RTS ON DERIVATIVES VALUATION FOR BAIL-IN PURPOSE

Public Hearing, EBA, 2 July 2015.

Content of this presentation

1. Background, mandate and timeline
2. Methodology and process
3. Destruction in value framework

1. BACKGROUND, MANDATE AND TIMELINE

1 – The legislator has NOT excluded derivatives from bail-in discipline

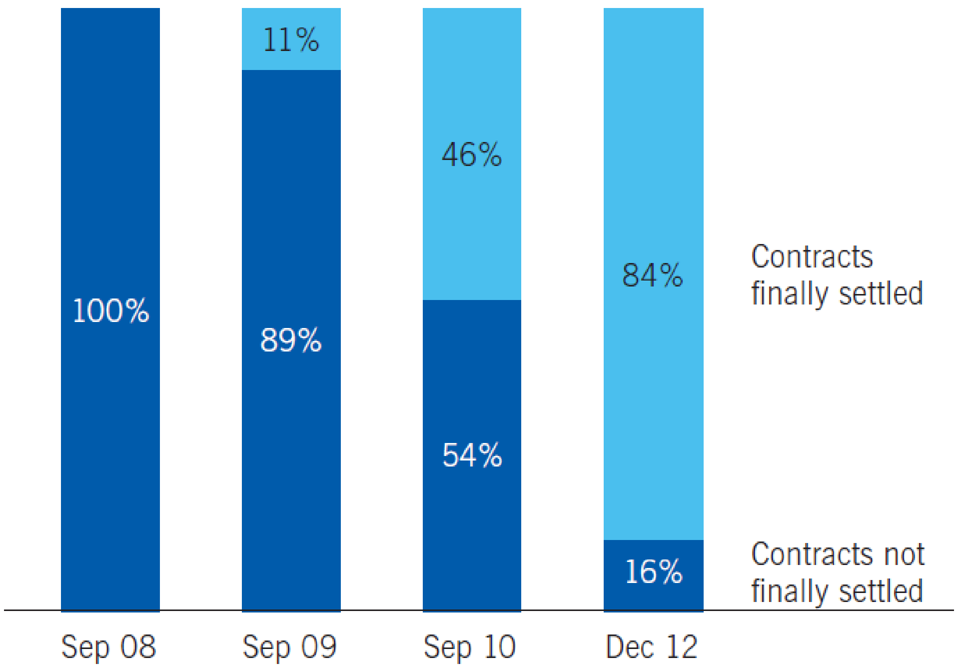
- Not excluded *per se*
- Case-by-case exclusions:
  - Secured liabilities (automatic)
  - Liabilities to EU-designated central counterparties (CCP) and participants <7d (automatic)
  - Not possible to bail-in within reasonable time (exceptional and optional)
  - Risk of widespread contagion (exceptional and optional)
  - Destruction in value greater than bail-in potential (exceptional and optional)

- Process in Article 49
  - Upon close-out
  - Close-out power
  - On a net basis

2- Lehman experience: derivatives valuation is prone to litigation

Exhibit 7: Settlement of Lehman Brothers' non-centrally cleared OTC derivative claims

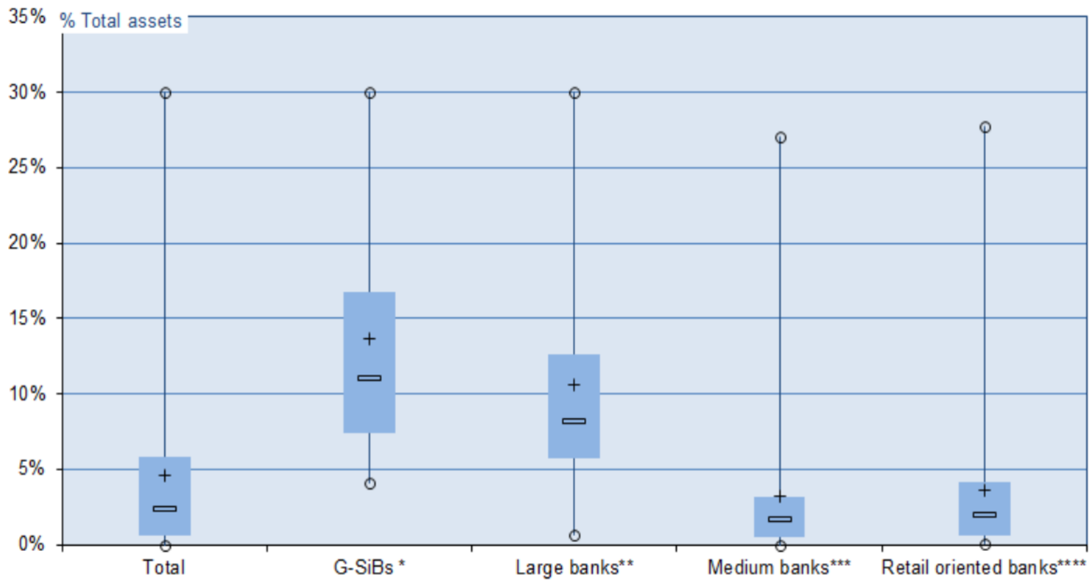
Settlement in terms of number of contracts



