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Consultation Paper

Draft Regulatory Technical Standards

On the valuation of derivatives pursuant to Article 49(4) of the
Bank Recovery and Resolution Directive (BRRD)

Contents

1. Responding to this Consultation	3
2. Executive Summary	4
3. Background and rationale	7
a. Valuation Methodologies – RTS section 2	9
b. Point in time – RTS section 3	12
c. Destruction in value – RTS section 4	12
d. Contribution to BRRD implementation and the single market	14
e. Proportionality	14
4. Draft Regulatory Technical Standards on the valuation of derivatives pursuant to Article 49(4) of the Bank Recovery and Resolution Directive (BRRD)	15
5. Accompanying documents	30
a. Draft Cost- Benefit Analysis / Impact Assessment	30
b. Overview of questions for Consultation	38

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 13.08.2015. 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 (EC) N° 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the EBA in its implementing rules adopted by its Management Board. Further information on data protection can be found under the Legal notice section of the EBA website.

2. Executive Summary

Reasons for publication

The Bank Recovery and Resolution Directive¹ (hereafter 'BRRD') entrusts resolution authorities with a write down and conversion power ("bail-in") in relation to liabilities of an institution under resolution to ensure that shareholders and creditors bear an appropriate part of the costs arising from the failure of a credit institution, with a view to and fostering sound risk behaviour in normal times.

The scope of the bail-in power extends to liabilities arising from derivative contracts, even though they might indirectly be excluded on the basis of ad hoc exemptions, for example the exclusion of secured liabilities or liabilities with a remaining maturity of less than seven days owed to systems designated according to Directive 98/26 or their participants.

Article 49 of the BRRD lays down the conditions to be complied with by resolution authorities when bailing in derivative liabilities. In particular resolution authorities will exercise the bail-in power only upon or after closing-out the derivatives. Resolution authorities are empowered by the BRRD to close-out and terminate derivatives for this purpose.

In this context resolution authorities must determine the value of derivative liabilities as part of the general valuation of assets and liabilities carried out pursuant to Article 36 of the BRRD and in accordance with methodologies and principles to be specified by regulatory technical standards and developed by the EBA. This is the purpose of the draft delegated regulation included in this consultation paper, on which the EBA seeks the views of stakeholders.

Contents

The draft RTS aims to strike the right balance between the need to provide resolution authorities with tools to carry out a swift and objective valuation of derivative liabilities while avoiding discrepancies with the insolvency counterfactual that could lead to breach the non-creditor-worse-off principle.

For this reason the RTS follows an approach whereby resolution authorities must respect the perimeter of the relevant netting set² (no "cherry picking") but apply a statutory valuation methodology laid down in the RTS without having to consider the methodology laid down in each and every contract. The RTS lays down a valuation principle whereby derivative liabilities will be

¹ Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, OJ 173/90 of 12.6.2014

² According to CRR (Reg. 575/2013), 'netting set' means a group of transactions between an institution and a single counterparty that is subject to a legally enforceable bilateral netting arrangement.

assessed as an early termination amount based on the costs or gains that would be incurred by the counterparty in replacing the contract.

Once the decision has been taken to place a credit institution under resolution and to use the bail-in tool, the resolution authority will notify its decision to close-out contracts to the derivative counterparties, and will give them a deadline to provide commercially reasonable replacement trades. Where such replacement trades have been provided within the deadline, they will be endorsed by the resolution authority in determining the close-out amount. In contrast, if no replacement trade or no commercially reasonable trade has been filed within the deadline, resolution authorities will apply their own valuation based on mid-market prices and reasonable replacement costs calculated using bid-offer spreads adjusted to the exposure size and credit worthiness of the counterparty.

Point in time

The point in time chosen for the valuation of derivatives is fully consistent with the valuation principle retained in the RTS. Resolution authorities will establish the value of derivative liabilities as at the close-out or as at the date when a price is available in the market for the contract or the underlying assets. This will allow a final valuation within a matter of days with maximum accuracy.

However, where resolution authorities decide under the prevailing circumstances to carry out a provisional valuation rather than a final one, the resolution authority or the valuer (henceforth 'the valuer') will be able to establish its valuation prior to the reference date mentioned above, based on estimates of replacement costs after taking into account the market conditions prevailing at that time. The valuation will subsequently be updated and may give rise, where justified, to either an adjustment to the creditors' treatment or creditor compensation pursuant to Article 74 of the BRRD.

Destruction in value

An early termination of derivative contracts may give rise to costs that would not have been incurred if the contracts had been maintained until maturity. For example, counterparties may be faced with unfavourable conditions (e.g. an illiquid market or a deteriorated credit worthiness) when covering hedging positions that were laid bare by the unexpected early termination, and will be entitled to a higher payment upon close out. Also, depending on the resolution strategy the firm under resolution may have to re-hedge some or all of the positions and incur additional costs.

Before taking the decision to close-out derivative netting sets, authorities will need to consider whether the loss-absorption capacity which will be liberated from the derivative contracts being closed out and bailed in will be offset by these additional costs that would result from the decision to close-out. If that is the case they may consider activating the option provided for in Article 44(3)(d) of the BRRD and exempt the contracts from close-out and bail-in on the ground that *"the application of the bail-in tool to those liabilities would cause a destruction in value such*

that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in”.

The RTS specifies the terms of this comparison and, in particular, lists a number of elements to be considered as a source of destruction in value, such as the replacement costs which are incurred by the counterparty, re-hedging costs for the firm under resolution, or a deteriorated franchise value for the firm under resolution.

Treatment of central counterparties (CCP)

Liabilities of a bank under resolution to a CCP are likely to fall under the exemptions from bail-in provided for under the BRRD.³ To the extent that they would not, the default and valuation processes implemented as a result of the EMIR Regulation for authorised EU CCPs and designated third-country CCPs⁴ are deemed to allow for a swift and objective determination of value. The draft RTS draws on these processes and resolution authorities will notify their decision to close-out to the CCP and will have to agree with the CCP and its competent authority on a deadline for the CCP to provide the early termination amount in line with its own EMIR compliant governance rules. The deadline will have to take into account the estimated liquidation timelines of the CCP, as well as the urgency of the resolution process. The resolution authority will be able to impose its own valuation only when the CCP does not deliver a close-out amount within the agreed deadline, or when the CCP does not apply its default procedures as described in its rule book.

Proportionality

The draft RTS respects the principle of proportionality. It refers only to institutions that have been placed under resolution with the use of the bail-in tool. It takes inspiration from common market practice for the determination of the close-out amount and derogates from common contractual practice only insofar as necessary to meet the constraints of the resolution process. The information requirements stemming from these RTS are supported by the provisions of the draft RTS on detailed records of financial contracts, currently under public consultation, in the context of an EBA mandate under Article 71 of the BRRD.

³ In particular the exclusion of secured liabilities under Article 44(2)(b) of the BRRD, and on the other hand, pursuant to Article 44(2)(f) the exclusion of liabilities with a remaining maturity of less than seven days, owed to systems or operators of systems designated according to Directive 98/26/EC or their participants and arising from the participation in such a system.

⁴ Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories; OJ L 201, 27.7.2012, p.1

3. Background and rationale

Introduction and mandate

The resolution framework laid down in Directive 2014/59/EU (Bank Recovery and Resolution Directive, hereinafter 'BRRD')⁵ entrusts the resolution authority with a set of tools and powers to intervene swiftly and at a sufficiently early stage in a non-viable entity, in order to ensure the continuity of the entity's critical functions, while minimizing the impact of its eventual failure on the economy and the financial system. The BRRD requires Member States to ensure that resolution authorities possess certain resolution tools and powers, including the sale of business tool, the bridge institution tool, the asset separation tool and the bail-in tool

The bail-in tool, through the write-down or conversion of certain of an institution's liabilities into equity, ensures that losses arising from the institution's failure are borne first by shareholders, followed by the claims of general creditors as per their ranking in the hierarchy. Bail-in powers extend to all liabilities of an institution within the scope of the BRRD (except certain liabilities specified in Article 44(2)) and, absent exceptional circumstances as described in Article 44(3), liabilities arising from derivative contracts are subject to write down or conversion.

The BRRD requires resolution authorities bailing-in derivatives to respect netting and collateral arrangements (Articles 44(2)(b) and 49), which may mean in many cases that the value of derivatives claims potentially subject to bail-in could be small or zero. Nevertheless, the possible application of the bail-in tool to derivative contracts enhances market discipline by creating incentives for shareholders and counterparties to properly scrutinise the risk profile and management practices of an institution in normal times. The bail-in tool must be in place no later than 1st January 2016 in all Member States.

Bailing-in derivative contracts can present unique and complex challenges to resolution planning and implementation. Institutions may have large values and volumes of outstanding derivative contracts and rely on these for risk management purposes. Derivative contracts can be settled via a central counterparty ('CCP')⁶ or bilaterally between counterparties. They may be traded in an

⁵ Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, OJ L 173/12.6.2014, p.190.

