EUROPEAN
COMMISSION

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COMMISSION DELEGATED REGULATION (EU) …/...

of 10.3.2022

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

(Text with EEA relevance)

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE DELEGATED ACT

Article 390(9) of Regulation (EU) No 575/2013 ('the Regulation') empowers the Commission to adopt, following submission of draft regulatory technical standards ('RTS') by the European Banking Authority ('EBA'), and in accordance with Articles 10 to 14 of Regulation (EU) No 1093/2010, delegated acts to specify how to determine the exposures arising from derivative contracts listed in Annex II of the Regulation 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.

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.

In order to ensure consistency through the different pieces of the regulatory framework, this delegated act builds on the Basel Large Exposures (LEX) standards with the intention of being consistent with market risk rules for the calculation of exposures from (credit) derivatives, complemented where needed by specificities stemming from the large exposures framework. In particular, to ensure compatibility with the jump-to-default (JTD) approach under the FRTB and the Regulation and the corresponding draft RTS on JTD which is currently being developed by the EBA in accordance with Article 325w(8) of the Regulation. The basis of both RTS is the variation in price of the derivative contract that would stem from the default of an issuer

In accordance with the fourth subparagraph of Article 10(1) of Regulation (EU) No 1093/2010 establishing the EBA, the Commission shall decide within three months of receipt of the draft RTS whether to endorse the drafts submitted. The Commission may also endorse the draft RTS in part only, or with amendments, where the Union's interests so require, having regard to the specific procedure laid down in those Articles.

2. CONSULTATIONS PRIOR TO THE ADOPTION OF THE ACT

In accordance with the third subparagraph of Article 10(1) of Regulation (EU) No 1093/2010, the EBA has carried out a public consultation on the draft RTS submitted to the Commission in accordance with Article 390(9) of the Regulation , 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. A consultation paper was published on 23 June 2020, and the consultation closed on 23 October 2020.

As specifically requested by the Commission, only these draft RTS and explanatory memorandum are submitted to the Commission for the adoption of these draft RTS. All relevant background information -notably the background and rationale of the draft RTS, the impact assessment and the feedback on the public consultation- is included in the final report accompanying these draft RTS, which was approved by the EBA's Board of Supervisors on 11 February 2021 and published on the EBA's public website.

3. LEGAL ELEMENTS OF THE DELEGATED ACT

These draft RTS, as indicated in Article 390(9) of the Regulation, cover all derivative contracts listed in Annex II of the Regulation and credit derivatives. This means that e.g. embedded derivatives and credit-linked notes fall into the scope. Outside the scope are derivative and credit derivative contracts for which the underlying does not entail a default

risk of an indirect client e.g. commodities, interest rate benchmarks, interest rate curvature spreads, and exchange rates. Such contracts neither entail default risk nor can their underlying be issued.

The provisions in these RTS propose a methodology for the calculation of indirect exposures under Part four of the Regulation for different categories of derivative contracts and credit derivative contracts with a single underlying debt or equity instrument and multiple underlying reference names. With a view to rationalising all types of derivative and credit derivative contracts under their scope, and building on the Basel standard, the draft RTS differentiate between three categories, namely a) options on debt and equity instruments; b) credit derivative contracts; and c) other derivatives having as underlying asset a debt or equity instrument and which are not included in the other two categories.

The indirect exposure to 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 basis of the proposed methodology in these RTS is the variation in price of the derivative contract that would stem from the default of the issuer of the underlying instrument. For each category, a general methodology as well as a fallback approach is provided.

Furthermore, the methodologies for the determination of the exposure value apply to all derivative or credit derivative contracts regardless of the allocation of the exposure to the trading book or the non-trading book.

These RTS serve the sole purpose of specifying the measurement methods for indirect exposures arising from derivative and credit derivative contracts for institutions to correctly identify and limit their large exposures. It should also be emphasised that these RTS do not impact on the calculation of own funds requirements, their valuation or reporting.

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(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) 648/2012[1], and in particular Article 390(9), third subparagraph, thereof[2],

Whereas:

(1) The determination of the indirect exposure values to a client arising from derivative and credit derivative contracts for large exposures purposes should differ from the calculation method 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 value) or gain (i.e. negative exposure value) that would result from a potential default of its underlying instrument. Under the large exposures regime set out in Part Four of Regulation (EU) No 575/2013, in the case of exposures in the trading book, institutions may offset positive and negative positions in the same financial instruments, or, under certain conditions, in different financial instruments, issued by a given client. The overall net exposure to an individual client is only considered if positive. Similarly, the overall net exposure to a given client, after the inclusion of the indirect exposures to that client arising from derivative or credit derivative contracts allocated to the trading book, should only be considered if positive. In order to avoid any offset of any indirect exposure arising from derivative or credit derivative contracts allocated to the non-trading book, any negative indirect exposure value arising from those positions should be set to zero.

(2) In order to ensure that the default risk is appropriately captured, the indirect exposure value of options, regardless of whether allocated to the trading book or the non-trading book, should therefore depend on the changes 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.

[1] OJ L 201, 27.07.2012, p. 1.
[2] OJ L 176, 27.6.2013, p. 1.

(3) 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 therefore 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.