Source: Federal Reserve Bank of New York – Fleming, M./Sarkar, A. 2014

3 - Derivatives = a significant share of bank balance sheets

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



**G-SIBs as classified by the FSB*

*** Banks with* Total assets > €300 Billion *(including G-SIBs)*

**** Banks with* Total assets < €300 Billion

****Banks with* $\frac{\text{Total retail and corporate deposits}}{\text{Total Assets}} > 30\ \%$

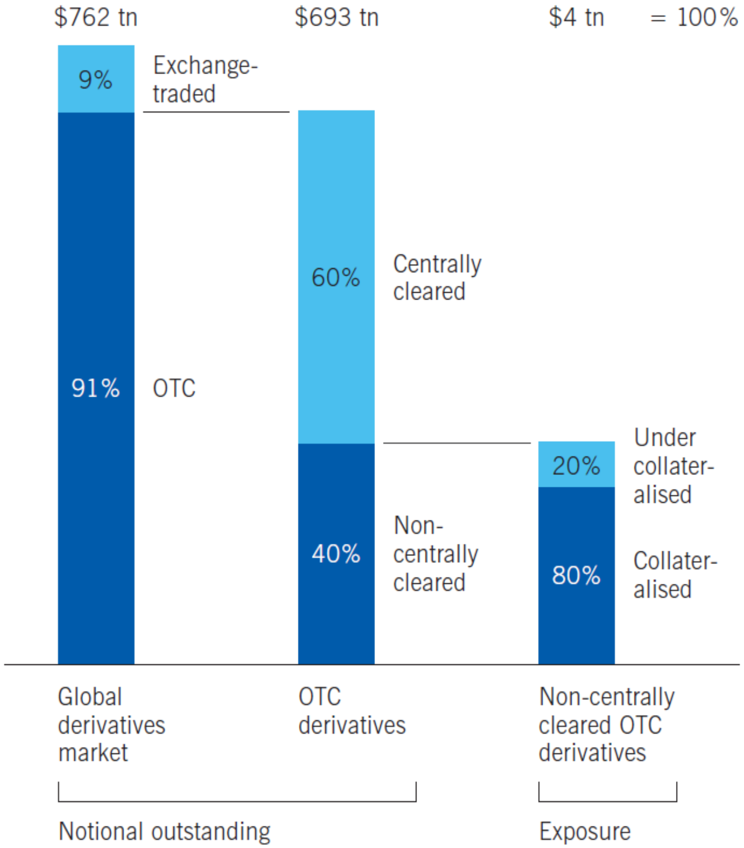
Source: SnL, EBA calculation based on a sample of 132 largest banks within EU count

Total derivative exposure estimated at \$4 tn in June 2013 (notional \$762 tn)