⁶ A CCP is a Financial Market Infrastructure which interposes itself between two counterparties, becoming the seller to every buyer and the buyer to every seller, through the novation of the derivative contracts. This structure flattens out risk and uncertainty and increases efficiency and confidence in the financial operations. That is because the CCP limits exposures among counterparties (each counterparty is essentially exposed only to the CCP) and requires collateral for its open positions by all counterparties and therefore allows each counterparty to be protected against credit and liquidity risks stemming from the other counterparty. A CCP usually deals only with a limited number of trusted counterparties, the 'clearing members'. The CCP does not take on market risk, i.e. the exposure to a change in the

exchange venue or bilaterally (over-the-counter or 'OTC' derivatives). The value of derivative contracts is linked to underlying instruments, assets or entities, of which the value evolves over time and only crystallises at maturity or upon termination ('close-out'). Also, most derivative contracts are subject to netting arrangements, allowing counterparties to close-out netted exposures across multiple contracts.

Experience in the administration of failed institutions following the 2008 crisis, illustrates that the valuation of derivatives upon the failure of one of the counterparties is a complex matter that may take time and is prone to disagreement and litigation between the counterparties. This had been particularly the case for OTC derivatives, for which there was neither clearly observable market price nor central clearing.

While an orderly resolution process will avoid many of the costs and shortcomings experienced in previous disorderly liquidation proceedings, its effectiveness will only be achieved if resolution authorities are equipped with appropriate methodologies to value liabilities arising from derivative contracts not only swiftly within the resolution timeline, but also on the basis of objective elements avoiding the risks of counterparties overestimating their claims.

In recognition of these challenges, Article 49 of the BRRD sets forth requirements regarding the write-down or conversion of derivative contracts, especially with respect to the determination of the value of the liability at the point of intervention. Article 49 of the BRRD provides that resolution authorities may write-down or convert derivative contracts only "upon or after closing-out the derivatives". Where a derivative contract is subject to a netting agreement, Article 49 requires the liability to be determined on a net basis, in accordance with the terms of the agreement.

Derivatives liabilities may fall under the general exclusions from the scope of the bail-in power under Article 44(2) BRRD, in particular the exclusion of secured liabilities to the extent the value of the liability does not exceed the value of the collateral. Additionally, derivatives liabilities may be excluded from bail-in using the resolution authority's discretion under Article 44(3) BRRD, in particular when it is not possible to bail-in that liability within a reasonable time or when the application of the bail-in tool would cause destruction in value, which would increase the losses borne by other creditors.

EBA has a mandate pursuant to Article 49(5) BRRD to develop draft regulatory technical standards ('RTS') specifying methodologies and principles to be applied by resolution authorities when applying write down and conversion powers to derivative liabilities. These methodologies and principles target three sets of issues:

- a) determining the value of classes of derivatives, including transactions that are subject to netting agreements;

market value of the trades that it enters into, because it runs a 'matched book': any position taken on with one counterparty is always offset by an opposite position taken on with another counterparty.

- b) establishing the relevant point in time at which the value of a derivative position should be established; and
- c) comparing the destruction in value that would arise from the close-out and bail-in of derivatives with the amount of losses that would be borne by derivative liabilities in a bail-in.

Approach

a. Valuation Methodologies – RTS section 2

Article 49 of the Directive sets out the modalities for bailing-in derivative contracts, with two main requirements:

- a) Derivative transactions subject to a netting agreement must be bailed-in on a net basis in accordance with the term of the netting agreement. The valuer must therefore respect netting sets as defined in netting agreements without being able to “cherry pick” certain contracts and exempt others.⁷
- b) Derivatives may only be bailed in upon or after close-out of the contracts. Therefore, methodologies must aim at enabling a timely valuation of the close-out amount, allowing the resolution authority the ability to write-down and convert the unsecured, net amount due under the netting agreement.

Contractual practice illustrates that netting agreements and standalone derivative contracts may contain different methodologies for determining the net amount due between counterparties upon close-out (for example market quotation, loss, close-out methods). In general, in an event of default of one of the parties, derivative contracts assign the power to determine the close-out amount or the termination date to the non-defaulting counterparties.

However, for the purposes of resolution, resolution authorities, when the conditions for resolution have been met, are empowered to close-out and bail-in derivatives, and to determine a valuation of the derivative liability at the moment of the exercise of the resolution power.

As required under Article 49 of the BRRD, this RTS provides a methodology to be followed by resolution authorities in order to conclude the valuation of derivative contracts upon close-out. The methodology set forth in this RTS determines the close-out amount based on the principle of ‘replacement cost.’ In general, replacement cost represents the cost which the non-defaulting counterparty would incur in order to replace the terminated contract, after taking into account any collateral posted or received.

The principle of replacement cost as a determinant for the close-out valuation is consistent with predominant market practice. Application of replacement cost is also in general consistent with

⁷ ‘Netting agreement’ usually refers to a contract between two counterparties establishing a single legal obligation over all the derivative contracts in its scope. Following a close-out, the netting agreement establishes a single amount, which the institution under resolution has the legal right to receive or the legal obligation to pay. ‘Netting set’ means the group of transactions included in a netting agreement.

the no-creditor-worse-off principle, as the approach to value to outstanding liability would be aligned with common market practice in insolvency proceedings.

When applying the replacement cost valuation methodology, resolution authorities should be able to rely on various sources of data. Replacement trades concluded by counterparties or other market transactions for similar contracts in order to replace or re-hedge the risk exposure upon close-out would constitute a meaningful source for valuation as long as the replacement trades are concluded on commercially reasonable terms.

The draft RTS on derivative valuation describes a process for determining the value of derivative liabilities (after netting and collateral) where derivatives have been closed out. To maintain consistency with standard netting agreements and the treatment of derivatives in insolvency, this RTS provides that resolution authorities shall notify the counterparty of the termination and close-out of the derivative contract, and require counterparties to provide evidence of replacement trades within a set deadline. If the counterparty is not able to provide a commercially reasonable replacement trades within the deadline, resolution authorities would be authorised to construct their final, non-provisional close-out valuation on the basis of mid-market prices and bid-offer spreads.

Articulation of this RTS with the valuation of assets and liabilities under Article 36 of the BRRD

Articles 36 and 49 of the BRRD should be read together and operate to provide a valuation process that is compatible with the swiftness inherent in the resolution process and allows for a valuation on the basis of prudential assumptions and objective elements.

As provided under Article 49(3) of the BRRD, the valuation of derivative liabilities should be made as part of the valuation of assets and liabilities carried out pursuant to Article 36 of the BRRD, and specifically form part of a valuation for the purpose of informing the extent of the write-down or conversion of eligible liabilities. In that context, the valuation of derivatives will be conducted by the valuer on a provisional basis, consistent with the processes described in Article 36 BRRD and the delegated acts adopted thereto, and will serve to inform the resolution decisions.

The methodologies contained in this draft RTS will ensure that, when employing the bail-in tool, losses under derivative contracts are fully recognised at the moment the resolution tools are applied, in accordance with Article 36(4)(g) of the BRRD.

Under Article 36(9), valuations may be conducted on a provisional basis where it is not possible to fulfil all of the requirements in the time available. Under the BRRD a provisional valuation is also a valid basis for resolution actions. The draft RTS reflects this possibility in Article 7(2). Where resolution authorities decide to bail-in derivatives based on a provisional valuation, they should employ reasonable valuation methods under the prevailing circumstances, including reliance upon internal models of the bank under resolution and data available at the time of the determination.

As in all cases where taking resolution action based on a provisional valuation, resolution authorities will need to ensure that a final and definitive valuation is carried out after resolution, and need to make arrangements to be able to adjust the treatment of creditors subsequently (e.g. by finalising the distribution of equity in the bailed-in bank after the final valuation is complete), or provide alternative compensation if necessary, on the basis of the valuation of difference in treatment pursuant to Article 74 of the BRRD.

Treatment of CCP cleared derivatives

This draft RTS takes into account the specificities of centrally-cleared derivatives. Indeed, CCPs active in the EU are subject to legislation and supervision (stemming particularly from the European Market Infrastructure Regulation - 'EMIR'⁸), requiring CCPs to apply sound risk management in its default procedures at the default of a clearing member.⁹ Such risk management ensures collateralisation and a prudent and transparent way to manage crisis situations, limiting the exposure and the costs for CCPs at the default of a clearing member.

When derivative contracts between a clearing member and a CCP are closed-out, for instance when the clearing member defaults, the CCP will seek to re-hedge its open positions or replace the trades it had with another – solvent – clearing member and thereby avoid open positions. For the replacement of the defaulting members' transactions, the CCP will apply its 'default procedures', which every authorised CCP in the EU is required to have in place pursuant to the EMIR and the relevant supervisory college. CCP default procedures generally require a series of steps to be taken by the CCP for the replacement, including recourse to a trading venue, an auction among the CCP's non-defaulting clearing members or bids by selected clearing members.¹⁰ The price offered will represent a cost or gain for the CCP, which the latter will offset against any collateral posted by the defaulting clearing member. The default procedures will therefore establish the CCP's replacement cost. It is unlikely that a defaulting clearing member would have a liability exceeding the collateral posted, thus bailing in such liabilities seems unlikely under normal risk management conditions.

