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

BANK AND INSURANCE
Bank regulation and supervision

TARGETED CONSULTATION DOCUMENT

ALTERNATIVE STANDARDISED APPROACH FOR MARKET RISK

While this publication does not represent a formal stakeholder consultation (which is not required under the rules for Better Regulation for this specific legislative proposal which will not have an economic impact due to its nature of operationalising a reporting requirement), interested parties are invited to provide their views in relation to the questions in this this publication.

You are invited to reply **by 11 November 2019** at the latest to the **online questionnaire** available on the following webpage:
https://ec.europa.eu/info/consultations/finance-2019-market-risk-alternative_en

Please note that in order to ensure a fair and transparent consultation process **only responses received through the online questionnaire will be taken into account and included in the report summarising the responses**.

Responses authorised for publication will be published on the following webpage: https://ec.europa.eu/info/consultations/finance-2019-market-risk-alternative_en#contributions

CONTENT OF THE CONSULTATION DOCUMENT

The global financial crisis revealed significant weaknesses in the prudential rules for banks, including the market risk rules. The inadequate measurement of market risk resulted in significant losses in banks' trading books which contributed to the erosion of their capital. As a response, the Basel Committee on Banking Supervision (BCBS) launched a fundamental review of the trading book which resulted in the publication of a new framework for market risk in January 2016. This framework significantly changed the approaches to be used by banks for the calculation of capital requirements for market risk. In December 2017, the Group of Central Bank Governors and Heads of Supervision asked the BCBS to carry out a second review to adjust the calibrations of these approaches. This second review was finalised in January 2019.

In line with its international commitment, the European Union agreed on a three-step approach to implement the new market risk framework in its legislation.

As a first step, the so-called banking package that was adopted in May 2019 introduces, through Regulation (EU) No 575/2013 (the Capital Requirements Regulation or CRR), a reporting requirement based on this framework.

As the changes to the standardised approach for market risk agreed in the second Basel review could not be incorporated in the banking package before its adoption, the co-legislators empowered the Commission to introduce them by means of a delegated act. The delegated act will contain the necessary elements to make the reporting requirement operational. The adoption by the Commission of this delegated act will represent the second step in the implementation process.

The third and final step, the introduction of an own funds requirement for market risk based on the new framework requires a Commission proposal to amend the CRR. The adoption of this proposal by the Commission is currently envisaged for June 2020.

The following text presents the intentions of Directorate General for Financial stability, financial services and capital markets union as regards the incorporation of the abovementioned revisions in the CRR, and in particular:

- consistent shocks to similar risk factors and revisions to the aggregation formula for the calculation of curvature risk;
- the possibility to subject instruments without optionality to curvature risk;
- three approaches for the calculation of own funds requirements for positions in collective investment undertakings (CIU) and conditions for their use;
- the possibility to treat positions in a CIU that tracks an index as a direct position in that index;
- an additional method to determine the own funds requirement for delta and curvature risks for foreign exchange risk factors, the so-called base currency approach.

1. Calculation of curvature risk

The BCBS text specifies the calculation of the own funds requirement for curvature risk for instruments with optionality. This includes the application of consistent shocks to similar risk factors and specifications of parameters in the low correlations scenario for the aggregation formula. These specifications would be implemented in Article 325g of the CRR (see point (2) of Article 1 of the attached text). For foreign exchange risk factors, the calculation needs to be adjusted in order to avoid double-counting those curvature risks (see point (6) of Article 1 of the attached text).

> *Q1. Do you have comments on the implementation of the revised rules for capturing curvature risk?*
>
> *Q2. In particular, do you have comments on the additional revision introduced to avoid double counting the own funds requirement for curvature risk for foreign exchanges risk factors?*

2. Possibility to include positions without optionality in the calculation of curvature risks

By default, instruments without optionality are only subject to own funds requirements for delta risk for the non-exotic underlying(s) of the instruments, but not for curvature risk. Nevertheless, the BCBS text provides a discretion for institutions to subject all instruments, including those without optionality, to the own funds requirement for curvature risk. This discretion could be helpful for institutions that manage and hedge positions with and without optionality together. This discretion would be implemented in Article 325e of the CRR (see point (1)(b) of Article 1 of the attached text). However, to prevent that it would be used primarily for the purpose of reducing own funds requirements, the institution wishing to exercise this discretion would be required to notify its intention to its competent authority, which could decide ex-post not to allow the institution to use it. The same process would apply in case an institution would want to stop using this discretion and revert to the default treatment.

> *Q3. What are your views in relation to the abovementioned discretion for institutions?*
>
> *Q4. What are you views in relation to the notification procedure and the role of competent authorities*?

3. Approaches for equity investments in collective investment undertakings (CIU) that do not qualify for the look-through approach

The treatment of positions in CIUs would be introduced in Article 325j of the CRR (see point (5) of Article 1 of the attached text). If the conditions for the use the look-through approach would not be met, but the mandate of the CIU is available and daily price quotes can be obtained, institutions would be allowed to use one of two alternative approaches. The first approach would require institutions to set up a hypothetical portfolio based on the mandate of the CIU to compute the own funds requirement of the position in the CIU. Because of the number of assumptions that institutions would need to make when using this approach, its use would be subject to supervisory approval at the level of each individual CIU. The second approach would allow institutions to consider the CIU as a single equity assigned to the equity bucket 'other sectors'.

Q5. How frequently would you expect to use the mandate-based approaches?

Q6. Under the 'hypothetical portfolio' approach, what are your views on the conditions to use it? Do you have any views on the operational aspects of the proposed supervisory approval process?

Q7. Do you have any comments regarding the 'single equity' approach?

4. Equity investments in CIUs that track an index

Institutions would be given the possibility to treat a CIU position that tracks an index as a direct position in that index. This treatment would be allowed as long as the annualised return difference between the CIU and the index it tracks remains below 1% over a 12-months period. Where less than 12 months of data would be available, institutions would need to seek the permission of competent authorities to use this approach (see point 5 of Article 1 of the attached text).

Q8. Do you have comments on the revised treatment of CIUs that track an index?

Q9. Do you have views on the condition for its use?

Q10. Do you have comments on the proposed solution for cases for which less than 12 months of data are available?

5. Use of a base currency

The BCBS text includes a 'base currency' approach that can be used as an additional method to determine the own funds requirement for delta and curvature risks for foreign exchange risk factors. Under this approach, institutions would be able to choose another currency than their reporting currency to express the foreign exchange risk factors. This treatment would be allowed if the institution would meet a number of conditions related to its management of the foreign exchange risk and would be subject to supervisory approval (see point (7) of Article 1 of the attached text).

Q11. Do you consider the introduction of the base currency approach as useful? Please explain.

Q12. Are the conditions for the application of this approach sufficiently clear? If not, how should they be clarified?

6. Other issues

Q13. Do you have comments on any other parts of the attached text?