EUROPEAN COMMISSION
Directorate-General for Financial Stability, Financial Services and Capital Markets Union

DG FISMA CONSULTATION DOCUMENT
PROPORTIONALITY IN THE FUTURE MARKET RISK CAPITAL REQUIREMENTS AND THE REVIEW OF THE ORIGINAL EXPOSURE METHOD

Disclaimer

This document is a working document of the Commission services for consultation and does not prejudge the final decision that the Commission may take.

The views reflected on this consultation paper provide an indication on the approach the Commission services may take but do not constitute a final policy position or a formal proposal by the European Commission.

The responses to this consultation paper will provide important guidance to the Commission when preparing, if considered appropriate, a formal Commission proposal

Introduction

During the 2008-2009 financial crisis, the level of own funds required against the market risk of trading book exposures of major institutions worldwide proved insufficient to absorb unexpected losses resulting from high volatility in financial markets. This period revealed a number of weaknesses in the design of the prudential framework for the trading book which needed to be addressed. Therefore, ever since 2009, despite a quick set of revisions implemented right after the crisis[1], the Basel Committee for Banking Supervision (BCBS) has been working on what is known as the "fundamental review of the trading book" (FRTB) to address these weaknesses. This work has concluded in January 2016 and led to revised international standards for calculating own funds requirements for market risk[2].

In the Communication "Towards the completion of the Banking Union", the Commission announced that further risk reduction measures were needed, including the "remaining elements of the regulatory framework agreed within the Basel Committee, and in particular measures to limit bank leverage, to assure stable bank funding and to improve the comparability of risk-weighted assets". The FRTB has a strong potential both for risk-reduction and for improving risk-comparability. Therefore, the Commission is currently assessing the benefits of implementing the new market risk international standard in the EU. To this end, the Commission mandated the European Banking Authority (EBA) to provide an assessment of the impact of introducing these standards in the EU and whether their introduction would warrant some adjustments to account for the specificities of the EU trading activities.

The potential introduction of new standards for market risks in the prudential framework provides an opportunity to re-assess the issue of proportionality for smaller or simpler financial institutions. The current market risk framework contained in Regulation (EU) No 575/2013 (Capital Requirement Regulation, hereafter "CRR") already establishes some features of proportionality. These are, namely, the possibility for institutions to use either the standardised or the internal models approach, and the derogation for small trading book businesses. Some elements of the latter, described in the following sections, would benefit from a review.

Going forward, the fact that the new standardised approach for capital requirements for market risk defined in the FRTB framework has been regarded by some institutions as more complex than the current one also raises some questions with regards to its adequacy for all trading books which are outside the scope of the derogation. This has been pointed out by some of the claims in the call for evidence. For smaller or simpler ones, the introduction of a simplified standardised approach could be a possibility.

An issue closely related to the derogation for small trading book businesses is the use of the Original Exposure Method ('OEM') under Article 275 of the CRR for the calculation of the exposures values of derivative contracts (the possibility to use this simplified framework is permitted only for institutions that are currently eligible for the derogation for small trading book businesses). Article 514 of the CRR requires the Commission to review the use of the OEM by 31 December 2016. In particular, this review could be used to change some of the features of the OEM to ensure some consistency with the

[1] " Revisions to the Basel II market risk framework - final version ", Basel Committee for Banking Supervision, July 2009, http://www.bis.org/publ/bcbs158.htm

[2] Minimum capital requirements for market risk, Basel Committee for Banking Supervision, January 2016, http://www.bis.org/bcbs/publ/d352.htm

new Standardised Approach for Counterparty Credit Risk[3] (hereafter 'SA-CCR'), which is yet to be implemented in the EU.

The Commissions services runs this consultation to gather the views of selected stakeholders, in particular, institutions with small trading books, associations representing these institutions and supervisory authorities, on proposed options to implement the principle of proportionality in the future market risk capital framework and the review of the OEM. Also, institutions using the standardised approach for counterparty credit risk, as well as relevant associations. Stakeholders are welcome to send their contributions to this public consultation by 24th June 2016 to this functional mailbox: FISMA-CONSULT-TRADING-BOOK@ec.europa.eu.

The Commission services invite stakeholders to provide specific and short answers, robust arguments justifying the option(s) preferred in the relevant questions, clear and simple examples which may help to illustrate these justifications, and where possible a quantitative or qualitative assessment of the expected impact of the different options envisaged on their business operations.

1. Proportionality in the market risk framework

1.1. The derogation for small trading book businesses

In the current text of the CRR there is a derogation for small trading book businesses (Article 94 of the CRR, c.f. Annex 1) which allows institutions with non-significant trading activities to use a simplified prudential framework to calculate capital requirements for their trading exposures. This provision is one of the existing proportionality features contained in the CRR; it provides a simpler, although less risk-sensitive, approach for small trading books.

In simple terms, Article 94 of the CRR allows institutions with non-significant trading activities to replace capital requirements for market risk (as referenced by Article 94(3b) of the CRR) with capital requirements for credit risk (as referenced by Article 94(3a) of the CRR). It is important to highlight that this alternative treatment only applies to so-called "position risk". Trading positions with foreign exchange and commodity risks are always subject to capital requirements for market risk even if the institution is eligible for the treatment set out in Article 94 of the CRR.