CCP default procedures under provide a high level of transparency and soundness in the risk mitigation and the determination of replacement costs by CCPs. In addition, CCPs play a crucial role in the functioning of financial markets and are not risk-assuming entities per se. For that reason, EU legislation, international initiatives and prudential supervision aim at protecting their operations from individual default events in order to ensure financial stability. Thus, this RTS draws extensively on the CCP default procedures and timelines.

⁸ Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories; OJ L 201, 27.7.2012, p.1

⁹ When a CCP is not subject to the EMIR requirement on default procedures, a resolution authority should regard it as a normal counterparty

¹⁰ Article 48(5) of EMIR Regulation also provides for, as a first step, a compulsory attempt to port asset and positions held by a defaulting clearing member for the account of its clients, to another clearing member under certain conditions.

Accordingly, with regard to centrally cleared derivatives, the resolution authority will notify its decision to close-out the contract and agree with the CCP and its competent authority on a deadline, by which the CCP should provide its replacement costs, taking into account its default procedures and the resolution timeline.

In contrast, where the CCP does not provide its replacement costs by the agreed deadline or where there is evidence that the CCP did not follow its default procedures, the resolution authority will be able to apply the methodology otherwise applicable to non-centrally cleared derivatives, after consulting the CCP's competent authority.

b. Point in time – RTS section 3

Section 3 deals with the reference point in time for the valuation.

The valuation approach seeks to employ replacement costs incurred by the counterparty in order to determine the close-out valuation of derivative contracts, while ensuring that the resolution authority's timeline to conclude a valuation remains consistent with the general resolution timeline and prevents unreasonable delay in determining the close-out amount incurred by counterparties.

Accordingly, Article 7(1) of the draft RTS defines a reference time and date on which the resolution authority shall determine the close-out amount. The close-out valuation should thus be determined as at the close-out date or, if that would not be commercially reasonable, the day and time at which a price is available in the underlying market for the derivative contract.

Establishing the derivative contract value on that reference date will secure maximum accuracy for resolution authorities. However, where the valuation of derivatives is part of a provisional valuation as described above, the resolution authority¹¹ will be able to establish a valuation of the close-out amount prior to the reference date, based on the resolution authority's own estimates of the replacement costs that the counterparty would incur at the reference date, and taking into account the market conditions at that time. In line with the processes described in Article 36 BRRD and the delegated acts adopted thereto, the data subsequently recorded at the reference date will feed into the final valuation pursuant to Article 36(10) of the BRRD, and resolution authorities may then either adjust the treatment of creditors in bail-in - provided the necessary arrangements have been made – or to provide alternative compensation if necessary, on the basis of the valuation of difference in treatment pursuant to Article 74 of the BRRD.

c. Destruction in value – RTS section 4

Resolution authorities are required under the BRRD to seek to minimise the cost of resolution, to avoid unnecessary destruction of value¹² and to avoid significant adverse effects on the financial

¹¹ Article 7(2) of this draft RTS.

¹² Article 31(2), last subparagraph, of the BRRD.

system.¹³ Accordingly, resolution authorities may exclude liabilities from bail-in under exceptional circumstances, notably where the exclusion is strictly necessary and proportionate to avoid giving rise to widespread contagion,¹⁴ or where the application of the bail-in tool to those liabilities would cause a destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in.¹⁵

The circumstances which may lead to the exemption from bail-in laid down under Article 44(3) of the BRRD are to be further specified by Commission delegated acts and are therefore not within the scope of this draft RTS.

However, in line with Article 49(4)(c) of the BRRD, this draft RTS sets out the approach to be followed by resolution authorities when making a comparison between, on the one hand, the destruction in value that would arise from the close-out and bail-in of derivatives and, on the other hand, the amount of losses that would be borne by those derivatives in a bail-in. Under the RTS, resolution authorities, on a case by case basis and in accordance with the BRRD and Commission delegated acts, will assess the potential destruction in value which would arise from the close-out and bail-in of derivatives. On the basis of this and other factors, resolution authorities will determine any liability exemptions that might follow as a consequence.

The close-out of derivative contracts may crystallise losses that are not fully reflected in the fair value of the contracts before close-out. These could stem for example, from additional replacement costs incurred by the counterparty, or costs incurred by the institution under resolution to re-establish hedges left open by the close-out. Where the amount by which the corresponding liability could be bailed-in (the “bail-in potential”) is less than the losses incurred by the institution under resolution stemming from the close-out of derivative contracts, the excess loss to the institution may increase the burden of bail-in for other creditors of the institution under resolution. In such case, resolution authorities may consider employing the exemption to bail-in under the conditions of Article 44(3)(d) of the BRRD and the Commission delegated act adopted under Article 44(11) of the BRRD.

In order to compare the destruction in value that would arise from the close-out and bail-in of derivative contracts with the amount of losses that would be borne by derivatives in a bail-in, resolution authorities should compare (a) the amount of losses that would be borne by the derivative contracts in a bail-in as part of the valuation under Article 36 and taking account the pro quota share of derivatives within equally ranking liabilities and all applicable exemptions that would reduce the loss absorption capacity of the liability, and (b) an assessment of the amount of the costs, expenses, or other impairment in value that would be incurred as a result of the early termination and close-out of the derivative contracts.

¹³ Article 31(2)(b) of the BRRD.

¹⁴ Article 44(3)(c) of the BRRD.

¹⁵ Article 44(3)(d) of the BRRD.

In order to assess the amount described in (b) above, resolution authorities should incorporate reasonable estimates of (i) the cost and expense for re-hedging, (ii) any reduction of the franchise value, or in the value of underlying assets, that would arise from the close-out; (iii) ancillary costs or other measures.

It should be noted that the assessment of destruction in value is intended to inform the resolution authority's decision whether or not to close-out derivative contracts, and so must be determined prior to the point of close-out.

d. Contribution to BRRD implementation and the single market

This RTS aims at providing resolution authorities with the tools to evaluate and close-out derivative contracts in the context of resolution. This is necessary in order to have the effective power to bail-in liabilities resulting from closing-out derivative contracts. It therefore ensures that the objectives of the BRRD are fulfilled, because such liabilities are in principle eligible for bail-in.

In addition, this RTS contributes to a harmonised framework for closing-out and bailing-in liabilities. It therefore contributes to the establishment of a single rulebook for the functioning of the internal market in the field of supervision and resolution of financial institutions.

e. Proportionality

The RTS respects the principle of proportionality. Indeed, it refers only to institutions that have been placed under resolution and where the bail-in tool is used, and as such has met the conditions under Article 32 of the BRRD.

In addition, the RTS establishes the right balance between the need to recognise market practice in the derivative marketplace and the need for objectiveness and swiftness which is central to the resolution process.

Finally, the RTS takes into account the specificities of centrally cleared derivatives and has specific provisions for closing-out this type of derivative contracts.

4. Draft Regulatory Technical Standards on the valuation of derivatives pursuant to Article 49(4) of the Bank Recovery and Resolution Directive (BRRD)

In between the text of the draft RTS that follows, further explanations on specific aspects of the proposed text are occasionally provided, which either offer examples or provide the rationale behind a provision, or set out specific questions for the consultation process. Where this is the case, this explanatory text appears in a framed text box.

Contents



EUROPEAN COMMISSION

Brussels, XXX
[...](2012) XXX draft

COMMISSION DELEGATED REGULATION (EU) No .../..

of XXX

[...]

COMMISSION DELEGATED REGULATION (EU) No .../..

Of XXX

[...]

Supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards for methodologies and principles on the valuation of liabilities arising from derivatives

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014¹⁶ establishing a framework for the recovery and resolution of credit institutions and investment firms, and in particular Article 49(5) thereof,

Whereas:

- (1) Directive 2014/59/EU entrusts resolution authorities with the power to write-down and convert liabilities of an institution under resolution, including those liabilities arising from derivative contracts, so that shareholders and creditors bear an appropriate part of the costs arising from the failure of a credit institution, with a view to fostering sound market discipline in normal times. Derivative contracts may represent a significant share of the liability structure of certain credit institutions.
- (2) However, the very nature of derivative contracts makes the valuation of liabilities arising from such contracts complex. The value of such derivative liabilities is linked to the value of underlying instruments, assets or entities, which evolves over time and only crystallises at maturity or upon close-out. Directive 2014/59/EU provides for resolution authorities to exercise write-down and conversion powers in relation to liabilities arising from derivative contracts only upon or after close-out and to that end entrusts them with the power to terminate and close-out any derivative contract and fully recognise losses upon exercise of resolution powers.