4 - Increasing use of central clearing

Exhibit 2a: The derivatives market today

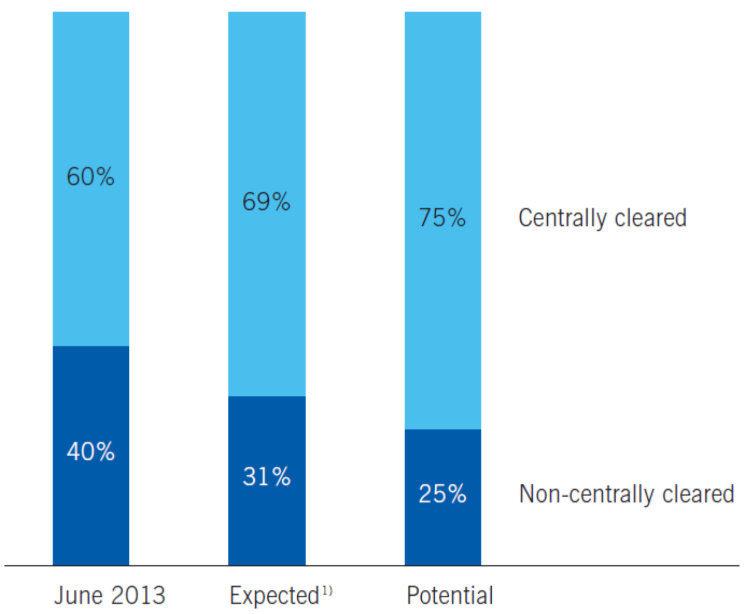
June 2013



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

Exhibit 2b: Outlook of central clearing of OTC derivatives

Extent of central clearing of OTC derivatives in terms of notional outstanding



1) Expected level of central clearing once the clearing obligation is implemented.
Source: FSB 2013a, ISDA 2013, ISDA 2014b, Macroeconomic Assessment Group on Derivatives 2013

Objectives

- A methodology preserving RA from:
  - Procrastination – control the timeline
  - Conflict of interest – control the valuation principle
  - Legal uncertainty – ensure NCWO.

- Otherwise:
  - **No bail-in discipline for a significant part of banks balancesheet,**
  - **Moral hazard against centrally cleared and properly collateralised OTC.**

- **Specific CCP concerns:**
  - **Increased confidence –** Regulated default procedures and margining (EMIR)
  - **Financial stability –** Legally recognised role as hub for counterparty risks

Mandate of the EBA and timeline (49 BRRD)

- Methodologies for determining value of classes of derivatives
- Principles for establishing point in time for valuation
- Methodologies for comparing destruction with bail-in potential

→ RTS due by 3 January 2016, target date end October 2015.

2. VALUATION METHODOLOGY AND PROCESS

Main methodology

Principle

"Early termination amount" =

[Close-out amount (replacement cost)] + [net unpaid amounts/collateral]

Respect netting set

- Amount calculated on a net basis
- No cherry picking within a set

Point in time

- At close-out or as soon as commercially reasonable thereafter

Process

1. RA notifies counterparty and sets deadline for replacement trades
2. At deadline close out amount:
   a) Commercially reasonable trades if provided;
   b) Otherwise, end of day mid-market and bid-offer spread, based on available data sources (internal, counterparty, market)

Special cases

Early determination process (Article 7§2)

1. RA notifies counterparty and already determines value based on same methodology but data available at the time. May call for replacement trades.
2. May update later on to take account of development on replacement markets or evidence of replacement trades.

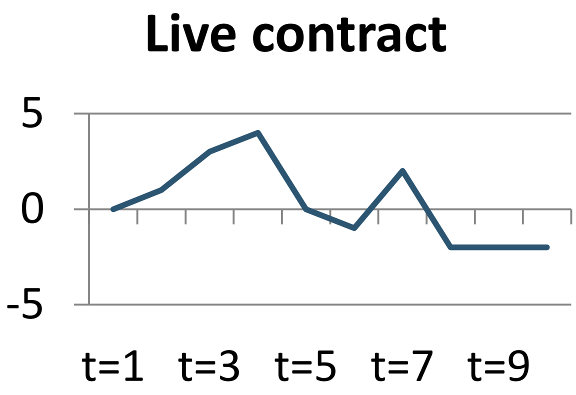
Special procedure for centrally cleared contracts (Article 6)

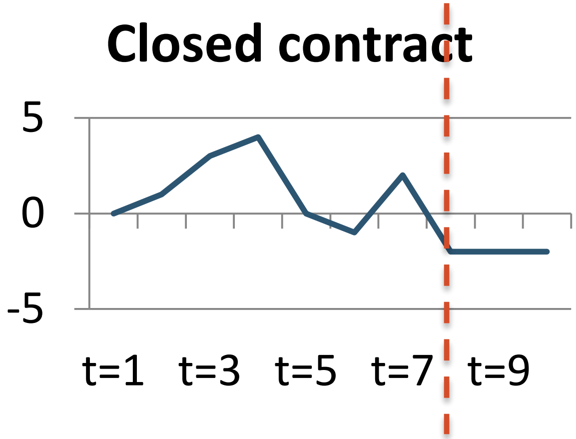
1. Notify close-out and agree on deadline with CCP and CCP CA having regard to CCP timelines and Resolution timeline.
2. RA may use early determination (above) - must update later on.
3. At deadline, RA respects CCP determination if provided
4. RA can impose its own determination if 1/ CCP does not meet deadline or 2/ does not respect its own default procedures.