The simplicity, therefore, lies mainly in the fact that institutions already apply the rules on capital requirements for credit risk to their non-trading exposures, so, in principle, they just have to extend the scope of application to their trading exposures.

Institutions that meet the conditions set out in Article 94 of the CRR are also allowed to use a simpler calculation method to compute their derivative exposures for the purposes of the counterparty credit risk capital charge (the OEM, see section 2 of this document).

To be eligible for the derogation, an institution has to meet two thresholds, one based on the absolute size of its trading activities and the other based on the relative size of its trading activities compared to its total activities. For each of them, there is a twofold metric:

[3] "The standardised approach for measuring counterparty credit risk exposures", Basel Committee for Banking Supervision, April 2014, http://www.bis.org/publ/bcbs279.htm

- in the case of the absolute threshold, the size of its trading activities must be "normally" less than EUR 15 million and "never" exceed EUR 20 million;
- in the case of the relative threshold, the size of its trading activities must be "normally" less than 5% of total assets and "never" exceed 6% of those assets.

The Commissions services are currently re-assessing this framework. In particular:

1. The level of the thresholds. Together with the EBA, we are currently performing an analysis of the population of institutions which are using/are eligible for the derogation, which will bring more clarity. This analysis will in particular determine whether the current level of the thresholds, in particular the one based on absolute size of trading activities, can be considered conservative, especially when compared to other jurisdictions with a similar feature. In the absence of a "simplified standardised approach", there would be more reason to increase the thresholds to target a wider population of institutions with an alternative approach for their trading book (see discussion in section 1.2)).

2. The definition of the thresholds. Having two conditions based on both relative and absolute values is considered adequate, but the way in which they are defined could be looked at to bring more clarity and homogeneity. In particular, the meaning of certain terms could be clarified (e.g. the term "normally" could be replaced by a more specific approach) and make more homogeneous the calculation of the size of trading activities (e.g. we could narrow down the way the size of debt instruments is measured).

3. The application of the credit risk framework to some trading activities is not clear. While capital requirements for credit risk can be easily applied to cash positions (e.g. equities, bonds), its application to derivative and securities financing transactions is less clear. How material these instruments are on the balance sheets of institutions which are currently using the derogation is something which deserves further attention.

1.2. A simplified standardised approach

The new BCBS standardised approach in the FRTB framework would bring significant modifications to the current standardised approach in the CRR with the purpose of making it more risk-sensitive and better suited for complex financial instruments.

It is the assessment that this higher risk-sensitivity comes at the cost of increased complexity compared to the current standardised approach. For example, in the current standardised approach, the main inputs needed to calculate capital requirements are readily available, such as the instrument type, its maturity and its associated rating. The new standardised approach uses an additional key input, the so-called "sensitivities", which must be derived from institutions' valuation models. Additionally, the new standardised approach can be computationally more intensive, mainly due to the methodology used to account for diversification effects when aggregating positions.

As a result of this, some stakeholders have raised questions on whether this increased complexity is adequate or assumable for all institutions with a trading book, however small or simple it is. Possible alternatives for smaller or simpler trading books could be one of the following:

- to implement a simplified version of the new standardised approach;
- to keep the current standardised approach.

The first alternative has the advantage that it would lead to a more coherent overall framework and may facilitate banks' transition to the (full) standardised approach when needed however it has the disadvantage that it would require banks to change their systems and methodologies. Moreover, developing a framework which delivers the right simplifications could be challenging.

The second alternative has the advantage that it would have no implementation costs for the institutions concerned, but has the disadvantage that it would be unrelated to the new framework's rationale and methodology and could be more prone to cliff effects.

In view of these considerations, we ask the following questions:

1. *Can the new standardised approach in the BCBS FRTB framework be easily applied to all institutions with a trading book? If not, which elements of this approach would be more challenging to implement and for which types of trading books? If possible, please provide a quantification of potential implementation costs for the institution concerned.*

2. *In case the new BCBS standardised approach from Basel is not considered an adequate framework for all institutions with a trading book, which of the following three alternatives would be considered the most appropriate framework to deal with smaller or simpler trading books and why?*

    a. *The current treatment under the derogation for small trading books with increased thresholds and potentially the necessary clarifications and reviews described above;*

    b. *a simpler standardised approach;*

    c. *a combination of the former two elements with potentially two different thresholds.*

    Please, also specify, for the alternative chosen, which considerations have to be taken into account to re-calibrate the level of the threshold(s) and the appropriate calibration of the threshold(s).

3. *In case option b) or c) have been chosen, which of these two possibilities would be considered the most appropriate regime for institutions with smaller or simpler trading books;*

    a. *a simplified version of the new standardised approach, to be developed; or*

    b. *the current standardised approach?*

    Please, justify your answer from a cost-benefit perspective. If a) is chosen, please specify which simplifications to the FRTB standardised approach would need to be performed.