(4) For other types of derivative contracts that constitute a combination of long and short positions, to ensure that the accurate default risk is captured, institutions should decompose those derivative contracts into individual transaction legs. Only the legs with default risk, where institutions have a risk of a loss in the case of default, should be relevant for the calculation of the indirect exposure value arising from those derivative contracts. However, where institutions are not able to apply that methodology, and to ensure a conservative treatment, 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.

(5) Derivatives can be written on instruments having multiple underlying reference names. For those multi-underlying derivatives, where an institution can look through to the underlying reference names, and to ensure that the most accurate method is used, the indirect exposure value should be calculated by looking at the variation in the price of the derivative in case of default of each of the underlying reference names in the multi-underlying instrument. To ensure consistency with the large exposures framework applicable to transactions where there is an exposure to underlying assets, Article 6(1) and (2) of Commission Delegated Regulation (EU) No 1187/2014[3] should apply to assign the exposures to the identified client, a separate client or the unknown client. In cases where institutions are not able to apply a look-through approach or where a look-through approach to a derivative with multiple reference names is unduly burdensome for them, and to ensure a conservative treatment, institutions should calculate the indirect exposure value by looking at the variation of the price of the derivative in the case of default of all those underlying reference names. Similarly, to ensure consistency with the large exposures framework applicable to transactions where there is an exposure to underlying assets, Article 6(3) of the Delegated Regulation (EU) No 1187/2014 should apply to assign the exposure to a separate client or the unknown client. In all cases where the underlying instruments are assigned to the unknown client, to avoid the risk that negative indirect exposure values are offset with positive indirect exposure values, institutions should set to zero any negative indirect exposure values.

(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

[3] 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).

Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council[4].

HAS ADOPTED THIS REGULATION:

Article 1

General rules for the determination of the indirect exposure value to a client arising from derivative and credit derivative contracts

1. Institutions shall calculate the indirect exposure value to a client arising from derivative contracts listed in Annex II to 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 of this Regulation.

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 collective investment undertaking, or where the derivative contracts have multiple underlying reference names, institutions shall calculate 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.

3. Where the derivative and credit derivative contracts referred to in paragraph 1 are allocated to the trading book, following the calculation of the indirect exposure values to a client arising from those contracts, institutions shall include those exposure values into the exposures to that client in the trading book. After aggregation, negative net exposures to the client shall be set to zero.

4. By way of derogation from paragraphs 1 and 2, where the derivative and credit derivative contracts referred to in paragraph 1 are allocated to the non-trading book and where, following the calculation of the indirect exposure values to a client arising from those contracts, the indirect exposures have a negative value, institutions shall set to zero those exposure values before counting them towards the exposures to that client.

Article 2

Allocation of the indirect exposures to categories of derivative contracts

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 an underlying asset a debt or equity instrument and which are not included in the categories referred to in points (a) or (b) of this paragraph.

[4] 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).

Article 3

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

1. Subject to paragraphs 2, 3 and 4 of this Article, institutions shall calculate the indirect exposure value for options referred to in Article 2, point (a), 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 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 equal to 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 that do not have a strike price available at transaction date, but 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. Where 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.

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 Article 2, point (b), shall be equal to 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. Where neither the market value, nor the fair value of a credit derivative contract is available at any date, institutions shall take the value at which the credit derivative contract is measured in accordance with the applicable accounting framework.

Article 5

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

1. When calculating the indirect exposure value to a client arising from other derivative contracts referred to in Article 2, point (c), including swaps, futures or forwards, institutions shall decompose their multiple transaction legs into individual transaction legs.

2. For the transaction legs referred to in paragraph 1 entailing default risk of the issuer of the underlying instrument, institutions shall calculate their indirect exposure value as if they were positions in those legs.

3. Where an institution is not able to 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.

Article 6

Calculation of the indirect exposure values arising from multi-underlying derivative contracts

1. When determining the indirect exposure value to a client arising from derivative contracts written on debt, equity or credit default swap indices or collective investment undertaking, or with multi-underlying reference names, institutions shall look through to all the individual underlying instruments and calculate the indirect exposure values as the variation in the price of the derivative contract in the case of default of each of the underlying reference names. Institutions shall assign each indirect exposure value either to an identified client, a separate client or the unknown client, as laid down in Article 6(1) and (2) of Delegated Regulation (EU) No 1187/2014.

2. Where an 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:

   (a) look through to those individual underlying instruments where the institution is able to do so or where it would not be unduly burdensome for the institution to do so and calculate the indirect exposure value in accordance with paragraph 1;

   (b) for those underlying instruments where the institution is not able to look through or where it would be unduly burdensome for an institution to do so, calculate the indirect exposure value by looking at the variation of the price of the derivative contract in the case of default of all those underlying reference names.

   The indirect exposure value referred to in point (b) of the first subparagraph of this paragraph shall be assigned either to the derivative transaction as a separate client or to the unknown client, as laid down in Article 6(3) of Delegated Regulation (EU) No 1187/2014.

3. By way of derogation from paragraphs 1 and 2 of this Article, where the indirect exposure values are to be assigned to the unknown client, as laid down in Article 6(2) and (3) of Commission Delegated Regulation (EU) No 1187/2014, and where the indirect exposure values are negative, the institution shall set to zero those

indirect exposure values before counting them towards the exposures to the unknown client.

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, 10.3.2022

For the Commission
The President
Ursula VON DER LEYEN