is high level and of a qualitative nature.

A. Background, Problem identification and Baseline scenario

Under the FRTB framework, the standardised approach (SA) comprises of three parts: a) the sensitivities-based method (SbM) for calculating the own funds requirement for market risk; b) the residual risk add-on (RRAO); c) the own funds requirements for the default risk (DRC). RRAO applies to instruments exposed to residual risks where they are either instruments referencing to an exotic underlying or instruments bearing other residual risks. CRR2 Article 325u(2) as well as the EBA RTS specifying technical details on the RRAO[8] provide guidance on the RRAO calculation.

In the CRR3, the introduced a provision in the RRAO framework allowing the exemptions from the RRAO charge for those instruments bearing residual risks taken as a hedge for hedging instruments bearing residual risks too. What is subject to the exemption is just the hedge, i.e. the hedged position must always be capitalised with an RRAO charge.

The lack of common specification on when instruments constitute a hedge for the purpose of the RRAO exemption could result in an inconsistent application of the RRAO across institutions, undermining the implementation of the FRTB standardized approach in the EU (called the alternative standardised approach).

B. Policy objectives

The specific objective of these draft RTS is to establish common criteria of when an instrument bearing residual risk qualifies as a hedge for the purposes of the RRAO exemption. In this way, these draft RTS aim to ensure a consistent implementation of the RRAO across EU institutions.

8 https://www.eba.europa.eu/regulation-and-policy/market-risk/regulatory-technical-standards-residual-risk-add#pane-new-7bdd87fb-e02f-492a-99d6-129449e3cf9d

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

C. Options considered, cost-benefit analysis, preferred option

General

The draft RTS has considered two options when setting the conditions that need to be met to recognize an instrument as a hedge for the purpose of the RRAO exemption:

Option 1a: Set conditions that distinguish between instruments that bear residual risks exclusively because they attract non-SbM risk factors, and the rest of instruments.

Option 1b: Set common conditions for all instruments, regardless of whether they bear residual risks exclusively because they attract non-SbM risk factors.

Option 1a allows to set different conditions for the two types of financial instruments, while Option 1b will set common conditions for all financial instruments. Option 1a recognises that the two types of financial instruments are of different nature and have different sources of risk. In the first case the hedging instrument attracts an RRAO charge exclusively because of the presence of one or more non-SbM risk factors. This allows to compute an institution’s sensitivity to these non-SbM risk factors with and without the hedge and set specific conditions that need to be met for this sensitivity. In the second case the RRAO charge relates to other reasons than the presence of a non-SbM risk factor, not allowing to compute an ex-ante and ex-post sensitivity (i.e. prior and after the hedge has been taken) and set any specific conditions in this regard. This important difference between the two types of instruments, allows Option 1a to set more specific and less punitive requirements for the case of instruments hedging non-SbM risk factors. On the other hand, Option 1b would err on the punitive side for all instruments, simply to avoid recognising hedging instruments other than instruments hedging non-SbM risk factors as hedges that do not genuinely act as a hedge.

Option 1a is kept.

Requirements for instruments hedging non-SbM risk factors

a. Institution’s sensitivity towards the non-SbM risk factors

For instruments hedging non-SbM risk factors to be recognised as hedging instruments, the draft RTS require that the institution’s sensitivity towards the non-SbM risk factors is reduced as a result of the hedge. The EBA has considered wo options for the level of this reduction:

Option 2a: the institution’s sensitivity towards the non-SbM risk factors is significantly reduced as a result of the hedge.

Option 2b: the institution's sensitivity towards the non-SbM risk factors is reduced by at least 50% as a result of the hedge.

Option 2a is more general and does not specify a specific level for the reduction in the institution's sensitivity as a result of the hedge; rather it specifies that the reduction shall be significant. As a downside, the term "significant" may leave excessive room for interpretation and lead to inconsistent application among banks. On the other hand, Option 2b is very prescriptive specifying the minimum level of reduction that should occur in the institution's sensitivity towards the non-SbM risk factors as a result of the hedge. This can result in Option 2b being overly prescriptive compared to Option 2a. On the other hand, Option 2b can generally improve harmonisation across banks, although with the caveat that the level of the assessment of the achievement of such percentage is not specified (e.g. transaction level or portfolio level).