4. *Please, indicate which of the two conditions provided in Article 94 of the CRR is currently more constraining for your institution, supporting your answer with data reflecting the evolution of total trading exposures in balance sheet.*

5. *Besides the level of the thresholds, do you agree with the previous analysis on the other elements of the derogation for small trading book business? Which ones would need to be addressed and how?*

    a. *The definition of the thresholds, making them more specific and harmonized as described above*

b. *the clarifications on the application of the credit risk framework to some trading exposures, especially derivatives; and/or*

In the case of item b) please specify which clarifications/modifications would be necessary and for which trading exposures in particular. In the case of changes to a) and b), please provide some measures of quantitative impact of the modifications proposed on your institutions.

2. Possible review of the Original Exposure Method

The European Commission is mandated to review and report by 31 December 2016 on the application of Article 275 of the CRR (use of the OEM) and submit a report to the European Parliament and the Council. The Commission may also make a a relevant legislative proposal, if it considers appropriate.

The OEM is a standardised approach used for the calculation of the exposures values of derivative contracts (its function is similar to the Standardised Method ('SM') and the Current Exposure Method ('CEM') known as the Mark-to-Market Method ('MtM method') under the CRR (see Articles 276 to 282 and Article 274 of the CRR, respectively) but only institutions that can benefit from the derogation for small trading book businesses can use it. In addition, the OEM is only applicable to interest rate derivative and foreign exchange derivative contracts (the exposure value of any other derivative transactions have to be calculated using SM or CEM).

The OEM was introduced as part of the 1988 Basel I Accords as a discretion for jurisdictions that wanted to propose a simpler alternative to CEM. Since the publication of the Basel II framework in 2005, the OEM has been removed from the Basel framework but the EU retained it in the subsequent versions of the Capital Requirements Directive (hereafter "CRD"), including in the CRDIV/CRR, based on the rationale that a simple approach like the OEM was more suitable for institutions with little trading activity than a more risk-sensitive and burdensome approach. The OEM should be straightforward to implement and does not require a sophisticated IT system since the inputs required for its calculation are minimal. However, the simple design of the OEM does not allow it to accurately capture the exposures value of derivative transactions, due to the following limitations:

- collateral is not recognised and, as a consequence, netting sets of derivative transactions subject to a margin agreement are treated as if they were unmargined. This may significantly overestimate the exposure;
- netting benefits are recognised in an overly simplified fashion by using the alternative table of percentages provided under Article 298(3) of the CRR;
- the exposure values of in-the-money derivative transactions (transactions with a positive current market value) are potentially significantly underestimated since the OEM does not take into account the replacement cost component of the transaction.

Banks that are permitted to use the OEM are also allowed to use an alternative, simple approach to compute their capital requirement for credit valuation adjustment (hereafter "CVA") risks (see Article 385 of the CRR). This approach does not exist in the Basel framework.

Finally, the use of the OEM is not only allowed for the purpose of calculating risk-based capital requirements. Institutions that are permitted to use it for that purpose are also allowed to use it for the purpose of the leverage ratio calculations (see Article 249a(8) of the CRR).

Given the above limitations of the OEM and in light of the future introduction of the SA-CCR in the EU, it is considered whether it would be more appropriate to either (i) keep the OEM in its current form and application; (ii) modify it in order to ensure its consistency with the SA-CCR; or (iii) remove it and replace it by the SA-CCR.

In view of these considerations, we ask the following questions:

6. *For those institutions that currently use the OEM, do you see any merits in replacing the OEM with the SA-CCR in the prudential framework? Would the operational difficulty to implement SA-CCR be the only impediment for your institution to the replacement of OEM by SA-CCR? Would your derivative activities be negatively impacted by the introduction of SA-CCR due to the impact of the replacement of OEM by SA-CCR on the risk-based capital requirements and leverage ratio requirement?*

7. *For those institutions that see no merits in replacing the OEM with the SA-CCR, do you find it appropriate to keep the OEM in its current form, including its link to the derogation for small trading book business, its specific use for the calculating the leverage ratio and the CVA charge? If not, please explain what you would like to change in the current application of the OEM under the CRR and why. In addition, would you find it relevant to develop some limited modifications to the OEM to ensure that it is more consistent with the SA-CCR (while avoiding undue increases to the complexity of the OEM)? If yes, which modifications would you propose to the OEM to be more consistent with SA-CCR?*

3. Possible replacement of the CEM and the SM with the SA-CCR

As mentioned above, the Commissions services are assessing whether to recommend the introduction of SA-CCR in the CRR and whether it would be more appropriate to either (i) not introduce SA-CCR and keep the MtM Method and/or the SM in the current form and application; (ii) introduce SA-CCR and keep the MtM Method and/or the SM in the current form and application; or (iii) remove the MtM Method and the SM and replace them with the SA-CCR.

8. *For those institutions that currently use either the MtM Method or the SM, do you see any merits in replacing these approaches with the SA-CCR in the prudential framework? Would the operational difficulty to implement SA-CCR be the only impediment for your institution to the replacement of these approaches by SA-CCR? Would your derivative activities be negatively impacted by the introduction of SA-CCR due to the impact of the replacement of these approaches by SA-CCR on the risk-based capital requirements and leverage ratio requirement?*