- (3) In addition, past experience illustrates that the valuation of derivative liabilities upon failure of one of the counterparties is complex, may be time-consuming, potentially involves enormous costs and is prone to litigation.
- (4) Furthermore, contractual practice illustrates that derivative contracts may contain different methodologies in determination of the amount due between counterparties upon close-out, some of them entirely leaving the determination of the close-out amount or the close-out date, or both, entirely to the non-defaulting counterparty.
- (5) Accordingly, in order to avoid moral hazard and ensure efficiency of the resolution actions, resolution authorities should adopt and implement appropriate methodologies to value liabilities arising from derivative contracts within a timeframe compatible with the swiftness inherent in the resolution process and based on objective and, where practicable, readily available information. To that end, Article 49(5) of Directive 2014/59/EU mandates the EBA to specify three elements, namely the methodologies for determining the value of liabilities arising from derivatives, the principles for establishing the point in time at which such value should be established, and the methodologies for comparing the destruction in value that would arise from the close-out and bail-in of derivatives with the amount of losses that would be borne by derivative liabilities in a bail-in.
- (6) Derivative transactions subject to a netting agreement give rise to a single close-out amount in the event of a contractual early termination. Consistently, Directive 2014/59/EU provides that the value of such contracts shall be determined on a net basis in accordance with the terms of the agreement. The resolution authority or independent valuer must therefore respect netting sets defined in the netting agreements without being able to “cherry pick” certain contracts and exempt others.
- (7) As required by Directive 2014/59/EU, the value of derivative contracts shall be determined by the resolution authority or independent valuer as part of the valuation carried out under Article 36 of that Directive. With respect to the valuation of derivative contracts, the valuation process should aim to determine a prompt and *ex ante* valuation for bail-in purposes, and at the same time allow the resolution authority flexibility to adjust claim amounts *ex post* depending upon circumstances.
- (8) The assessment whether to bail-in derivative liabilities or to exclude them from the scope of bail-in pursuant to Article 44(3) of Directive 2014/59/EU should be made prior to the decision to close-out, as part of the valuation under Article 36 of that Directive.
- (9) The need for consistent interpretation of paragraphs (3) and (4) of Article 49 of Directive 2014/59/EU requires this Regulation to specify methodologies and principles for the valuation of derivatives carried out by independent valuers as well as by resolution authorities.
- (10) A valuation methodology reliant on the hypothetical replacement cost for the closed-out liabilities is consistent with predominant market practice and with the principles governing the valuation required under Article 74 of Directive 2014/59/EU aimed at establishing whether shareholders and creditors would have

received better treatment if the institution under resolution had entered into normal insolvency proceedings (the “no-creditor-worse-off principle”).

- (11) In applying the valuation methodology, the resolution authority should be able to rely on various sources of data, including a data source provided by the institution under resolution, counterparties or third parties. This Regulation should nevertheless set out principles on the types of data that should be taken into consideration in the course of the valuation in order to ensure an objective determination of value.
- (12) Replacement trades concluded by counterparties to replace their exposure upon close-out should constitute a data source for the close-out valuation as long as they are concluded on commercially reasonable terms as at the close-out date or as soon as reasonably practicable thereafter. If not, resolution authorities should be able to construct their valuation on the basis of available market information, such as mid-market prices and bid-offer spreads in order to assess a hypothetical replacement trade, i.e. the loss or cost that would have been incurred as a result of re-establishing a hedge or related trading position on a net risk exposure basis.
- (13) EU legislation adopted in recent years, consistent with international standards, has sought to increase transparency and risk mitigation in the market for derivative contracts by providing for (i) mandatory clearing through central counterparties (‘CCP’) for standardised over-the-counter (‘OTC’) derivatives; (ii) valuation and margining requirements for CCP-cleared derivatives and for a wide range of OTC derivatives, and (iii) mandatory reporting to trade depositories for all OTC derivatives.
- (14) Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (‘EMIR’) requires CCPs authorised in a Member State or recognised in the EU to have in place a sound risk-management framework and adequate procedures and mechanisms to deal with the default of a clearing member. These procedures are meant to be a prudent and transparent way to manage the default of a clearing member.
- (15) In the event that a CCP clearing member were placed under resolution, and the resolution authority closed-out derivative contracts prior to a bail-in, that clearing member would qualify as a defaulting clearing member vis-à-vis the CCP in relation to the particular netting set(s). The internal procedures and mechanisms governing the default of a clearing member (‘CCP default procedures’) implemented by CCPs in light of the EMIR regulation requirements, offer a reliable basis to determine the valuation of the derivative liability netting sets at close-out also in the context of bail-in in a resolution process.
- (16) Conducting CCP default procedures may take several days following the trigger event. However, for the particular case of resolution, the application of default procedures over a long period of time could undermine the resolution timeline and objectives and could result in unnecessary disruption in the financial markets. It is therefore necessary for the resolution authority to ensure the cooperation of the CCP and the CCP competent authority in order to determine, by common agreement, a deadline for determining the close-out amount, taking into account

both the CCP default procedures and the resolution timeline envisaged by the resolution authority.

- (17) The resolution authority should nevertheless have the possibility to rely on its own estimates or on an alternative objective methodology to determine the close-out amount where the CCP fails to deliver the valuation of a close-out amount within the agreed deadline or does not apply its default procedures. The resolution authority should also be able to apply an early determination based on its own estimates, where such action is justified by the urgency of the resolution process, and provided it updates its valuation upon completion of the CCP default procedure.
- (18) In any case, and for the sake of completeness, any exercise of the bail-in power in relation to such liabilities should be subject to the exemptions set out in Article 44(2) of Directive 2014/59/EU and to the discretionary exemptions laid down in Article 44(3) of Directive 2014/59/EU as specified in the Commission Regulation XXXXX adopted pursuant to Article 44(11) of that Directive.
- (19) The provisions in this Regulation should not affect the CCP internal procedures for the transfer of the assets and positions held by a defaulting clearing member (“porting”), adopted in accordance with Article 48(5) and (6) of Regulation (EU) No 648/2012, and any other relevant provisions which, in principle, have the effect of precluding liabilities from arising from the relevant derivative contract.
- (20) The point in time for the valuation of derivative contracts should reflect the valuation principle retained by this Regulation which takes into account the actual or the hypothetical replacement costs incurred by counterparties. Therefore the valuation should be as at the close-out date or, if that would not be commercially reasonable, as at the first day and time at which a market price is available for the underlying asset.
- (21) The valuation will be most accurate where produced at that reference date. However, where, due to the urgency in the prevailing circumstances, the resolution authority decides to carry out a provisional valuation pursuant to Article 36(9) of Directive 2014/59/EU, the resolution authority or the valuer should also be able, as part of that provisional valuation, to produce an early determination of derivative liabilities prior to that reference date, based on value estimates and available data as at that time. In line with Article 36(12) of Directive 2014/59/EU, a provisional valuation containing such an early determination should be a valid basis for resolution actions. In such a circumstance relevant market developments observed or evidence of actual replacement trades as at the reference date would either be reflected in a subsequent provisional valuation or, in any case, in the final valuation carried out pursuant to Article 36(10) of Directive 2014/59/EU. As in any case where resolution authorities take resolution action on the basis of a provisional valuation, creditors, where necessary, should either have their treatment adjusted, if and to the extent the resolution authority has made necessary arrangements for holding sufficient equity, or be entitled to compensation on the basis of the valuation of difference in treatment pursuant to Article 74 of Directive 2014/59/EU.
- (22) The close-out of derivative contracts may crystallise additional losses that are not reflected in the going-concern valuation, stemming for example from actual

replacement costs incurred by the counterparty that would increase the close-out costs owed by the institution under resolution, or costs incurred by the institution under resolution in re-establishing trades on open market risk exposures resulting from the close-out. If these losses incurred or expected to be incurred from the close-out of derivatives exceed the share of the corresponding liabilities that would be effectively available for bail-in, the excess loss may increase the burden of bail-in for other creditors of the institution under resolution. In such cases, the amount of losses that would be borne by the liabilities other than derivative contracts in a bail-in would be higher than without closing out and bail in derivative contracts, and therefore the resolution authority may consider exempting derivative contracts from bail-in in accordance with Article 44(3), letter (d) of Directive 2014/59/EU and with the Commission Regulation adopted under Article 44(11) of that Directive. When doing so, the resolution authority should analyse the destruction in value that would stem from the close-out of derivative contracts and the bail-in potential of the corresponding liabilities.

- (23) This Regulation is based on the draft regulatory technical standards submitted by the European Banking Authority to the Commission.
- (24) 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 opinion of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010.