Both options are put forward for consultation.

b. Institution's internal policy: criteria for identifying what is the hedge and the hedged instruments

For instruments hedging non-SbM risk factors to be recognised as hedging instruments, the draft RTS require that the hedge is entered in accordance with the institution's internal policy, which, among others, lays down criteria for identifying what is the hedge and the hedged instruments. The EBA has considered two options when setting these criteria:

Option 3a: The institution shall ensure that the internal policy takes into consideration the counterpart of the trade.

Option 3b: No specific considerations about the counterpart of the trade are prescribed.

Option 3a allows for a better identification of the hedge and hedged position, as it is expected that most hedges will be made in the interbank market and hence the information on the counterpart of the trade can be important for distinguishing between hedged and non-hedged positions. On the other hand, it may be more burdensome than Option 3b which would allow the institution to set these criteria as it sees appropriate.

Option 3a is kept.

c. Independent review

For an instrument hedging non-SbM risk factors to be recognised as a hedging instrument, it needs to meet the conditions laid out in Article 1(a)-(f). The EBA has considered two options to ensure compliance with these conditions:

Option 4a: Compliance with the conditions is subject to the independent review referred to in Article 325c(4) of Regulation (EU) No 575/2013.

Option 4b: Compliance with the conditions is not subject to the independent review referred to in Article 325c(4) of Regulation (EU) No 575/2013.

Option 4a ensures that compliance with the conditions is independently assessed, either as part of the institution's regular internal auditing process, or by mandating a third-party undertaking to conduct that review. Although an independent review may put an additional burden on institutions, the additional costs should be weighted against the need to have a more prescriptive framework in the absence of such safeguard. In that sense, Option 4b, which does not include an independent review of the conditions, would require a more prescriptive framework to ensure that the conditions are fulfilled.

Option 4a is kept.

Requirements for hedging instruments other than instruments hedging non-SBM risk factors

For hedging instruments other than instruments exclusively attracting non-SbM risk factors, the EBA has considered two options when setting the conditions to be met to recognise them as hedging instrument for the purposes of the RRAO exemption:

Option 5a: Require the hedging instrument to completely offset the RRAO risk linked to the hedged instrument.

Option 5b: Consider alternative less strict conditions.

Option 5a is based on a very strict condition, while Option 5b considers alternative less prudent conditions. The rationale behind Option 5a is that where the RRAO relates to other reasons than the presence of a non-SbM risk factor, it is more difficult to objectively assess whether the hedging instrument actually hedges the source of risk generating the RRAO charge, e.g. how a barrier in a given option can be hedged (by means of another RRAO-bearing instrument). Most importantly, in this case, since there is not a risk factor, it is not possible to compute an ex-ante and ex-post sensitivity (i.e. prior and after the hedge has been taken) and hence more difficult to set specific conditions that will be less strict under Option 5b. As a result, Option 5b has the risk of seeing instruments that do not genuinely act a hedge to be recognised as such. Furthermore, the EBA expects that there are no material cases, except for CMS spread options, where banks would hedge a RRAO instrument by means of another RRAO instrument. Accordingly, considering that CMS spread options are under the scope of those instruments exclusively relating to a non-SbM risk factor, an overly complex framework to capture other cases is not warranted. Hence, option 5a, although being punitive, is preferable to option 5b, as it doesn't add complexity. Option 5a is kept.

5.2 Overview of questions for consultation

Q1. Do you agree with the distinction between instruments with residual risks that are characterised by a non-SbM risk factor, and the rest of the instruments? Please elaborate.

Q2. Do you agree with the requirements set out in Article 2 for instruments with residual risks that are characterised by a non-SbM risk factor? What is your preferred option between option A and option B in point (d) of that Article? Please elaborate, highlighting operational challenges that you may face under the two options.

Q3. Do you agree with the requirements set out in Article 1 for instruments with residual risks that are not characterised by a non-SbM risk factor? In which cases, other than back-to-back positions, do you think hedging instruments would meet the conditions referred to in Article 1? Do you think there are alternative objective ways of assessing whether instruments currently falling under the treatment set out in Article 1 act as a hedge? Please elaborate.

Q4. What are your views in relation to the requirement to consider whether an instrument has been taken in the interbank market, as a way to distinguish the hedge from the hedged instrument? Which are the cases where the hedge is not performed with the interbank market? Please elaborate.

Q5. What are the material cases where institutions hedge an instrument with residual risks using other instruments with residual risks? Does the proposed regulation address those cases? If not, how can the assessment of the hedge be performed in those cases? Please elaborate.