German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

EBA/CP/2024/04 – RTS RRAO exemption

German Lobby Register No R001459
EU Transparency Register No 52646912360-95

Contact:
Dr. Silvio Andrae
Telefon: +49 30 20225-5437
Telefax: +49 30 20225-5404
E-mail: silvio.andrae@dsgv.de

Berlin, May 03, 2024

The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks.

Coordinator:
German Savings Banks Association
Charlottenstraße 47 | 10117 Berlin | Germany
Telephone: +49 30 20225-0
Telefax: +49 30 20225-250
www.die-deutsche-kreditwirtschaft.de

General comments

We appreciate the EBA's efforts to bring about a timely finalisation of the RTS in accordance with Article 325u CRR III. It is essential for the functioning of hedging services and the competitiveness of EU banks that the foreseen exemptions can be applied in practice.

Furthermore, we concur with the EBA's assessment that CMS Spread Options are the most relevant instruments that are going to be subject to the exemption. As CMS Spread Options attract a residual risk in the form of a non-SbM risk factor (correlation risk) but are non-path dependent. All in all, the proposal is largely adequate with respect to the treatment of those. However, we appreciate the EBA explicitly asking for further examples and an assessment of the proposal's suitability for those. Indeed, other instruments used in practice should be examined, which would require changes to the EBA's proposal. This applies, in particular, to path-dependent products that contain a non-SbM risk factor. Path dependency does not limit the ability of institutions to hedge the non-SbM risk factor. Therefore, we would suggest that the treatment of path-dependent products is aligned with the treatment of CMS Spread Options.

Moreover, it is worth mentioning, that the U.S. NPR rules already exempt all CMS spread option trades, including client legs (p.64129). The industry is proposing even broader exemptions, most notably:

- hedges that reduce non-SBM risk factors regardless of path dependency;
- all options without path-dependent pay-offs or with two or fewer underlying.

The industry proposal will likely be adopted. Even more so, we would like to ask the EBA to incorporate the comments provided in the following section to limit the competitive disadvantage of European banks.

5.2 Overview of questions for consultation

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

We appreciate the EBA's proposal to apply less restrictive requirements (notably refraining from the need for a complete offset of the residual risk) for a specific subset of instruments.

However, we disagree with the proposed specific distinction (in the annexes). In fact, the application of Article 2 should not be strictly limited to non-path dependent options from the outset. In particular, Bermudan options should be allowed to be treated in accordance with Article 2 as well (c.f. question 5).

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.*

We agree with the EBA's reasoning that both options have advantages and disadvantages. Indeed, requiring a "significant" reduction appears to be flexible but, in turn, somewhat ambiguous. On the other hand, setting a certain minimum percentage of sensitivity reduction would be highly prescriptive but

ensure clarity and comparability. Still, the actual percentage rate itself would have to be set arbitrarily in the first place.

That is why we prefer a third option that simultaneously combines the advantages and avoids the disadvantages of the two proposed options. In our opinion, instruments should be exempted whenever they reduce the institution's sensitivity to the respective non-SbM risk factor, regardless of the exact extent.

- The fulfilment of this condition can be unambiguously determined and provides a maximum level of harmonisation.
- At the same time, this option avoids the need to set arbitrary, overly prescriptive or ambiguous materiality threshold and it limits the RTS's complexity.
- Moreover, it should be noted that this option would move the EU regulation closer to a level playing field with the US NPR treatment exempting all CMS spread 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.*

From an economic point of view, the net notional should be the basis for the RRAO calculation in case of partially hedged residual risks (where a hedge is characterised by similar terms but does not have the same notional as the hedged trade). Consequently, back-to-back options with identical notionals should not attract any RRAO as market risk is eliminated anyway, irrespective of the specific nature of the respective risk factors. In that sense, limiting the RRAO exemption to just one leg of an option pair is overly conservative in the first place.

That being said, we are of the opinion that the requirement in Article 1 paragraph 1 (c) (iii) leads to a disproportionate additional burden. In practice, constantly monitoring the PnL and hedge effectiveness at portfolio level should be sufficient.

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.*

In our view, the decisive factor for an instrument being exempted from the RRAO should be whether it reduces in the institution's sensitivity to the respective non-SbM (market) risk factor. The (type of) counterparty should be interpreted as a potential indication but not be used as a binding factor. We do not deny that the interbank market is commonly used as a source for hedging instruments. Thus, a position in the interbank market may serve as an additional hint. However, other potential sources should not be neglected. For instance, in the case of structured products, funds looking for particular payoff profiles may also be suitable counterparties.

Consequently, we propose two concrete amendments:

- Article 1(2)(b) should be changed replaced by the following:
  "~~(b) whether the trade was made in the interbank market;~~"

  "(b) the industry of the counterparty (e.g. interbank, funds, other)"

- Article 1(2)(d) should be omitted as we cannot confirm a clear connection between the rationale of choosing a certain counterparty and the purpose of the transaction in terms of risk management.

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.*

We agree with the EBA's assessment that CMS spread options and back-to-back options are expected be the most common instruments in scope of the RRAO exemption laid out in Article 325u of the CRR III. However, there are indeed other instruments with residual risk being used to hedge other instruments with residual risk. For instance, Bermudan options are used in practice to effectively reduce an institution's sensitivity to non-SbM risk factors.

A Bermudan Option gives the holder the right to exercise at various pre-specified dates. In contrast, European options can be exercised at expiry only. The premium of a Bermudan Option has to be higher than the maximum premium of an equivalent set of European options (i.e. a combination of European options with expiry dates aligned with those of the Bermudan option). The difference is called "Switch Value". An additional non-SbM risk factor called "Berm Tax" ensures that the "Switch Value" the model produces matches prices seen in the market. Hedging the "Switch Value" converts the Bermudan payoff profile into a European payoff. Institutions typically hedge this non-SbM risk factor in the interbank market or with hedge funds using Bermudan options.

Typical client segments where IR Bermudan Options are offered include:

- bank own Structured Note issuances (including via SPVs);
- hedging service to a third party, e.g. Corporate, Municipal and Local Governments or Banks issue callable bonds and require a hedge.

In order to allow for Bermudan options to be treated by Article 2, we propose the following changes to Annex I:

- include single underlying options;
- do not restrict non-SbM risk factors to the correlation between underlying but allow for other non-SbM risk factors that can be hedged;
- allow for path dependency.