HAS ADOPTED THIS REGULATION:

Section 1

Definitions

Article 1 – Definitions

1. “Derivatives” means derivatives as defined in Article 2(5) of Regulation (EU) No 648/2012;
2. “Write-down and conversion powers”, or “bail-in” powers, means the powers referred to in Article 59(2) and Article 63(1) letters (e) to (i) of Directive 2014/59/EU;
3. “Derivative liability” means a liability of an institution under resolution arising from the close-out of a derivative contract or a netting set;
4. “Netting set” means a netting set as defined in Article 272(4) of Regulation (EU) 575/2013;
5. “Valuer” means any of: (a) the independent expert in compliance with the requirements and the criteria set out in Commission Regulation (EU) No. xx/xxxx (EBA RTS 2015/xx/EU) specifying circumstances in which a valuer is to be considered independent, which is appointed to carry out the valuation; or (b) the

- resolution authority when conducting the valuation pursuant to paragraphs (2) and (9) of Article 36 of Directive 2014/59/EU;
6. “Unpaid Amounts” means, in respect of closed-out derivative contracts, the amounts that became payable on or prior to the close-out date and which remain unpaid as at that date, and for each obligation of the derivative contracts which was required to be settled by delivery on or prior to the close-out date and which has not been settled as at the close-out date, an amount equal to the fair market value of that which was required to be delivered;
 7. “Central counterparty”, or “CCP”, means a CCP as defined in Article 2(1) of Regulation (EU) No 648/2012 and to the extent that it is (i) established in the EU and authorised in accordance with the procedure set out in Articles 14 through 21 of Regulation (EU) No 648/2012 or (ii) established in a third country and recognised in accordance with the procedure set out in Article 25 of Regulation (EU) No 648/2012;
 8. “Clearing member” means a clearing member as defined in Article 2(14) of Regulation (EU) No 648/2012;
 9. “Close-out date” means the day and time of the close-out as specified by the resolution authority in the notification of a close-out;
 10. “Replacement trade” means a transaction entered into as at the close-out date of a derivative contract to re-establish any hedge or related trading position that has been terminated on equivalent economic terms as the closed-out transaction;
 11. “Commercially reasonable replacement trade” means a replacement trade entered into on a netted risk exposure basis, on terms consistent with common market practice and making best efforts in order to obtain best value for money;
 12. “Porting” means the transfer by a CCP of the positions and assets of a defaulting clearing member’s clients to a solvent clearing member, according to the provisions of Article 48(5) and (6) of Regulation (EU) No 648/2012;
 13. “Institution under resolution” means an institution under resolution as defined under Article 2(1)(83) of Directive 2014/59/EU;
 14. “Bid price” means the best quoted price for an immediate sale of an asset or contract;
 15. “Offer price” means the best quoted price for an immediate purchase of an asset or contract;
 16. “Mid-market price” means the average of the Bid price and the Offer price;
 17. “Bid–offer spread” means the difference between the bid price and the offer price quoted for an immediate sale (bid) and an immediate purchase (offer). The size of the bid-offer spread in a security is a measure of the liquidity of the market and of the size of the transaction cost. If the spread is 0 then it is a frictionless asset;
 18. “Mid-to-bid spread” and “mid-to-offer spread”, mean the share of the bid-offer spread between the mid-market price and, respectively, the bid price or the offer price.

Question 1: Do you agree with the definitions above? Do you consider it necessary to specify some of them further, and in particular the definitions of “commercially reasonable replacement trades” and “unpaid amounts”?

Section 2

Determination of value

Article 2 - Notification of the decision to close-out

1. Prior to exercising the write-down and conversion powers in relation to derivative liabilities, the resolution authority shall notify the derivative contract counterparty being closed-out of its decision to close-out the derivative contracts pursuant to Article 63(1), letter (k), of Directive 2014/59/EU. The decision to close-out shall take effect immediately or at a later close-out date and time as specified in the notification.
2. In the decision referred to in paragraph 1, the resolution authority shall specify a date and time, expected to meet the requirements of Article 7(1)(c), by which counterparties shall provide evidence of commercially reasonable replacement trades. The counterparty shall provide a summary of any replacement trades.
3. This article shall not apply to the close-out and valuation of centrally cleared derivative contracts entered into between the institution under resolution, acting as a clearing member, and a CCP, which shall be governed by Article 6.

Question 2: Should the deadline given by the resolution authority to the counterparty be further framed? If yes, explain why and how? Does this drafting allow the resolution authority to conclude resolution actions in a sufficiently swift manner?

Article 3 – Role of the netting agreement

For transactions subject to a netting agreement, the valuer shall determine, for all contracts in a netting set, a single amount which the institution under resolution has the legal right to receive or the legal obligation to pay as a result of the close-out of the derivative contracts in the netting set.

Article 4 – Valuation principle for early termination amount

1. The valuer shall determine the value of liabilities arising from derivative contracts under a netting set as an early termination amount calculated as the sum of:
 - a. Unpaid amounts, collateral or other amounts due from the institution under resolution to the counterparty, less unpaid amounts, collateral and other

amounts due from the counterparty to the institution under resolution as at the close-out date; and

- b. A close-out amount covering the amount of losses or costs incurred by derivative counterparties, or gains realised by them, in replacing or obtaining the economic equivalent on material terms of the contracts and the option rights of the parties in respect of the terminated contracts.

Question 3: This valuation principle is intended to be aligned with common market practice that recognises replacement costs in an early termination event, whilst giving certainty to the resolution authority on the methodology to be followed. Do you agree that this valuation principle would result in a fair valuation for the closed-out netting set and as such avoid a breach, from the counterparty's perspective, of the no-creditor-worse-off principle?

Article 5 – Determination of the close-out amount

1. Where a counterparty has provided evidence, by the deadline set out pursuant to Article 2(2), of actual commercially reasonable replacement trades, the valuer shall determine the early termination amount at the prices of those replacement trades.
2. Where a counterparty has not provided evidence of actual replacement trades within the deadline set out pursuant to Article 2(2), where Article 7(2) applies, or where the valuer concludes that those trades were not concluded on commercially reasonable terms, the valuer shall determine the close-out amount on the basis of:
 - a. The mid-market end-of-day prices in line with the business-as-usual processes within the institution under resolution on the date determined pursuant to Article 7;
 - b. the mid-to-bid or mid-to-offer spread, depending on the direction of the netted risk position, in order to estimate the loss or cost deemed to be incurred by the counterparty as a result of the close-out in liquidating, obtaining or re-establishing any hedge or related trading position; and
 - c. adjustments to letter b) in order to reflect the size of the exposure and credit worthiness of the counterparty.

With regard to the determination of the close-out amount for cleared derivatives contracts entered into between an institution under resolution and a CCP, the provisions of this paragraph will be applicable only in the exceptional circumstances set out in Article 6, paragraph 6.

3. With regard to intra-group liabilities, the valuer may establish the value at mid-market price as referred to in paragraph 2(a), without regard to paragraph 2(b) and 2(c), where the resolution strategy would imply re-hedging the terminated transactions via another intra-group derivative transactions.
4. For determining the close-out amount pursuant to paragraph 2, the valuer may rely on the following sources of data:
 - a. For standardised products, valuations generated by the own systems of the valuer;

- b. Data available within the institution under resolution, such as internal models and valuations including independent price verifications performed pursuant to Article 105(8) of Regulation (EU) No 575/2013;
- c. Data provided by counterparties other than evidence of trades communicated pursuant to Article 2(2), including data on current or previous valuation disputes on similar or related transactions;
- d. Data provided by third parties, such as market data and quotes from market makers, or values obtained from central counterparties where a contract is centrally cleared;
- e. Any other relevant data.

Question 4: Do you agree with the preferential status given to commercially reasonable replacement trades? Should there be also a prioritisation among other sources of data?

Question 5: Do you agree with the method described under paragraph 2 for the resolution authority to calculate the close-out amount? Is there a reason to believe that mid-market prices might not always be available or possible to derive from other data sources? And under which circumstances? In that case, what do you consider as an appropriate reference for calculating the close-out amount?

Question 6: Should adjustments to the bid-offer spread, other than those specified under Article 6(4)(c), be considered?

- 5. For the purpose of paragraph 2(b), the resolution authority may instruct the institution under resolution to perform an updated independent price verification as at the reference date determined pursuant to Article 7, using end-of-day information available as at the close-out date.

Article 6 – Valuation of cleared derivatives contracts entered into between an institution under resolution and a CCP

- 1. The valuer shall establish the value of liabilities arising from derivative contracts in a netting set entered between, on the one hand, an institution under resolution acting as a clearing member and, on the other hand, a CCP, based on the valuation principle specified in Article 4. The early termination amount shall be determined by the CCP in accordance with the CCP default procedures and within the deadline specified under paragraph 5.
- 2. The resolution authority shall notify the CCP and the CCP's competent authority of its decision to close-out the derivative contracts pursuant to Article 63(1), letter (k), of Directive 2014/59/EU. The decision to close-out shall take effect immediately or at a later close-out date and time as specified in the notification.
- 3. The resolution authority shall instruct the CCP to provide the early termination amount for all the derivative contracts in the relevant netting set, in accordance with the steps set forth in the CCP default procedure.

4. The CCP shall provide the resolution authority with the CCP default procedure documents and shall report the default management steps undertaken to liquidate or completely re-hedge the positions of the defaulting clearing member.
5. The resolution authority, in agreement with the CCP and the CCP competent authority, shall indicate the deadline by which the CCP shall provide the valuation of the early termination amount. For this purpose, the resolution authority, the CCP and the CCP competent authority shall take into account:
 - a. the default procedure, as established by the CCP governance rules in compliance with Regulation (EU) No 648/2012; and
 - b. the resolution timeline.

The CCP shall confirm to the resolution authority that it can provide the close out amount within the agreed deadline.

6. By derogation to paragraph 1, the resolution authority, taking into account the circumstances of the specific situation, may decide to apply the methodology laid down in Article 5(2) of this Regulation, after consulting the CCP competent authority, where:
 - a. the CCP does not provide the valuation of the early termination amount within the deadline indicated by the resolution authority pursuant to paragraph 5; or
 - b. the resolution authority has evidence that the CCP has not provided a valuation of an early termination amount in line with the CCP default procedures.