3. COMPARING DESTRUCTION IN VALUE AND BAIL IN POTENTIAL

Destruction in value - concept

Ideal world (mid-market):





<u>But</u> additional costs (destruction in value) for resolved bank:

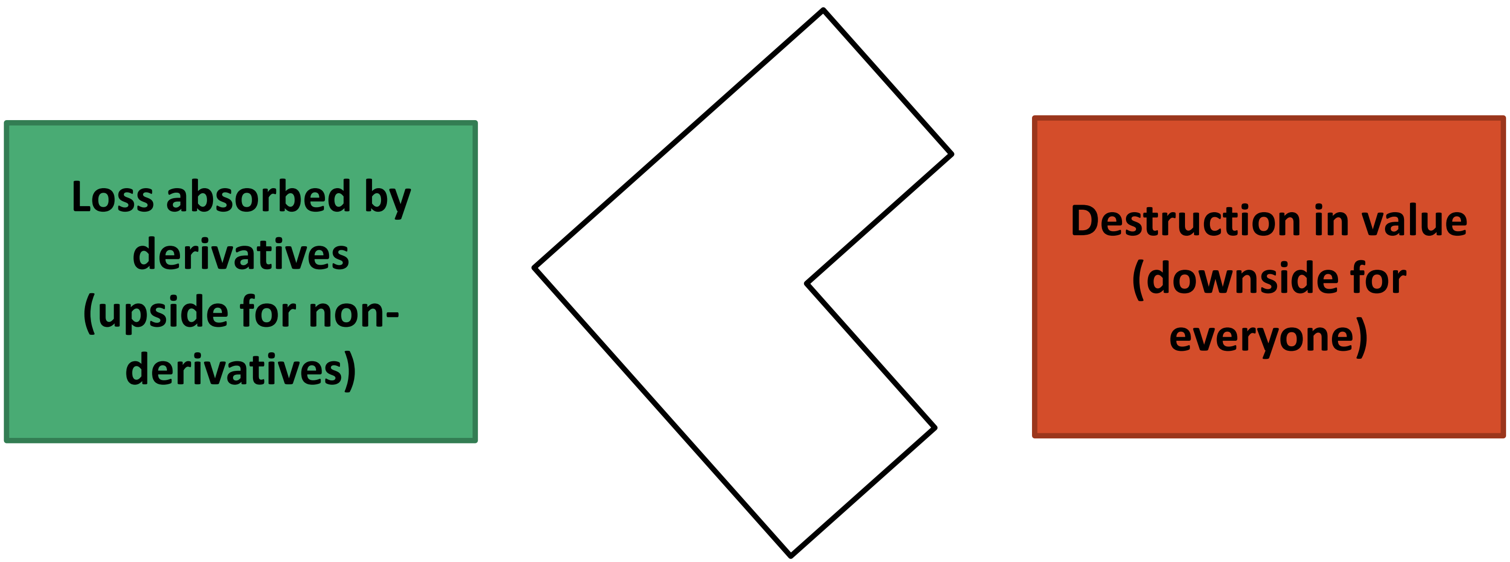
Illiquidity → ↗counterparty costs → ↗ close-out amount charged on bank

Hedging costs, deteriorated franchise value, ↗ funding costs

Unforeseeable market effect of close-out decision

Destruction in value – concept (2)

- Bail-in increases losses for other creditors if:



- Bail-in least advantageous when:
  - Close-out costs are high <u>and</u>
  - Derivatives make a small share of equally ranked debt

Destruction in value – process

1. **<u>Assess destruction in value</u>** based on data available (mid market, bid offer, estimates of hedging costs based on resolution strategy)

2. **<u>Compare with bail-in potential</u>** (In Article 36 valuation context, taking into account resolution strategy, pari passu treatment etc).

3. If destruction > bail-in potential → RA **<u>may</u> exempt**.

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