Question 7: Do you agree with the treatment of CCPs as laid down in this Article? Are the conditions laid down in this article compatible with a swift and efficient valuation of cleared derivatives within the context of a resolution process? Do you see any material risk that the treatment of CCPs as laid down in this Article could conflict with the requirements for a sound risk-management framework to deal with the default of a clearing member?

Section 3

Point in time for establishing the value of derivatives liabilities

Article 7 – Point in time for establishing the value of derivative liabilities and early determination

1. The valuer shall determine the value of derivative liabilities as at the following point in time:
 - a. where the valuer determines the early termination amount at the prices of replacement trades pursuant to Article 5(1), the day and time of the conclusion of the replacement trades;
 - b. where the valuer determines the early termination amount in accordance with the CCP default procedures pursuant to Article 6(1), the day and time when the early termination amount has been determined by the CCP;
 - c. in all other cases, the close-out date or, if that would not be commercially reasonable, the day and time at which a price is available in the market for the underlying asset.
2. The valuer, as part of a provisional valuation carried out pursuant to Article 36(9) of Directive 2014/59/EU, may produce its valuation of liabilities arising from derivatives earlier than at the point in time determined pursuant to paragraph 1. Such early determination shall be made on the basis of estimates, relying on the principles laid down in Article 4 and in paragraphs (2) to (4) of Article 5, and on data available at the time of the determination.
3. Where the valuer carries out an early determination pursuant to paragraph 2, the valuer may update its provisional valuation at any time upon decision of the resolution authority to take into account relevant observable market developments or evidence of commercially reasonable replacement trades available at the point in time determined pursuant to paragraph 1. These developments or evidence shall be taken into account in the final valuation carried out pursuant to Article 36(10) of Directive 2014/59/EU.

Question 8: Article 7(1) is intended to be aligned with market practice in early termination events. Do you see a risk of increased market volatility on the first market day following the close-out notification, which could adversely affect the termination value? Do you consider the notion of “commercially reasonable” date sufficiently self-evident or should it be further specified?

Question 9: As provided for under Article 7(2), the resolution authority will have the possibility to produce a valuation at a date or time earlier than the earliest commercially reasonable date as part of a provisional valuation carried out pursuant to Article 36(9) of the BRRD. This possibility is intended to allow for a swifter resolution process as resolution authorities will be

able to apply the write down and conversion powers on the basis of the early determination. As in all cases where taking resolution action based on a provisional valuation, resolution authorities will update their determination either as part of a subsequent provisional valuation or the final valuation. At that point they will either adjust the write down and conversion of creditors, provided they have previously made the necessary arrangements such as holding sufficient equity, or provide alternative compensation, if necessary, on the basis of the final valuation of difference in treatment pursuant to Article 74 of Directive 2014/59/EU.

Do you consider this optional early determination appropriate, or do you consider that this option would unreasonably increase the risk of litigation or ex post compensation according to Article 74 of the BRRD?

Question 10: Alternatively, should resolution authorities always wait until there is pricing available in the market before producing their valuation, and therefore wait until that date before applying the bail-in tool?

Question 11: The possibility to produce an early determination is available also in relation to claims of a CCP. In this case the final valuation will reflect the CCP claim as determined pursuant to Article 6, on the basis of the CCP default procedures if provided under the conditions of that Article. Do you consider it appropriate to also allow an early determination in relation to CCP claims?

Question 12: If so, do you consider that, with regard to CCP claims, resolution authorities should always be obliged to adjust the bail-in treatment of the CCP if and once the CCP provides its determination pursuant to Article 6? In that case, how do you assess the risk that the CCP determination process could hold back the finalisation of the bail-in process also for other claims? Alternatively, does the assessment of difference in treatment pursuant to Article 74 of the BRRD provide a sufficient safety net for CCPs?

Section 4

Comparison between the destruction in value that would arise from the close-out and the bail-in potential of derivative contracts

Article 8 - Terms of the comparison

1. For the purpose of Article 49(4)(c) of Directive 2014/59/EU, the resolution authority shall compare:
 - (a) the amount of losses that would be borne by the derivative contracts in a bail-in, obtained by multiplying:
 - (i) the share, within all equally ranked liabilities, of liabilities arising from the derivatives contracts determined as part of the valuation under Article 36 of Directive 2014/59/EU and not falling within

- the exclusions from bail-in pursuant to Article 44(2) of that Directive; by
- (ii) the total losses expected to be borne by all liabilities ranking equally to derivatives, including the derivative liabilities stemming from the close-out ; with
- (b) the destruction in value based on an assessment of the amount of the costs, expenses, or other impairment in value that is expected to be incurred as a result of the close-out of the derivatives contracts, and obtained by summing up the following elements:
- (i) the risk of an increased counterparty close-out claim arising from re-hedging costs expected to be incurred by the counterparty, by taking into account the bid-offer spreads in line with Article 5, paragraph 2, letter (b);
 - (ii) the cost expected to be incurred by the institution under resolution in establishing any comparable derivative trades considered necessary in order to re-establish a hedge for any open exposure or in order to maintain an acceptable risk profile in line with the resolution strategy. This could be achieved by taking into consideration initial margin requirements and prevailing bid-offer spreads;
 - (iii) any reduction to franchise value arising from the close-out of derivative contracts, including any valuation impairment for other or underlying assets that are linked to the derivative contracts being closed out, and any impact to funding costs or income levels;
 - (iv) any precautionary buffer against possible adverse implications from close-out, such as errors and disputes on transactions or in respect of collateral exchange.
2. The comparison under paragraph 1 shall be made before a decision to close-out is taken, as part of the valuation to inform decisions about resolution actions required under Article 36 of Directive 2014/59/EU, and consistently with the requirements of Part III of [EBA TS XX].

Question 13: Do you find the guidance provided in paragraph 2 of this Article sufficiently clear as to the terms of comparison?

Question 14: Do you agree with the main drivers of the destruction in value as described in this Article?

Question 15: Do you agree with the provision for a precautionary buffer? Do you consider the indicative elements supporting this precautionary buffer as sufficient? Do you see other considerations that should be taken into account when calculating a precautionary buffer?

Question 16: In determining destruction in value, should resolution authorities incorporate into their analysis the impairment to the firm's franchise value that would result from the termination and closing-out of a firm's derivatives contracts and the cessation of its related business operations?

Section 5

Final provisions

Article 9 – Entry into force

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*

[Position]

5. Accompanying documents

a. Draft Cost- Benefit Analysis / Impact Assessment

Introduction

Article 49(5) of the Directive 2014/59/EU (Bank Recovery and Resolution Directive, hereinafter ‘BRRD’)¹⁷ mandates the EBA to develop draft Regulatory Technical Standard (‘RTS’) to specify the methodologies and principles to be applied by resolution authorities and independent valuers for determining the value of liabilities arising from derivatives contract with a view to applying bail-in powers.

As per Article 10(1) of the EBA regulation (Regulation (EU) No 1093/2010 of the European Parliament and of the Council), any RTS developed by the EBA shall be accompanied by a cost and benefit analysis. Such an annex shall provide the reader with an overview of the problem identifications, the options identified to remove each problem and the potential impact of each option.

This annex presents the assessment of the policy options considered in this RTS.

Background and problems identification

In some EU banks, derivative liabilities represent the category of liabilities that could absorb the largest fraction of losses beyond those covered by the equity and subordinated debt.

The derivatives market is one of the largest segments of financial markets. As of December 2014, the global Over-The-Counter (‘OTC’) derivative market amounted to nearly USD 700 trillion in terms of notional amount outstanding (an increased by nearly 50% since 2007) and an estimated gross market value (which represents the maximum loss that market participant would incur if all counterparties failed to meet their contractual payments and the contracts were replaced at current market prices) of €17 trillion.¹⁸

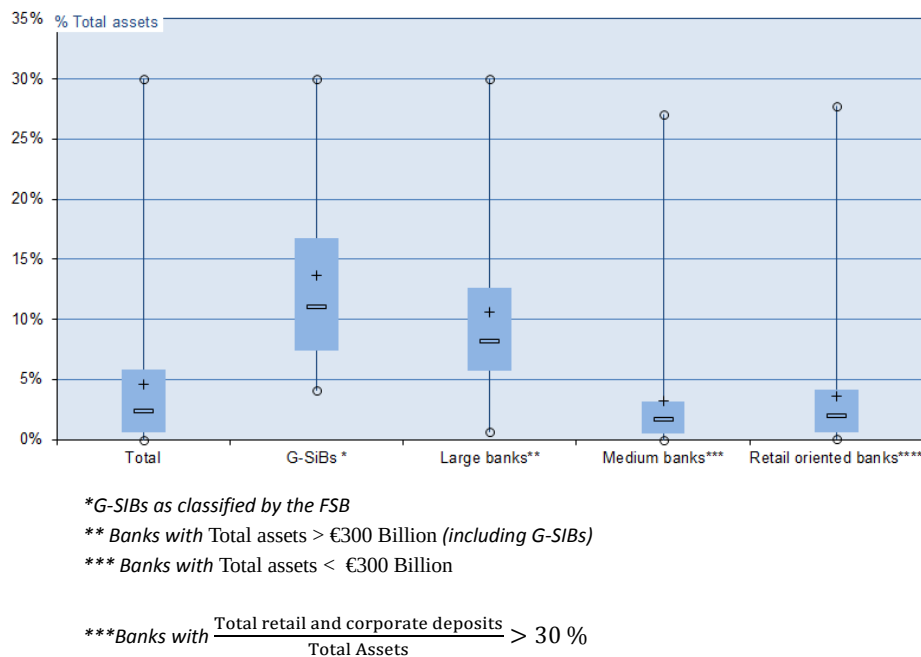
Particularly in Europe, the derivatives market has been very dynamic thanks to the development of the EU single market and the introduction of the EU Investment Services Directive in January

¹⁷ Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, OJ L 173/12.6.2014, p.190.

¹⁸ BIS Statistical release, November 2013, OTC derivative statistics at end June 2013 http://www.bis.org/publ/otc_hy1311.pdf

1996.¹⁹ Many European banks are currently global leaders in derivatives and some of them (*ie.* G-SIBs and large banks) hold more than 13% of their total assets in the form of derivatives liabilities (See figure 1). As a result, in case of resolution, derivative liabilities could constitute a significant buffer to absorb potential losses.

Figure 1: Derivative liabilities as a share of total asset (2013Y)²⁰



Source: SnL, EBA calculation based on a sample of 132 largest banks within EU countries

However, establishing derivative liabilities following a counterparty default is complex and there is no current framework that would allow for an efficient bail-in of the derivatives liabilities in case of resolution.

The difficulties observed in large bank liquidations during the recent financial crisis have been partly attributed to poor bankruptcy planning and poor oversight of the derivative market. The OTC derivative settlements following default have typically been long and complex procedures. Due to the complexities involved, it can lead to legal disputes.

Indeed, a study published by Michael J. Fleming and Asani Sarkar²¹ shows that the complexity of Lehman Brothers' bankruptcy was mainly rooted down to OTC derivative transactions. As a result, the creditors' recovery rate for such liabilities was far below historical averages observed in the US

¹⁹ Council Directive 93/22 on Investment Services in the Securities Field, 1993 O.J. (L 141) 27, corr. at 1993 O.J. (L 170) 32 and (L 194) 27.

²⁰ Figure 1 indicates for each banking groups the degree of dispersion (spread) in the share of derivatives over total asset. The bottom and top of the box represent the first and third quartiles. The band inside the box is the second quartile (the median) and the cross stand stands for the mean. Minimum and maximum values are displayed with a circle.

²¹ FRBNY Economic policy review, M. J. Fleming and A. Sarkar. (Dec 2014), *The failure resolution of Lehman Brothers*

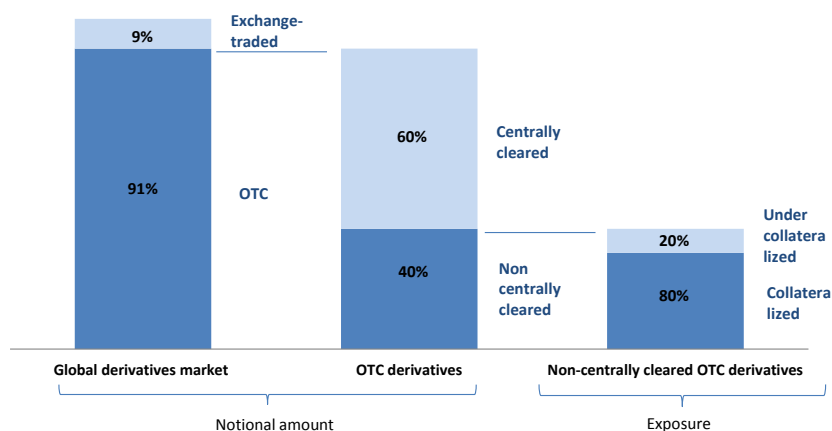
(28%) and compared to similar firms as Lehman Brothers.

This situation raised concern on the difficulties in bailing in derivative liabilities an institution under resolution, which called for a need to define an efficient bail-in framework for derivative liabilities.

In addition, the absence of a credible bail-in framework for derivatives could lead to moral hazard and negative externalities

Among the total global derivatives market, OTC derivatives still constitute the largest fraction (91% in June 2013). Following global reforms (for instance the adoption of EMIR²² in the EU), a majority of them (60%) are now centrally cleared through a central counterparty (CCP) and collateralised due to the strengthening of the regulation to mitigate counterparty risks in many jurisdictions (See Figure 2). The global share of centrally cleared OTC derivatives is expected to further increase up to a potential of 75%, according to Eurex Clearing.²³

Figure 2: The derivative market in June 2013²⁴



Source: BIS 2013, FSB 2013a, ISDA 2013, ISDA 2014 b.*

In principle, central clearing improves price transparency and risk mitigation. CCPs are required to have in place sound procedures for dealing with defaulting counterparties (clearing members) and covering any open positions. They also have a strong incentive to revalue derivative contracts regularly in order to keep sufficient collateral against a potential default of a clearing member and the subsequent liquidation of the position.

²² Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories; OJ L 201, 27.7.2012, p.1.

²³ *financial market*.

²⁴ Published by Deutch Borse Group and Eurex Clearing *Ibid*

Collateralised liabilities would in any event be exempted from bail-in, in accordance with Article 44(2) letter (b) of the BRRD. However, in the absence of a credible valuation methodology for bailing-in uncollateralised derivative liabilities, counterparties might expect such liabilities to be exempted. This could create incentives for banks such as disguised funding through insufficiently collateralised derivatives. Such behaviour would create moral hazard towards other creditors. In the event of a resolution and bail-in, counterparties could also misrepresent their exposure towards the institution under resolution or procrastinate in filing their valuation, thus jeopardising the efficiency of the resolution process.

Objectives of the RTS

Against this background, the main objectives of the RTS is to ensure an efficient bail-in of eligible derivative liabilities by 1) providing clear guidance to resolution authorities in how to perform the valuation and by 2) ensuring maximum transparency for market participants.

The draft RTS also aims to:

- guarantee maximum legal safety for counterparties and resolution authorities by ensuring a smooth articulation between the RTS and the counterfactual no-creditor- worse-off principle;
- allow the valuation methodology to be practicable in a very restricted period (resolution period) while taking into account the broader context of the derivative market and any concerns of financial instability.

Policy options

While drafting the RTS, the EBA considered several policy options under four specific subject matters:

1. Reliance on derivative contracts to determine valuation methodology, (i.e. extent to which the resolution authorities can deviate from the contractual terms)
 - Option A suggests that the resolution authorities fully apply the contractual terms, which, based on market practice, would often mean relying on the other (non-defaulting) counterparty for the termination and valuation;
 - Option B suggests that the resolution authorities apply contractual terms but can amend the valuation obtained under certain circumstances;
 - Option C suggests that the resolution authorities respect the netting set as defined in the netting agreement, but shall apply a specific methodology as defined in the RTS. The methodology would consider common market practice, such as calculating the close-out amount with reference to replacement costs.

2. Reference date for the valuation (reference date used by the resolution authorities to determine the value of the derivatives)
 - Option A: The resolution authorities would determine the valuation by reference to the moment when the institution was put into resolution;
 - Option B: The resolution authorities would determine the valuation by reference to the moment of a close-out;
 - Option C: The resolution authorities would determine the valuation by reference to the moment of a close-out or as soon as commercially reasonable thereafter.
 - Option D: The resolution authorities would perform the valuation at a moment which is convenient for the resolution objective, with an option to correct it at a later point in time.

3. Treatment of centrally cleared derivatives (resolution of a clearing member)
 - Option A proposes that the same valuation methodology is applied to all derivatives, regardless whether they are centrally cleared;
 - Option B suggests that the CCP should implement its default procedure without any intervention by the resolution authorities.
 - Option C would allow for the implementation of the default procedure as defined by the CCP, but with a minimum level of intervention by and agreement with the resolution authorities, in order to ensure that the procedure is carried out within the resolution strategy timeline.

Cost and benefit analysis

The following table shows the advantages and disadvantages of each of the options considered in these RTS:

Areas	Options	Advantages	Disadvantages
1 Reliance on derivative contracts to determine the valuation methodology.	A. Apply contractual terms to the letter.	- Full symmetry with insolvency counterfactual - Predictability for counterparties	- Can be time consuming and complex to implement for RA (Resolution Authority) - Risk of misrepresentation of claims by counterparties - No control by the RA - Possible inconsistencies with BRRD (e.g. that the RA “determines” the value) - Process would most likely exceed the resolution timeline and could undermine the resolution objectives
	B. Apply contractual terms with possibility for corrections by RA	- In principle symmetry with insolvency counterfactual - Possibility to avoid risk of misrepresentation of claims	- Can be time consuming and complex to implement for RA (Resolution Authority) - Difficult for RA to scrutinise
	C. Respect netting sets but apply a methodology in line with market practice	- Easier implementation for RA - Transparency and clarity for counterparties, as in line with common market practice - In line with the resolution timeline and objectives - Avoids risk of claim misrepresentation - Limited risk of breaching the “no-creditor worse-off” principle as aligned to market practice	May require contracts to reflect special termination provisions in the context of BRRD resolution
2 Reference date for valuation	A. Moment of entry into resolution	RA can perform all valuations (i.e. estimation of destruction in value and actual valuation) on the basis of a single value	- Ignores the counterparty’s actual replacement costs incurred in replacing the contract - Increased risk of breaching the “no-creditor-worse-off” principle
	B. Moment of close-out	RA can determine the moment when the liability valuation would be most	Ignores the counterparty’s actual incurred replacement cost in replacing the contract

4			advantageous for the resolution	Increased risk of breaching the “no-creditor-worse-off” principle
		C. At close-out or as soon as commercially reasonable	Transparency and clarity for counterparties, as aligned to market practice	- Can delay the resolution process (e.g. if the valuation process is dependent on data observable only on the next trading day) - Can expose counterparties to market volatility following resolution
		D. At a moment convenient for the resolution objective, with an option to correct it at a later point.	- RA can have a reliable valuation in order to take decisions on resolution - May be necessary due to urgency of resolution	- Valuation made without relying on observed market price changes for potential replacement trades – risk of breaching the “no-creditor-worse-off” principle - Particular risk for CCPs (legal, financial) - Possibility to correct it later might increase the RA’s additional administrative costs.
	Treatment of centrally-cleared derivatives	A. Apply same methodology for all derivatives	Consistency across the board	- Legislation requires CCPs to have in place default procedures aiming at minimum liquidation/replacement cost - Losses exceeding collateral can endanger CCP and the financial stability - Increased risk of deviation between RA’s close-out amount and actual close-out amount.²⁵
		B. Apply CCP default procedure without intervention	- Justified by the quality of CCP’s default procedures - Respects systemic role of CCPs - Ensure maximum predictability to market participants	- May exceed resolution timeline - May expose CCP to extreme market volatility, as market participants might be aware of the CCP being subject to close-out and has to re-hedge or replace open positions
		C. Apply CCP default procedure but with possible intervention of the RA	- Justified by the quality of CCP’s default procedures - Respects systemic role of CCPs - Grounds for alignment with resolution timeline and objectives	CCP may need to adjust its default procedures in order to perform default procedures outside market hours

²⁵The CCP must have a balanced book, which means that in principle any “open position” resulting from a close-out will be re-hedged or replaced. This will result in an observable close-out amount. If RA’s valuation is different, as suggested by Option C in Area 1, then this observable close-out amount could give rise to litigation and a claim of breach of the no-creditor-worse off principle.

Preferred policy options

Option 1C. The resolution authorities respect the netting set defined in the netting agreement, but shall apply a specific methodology as defined in the RTS by taking into account common market practice, such as calculating the close-out amount by reference to replacement costs.

Taking into account the BRRD mandate and the very important risks that arise in delaying the conclusion of a resolution and the potential risk of counterparties misrepresenting their claims, option 1C appears to be the option that better serves the RTS objective.

Option 2C+2D. The resolution authorities would determine the valuation by reference to the moment of close-out or as soon as commercially reasonable thereafter. However, the resolution authority would also have the ability to perform the valuation at the moment most convenient for the resolution objective, with an option to adjust it later, when justified by the urgency of the resolution.

In respect of derivatives, the reference date for close-out valuation appears to be a very important element, as indicated by relevant jurisprudence.²⁶ It is therefore preferable to choose the option that is aligned to market practice. However, option D provides significant advantages, in particular catering for the urgency of resolution, while allowing subsequent correction. The EBA has therefore decided to follow option C as the main option in combination with option D that can be pursued, when justified, and with a particular provision that the resolution authority will update its valuation at a later stage, to take into account the outcome of CCP default procedures.

Option 3B+C: The resolution authorities would perform the valuation at the moment of close-out or as soon as commercially reasonable thereafter.

Here option B appeared to be sufficiently prudent, for reasons similar to the ones regarding the reference date.

Option 4C. Apply the default procedure as defined by the CCP, but with a minimum level of intervention by and in agreement with the resolution authorities. This is to ensure that the procedure is carried out within the resolution context.

As described in this impact assessment sections: Background and Problem identification, the role of CCPs has been enhanced by recent legislation and is expected to significantly improve transparency and risk mitigation in the derivative market. Their function should therefore not be undermined. The risk of litigation and breaching the “no-creditor-worse-off” principle was also judged as significantly high. It was on the other hand considered important to reserve a role for the resolution authority, to ensure, to the extent possible, consistency with the resolution timeline and objective.

²⁶ See for instance *Lehman Brothers Finance S.A. (in liquidation) v. Sal. Oppenheim Jr. & Cie. KGAA*, [2014] EWHC 2627 (Comm).

b. Overview of questions for Consultation

Respondents are invited to comment in particular on the following questions:

Questions

1. Do you agree with the definitions above? Do you consider it necessary to specify some of them further, and in particular the definitions of “commercially reasonable replacement trades” and “unpaid amounts”?
2. Should the deadline given by the resolution authority to the counterparty be further framed? If yes, explain why and how? Does this drafting allow the resolution authority to conclude resolution actions in a sufficiently swift manner?
3. This valuation principle is intended to be aligned with common market practice that recognises replacement costs in an early termination event, whilst giving certainty to the resolution authority on the methodology to be followed. Do you agree that this valuation principle would result in a fair valuation for the closed-out netting set and as such avoid a breach, from the counterparty’s perspective, of the no-creditor-worse-off principle?
4. Do you agree with the preferential status given to commercially reasonable replacement trades? Should there be also a prioritisation among other sources of data?
5. Do you agree with the method described under paragraph 2 for the resolution authority to calculate the close-out amount? Is there a reason to believe that mid-market prices might not always be available or possible to derive from other data sources? And under which circumstances? In that case, what do you consider as an appropriate reference for calculating the close-out amount?
6. Should adjustments to the bid-offer spread, other than those specified under Article 6(4)(c), be considered?
7. Do you agree with the treatment of CCPs as laid down in this Article? Are the conditions laid down in this article compatible with a swift and efficient valuation of cleared derivatives within the context of a resolution process? Do you see any material risk that the treatment of CCPs as laid down in this Article could conflict with the requirements for a sound risk-management framework to deal with the default of a clearing member?
8. Article 7(1) is intended to be aligned with market practice in early termination events. Do you see a risk of increased market volatility on the first market day following the close-out notification, which could adversely affect the termination value? Do you consider the notion of “commercially reasonable” date sufficiently self-evident or should it be further specified?
9. As provided for under Article 7(2), the resolution authority will have the possibility to produce a valuation at a date or time earlier than the earliest commercially reasonable date as part of a provisional valuation carried out pursuant to Article 36(9) of the BRRD. This possibility is intended to allow for a swifter resolution process as resolution authorities will be able to apply the write down and conversion powers on the basis of the early determination. As in all cases where taking resolution action based on a

provisional valuation, resolution authorities will update their determination either as part of a subsequent provisional valuation or the final valuation. At that point they will either adjust the write down and conversion of creditors, provided they have previously made the necessary arrangements such as holding sufficient equity, or provide alternative compensation, if necessary, on the basis of the final valuation of difference in treatment pursuant to Article 74 of Directive 2014/59/EU. Do you consider this optional early determination appropriate, or do you consider that this option would unreasonably increase the risk of litigation or ex post compensation according to Article 74 of the BRRD?

10. Alternatively, should resolution authorities always wait until there is pricing available in the market before producing their valuation, and therefore wait until that date before applying the bail-in tool?
11. The possibility to produce an early determination is available also in relation to claims of a CCP. In this case the final valuation will reflect the CCP claim as determined pursuant to Article 6, on the basis of the CCP default procedures if provided under the conditions of that Article. Do you consider it appropriate to also allow an early determination in relation to CCP claims?
12. If so, do you consider that, with regard to CCP claims, resolution authorities should always be obliged to adjust the bail-in treatment of the CCP if and once the CCP provides its determination pursuant to Article 6? In that case, how do you assess the risk that the CCP determination process could hold back the finalisation of the bail-in process also for other claims? Alternatively, does the assessment of difference in treatment pursuant to Article 74 of the BRRD provide a sufficient safety net for CCPs?
13. Do you find the guidance provided in paragraph 2 of this Article sufficiently clear as to the terms of comparison?
14. Do you agree with the main drivers of the destruction in value as described in this Article?
15. Do you agree with the provision for a precautionary buffer? Do you consider the indicative elements supporting this precautionary buffer as sufficient? Do you see other considerations that should be taken into account when calculating a precautionary buffer?
16. In determining destruction in value, should resolution authorities incorporate into their analysis the impairment to the firm's franchise value that would result from the termination and closing-out of a firm's derivatives contracts and the cessation of its related business operations?