

The European Banking Authority
20 Avenue André Prothin
92400 Courbevoie
France

Subject: Public consultation: Draft Regulatory Technical Standards on gross JTD amounts under Article 325w(8) of Regulation (EU) No 575/2013¹

The International Swaps and Derivatives Association (ISDA) and the Association for Financial Markets in Europe (AFME), the 'Joint Associations' and their members ('the Industry'), welcome the opportunity to comment on the EBA's consultation on the "draft RTS on gross JTD".

The Industry appreciates the EBA's efforts in developing regulatory standards and the EBA's commitment to providing channels of communication with the industry that has benefited the development of robust market risk technical standards. The Industry is confident that the present consultation and the constructive feedback we provide in this comment letter will help the EBA's decision-making process.

With regards to this consultation, the Industry remains concerned by certain elements in the Basel III reforms and the significant impact the package will have on capital requirements for specific product and risk categories. The implementation of the Fundamental Review of the Trading Book (FRTB) will materially increase capital requirements for banks with market making activities in the EU.

For that purpose, we remind the EBA that the standardised approach is a key element of the framework since it is the basis of the capital charge for banks that do not have an internal model and it is a part of the capital charge for internal model approach banks either directly for desks not validated for IMA or via the output floor.

We thank you in advance for your consideration and please do not hesitate to contact the undersigned associations with questions or if you would like to discuss our recommendations further. We remain committed to assisting policymakers in achieving the objectives of this important RTS.

Gregg Jones
Director, Risk and Capital
International Swaps and Derivatives Association, Inc. (ISDA)
25 Copthall Avenue (3rd floor), London EC2R 7BP
Tel: +44 (0)20 3088 9746
gjones@isda.org

Jouni Aaltonen
Managing Director, Prudential Regulation
Association for Financial Markets in Europe (AFME)
25 Canada Square, London E14 5LQ
Tel: +44 (0)20 3828 2671
jouni.aaltonen@afme.eu

¹ <https://www.eba.europa.eu/calendar/consultation-draft-rtis-gross-jump-default-jtd-amounts>

Article 1: Determination of the components *P&L(long)*, *P&L(short)*, *Adjustment(long)* and *Adjustment(short)* for the calculation of gross JTD amounts for exposures to debt or equity instruments

This Article is intended to address the mandate in point (a) of Article 325w(8) of the CRR, and specifies how to determine the components P&L(long), P&L(short), Adjustment(long) and Adjustment(short) of the CRR formulae for the calculation of gross JTD amounts. With regard to the determination of VA and VF, VA should be readily available to institutions as it represents the market value of the instrument constituting the exposure at the time of the calculation. On the contrary VF represents a hypothetical market value that the instrument would have at the time of the calculation following an instantaneous default event for the debt or equity instrument leading to its full loss in value, and therefore a specific calculation is required for its determination.

Q1. Do you agree with the proposed specification for the determination of the components P&L(long), P&L(short), Adjustment(long) and Adjustment(short) of the CRR formulae for the calculation of gross JTD amounts? If not, please explain why and how you would determine those components for the exposures in scope of the mandate in point (a) of Article 325w(8) of the CRR, including the rationale for your proposal.

Response:

The Industry welcomes the proposed definitions as these ensure identical outcomes across the BCBS standard and the CRR. We believe that to avoid undue burden, institutions should not be asked to report the quantities separately as this might lead to unnecessary implementation efforts.

Article 2: Estimation of gross JTD amounts for exposures referred to in Article 325w(7) of Regulation (EU) No 575/2013

This Article is intended to address the mandate in point (b) of Article 325w(8) of the CRR and specifies how to determine the gross JTD amounts of those exposures falling under Article 325w(7) of the CRR. This Article covers the exposures mentioned in point (4) of MAR22.12 of the FRTB standards, such as the example transaction mentioned therein of a foreign exchange-credit hybrid option where the cash flows are swap of cash flows, long EUR coupons and short USD coupons with a knockout feature that ends cash flows on an event of default of a particular obligor.

Q2. Do you agree with the proposed specification for the estimation of gross JTD amounts of exposures in scope of Article 325w(7) of the CRR? If not, please explain why and how you would determine gross JTD amounts for those exposures, including the rationale for your proposal.

Response:

The Industry welcomes the proposed definitions as these ensure identical outcomes across the BCBS rules and its EU implementation.

Article 3: Notional amounts of instruments

This Article is intended to address the mandate in point (c) of Article 325w(8) of the CRR, and specifies how to determine the notional amount of instruments falling under Article 325w(1), (2) and (5) of the CRR. With regard to VD, similarly to VF it represents a hypothetical market value that the instrument would have at the time of the calculation following an instantaneous default of the debt instrument leading it, however, to experience a positive regulatory recovery rate calculated with respect to its face value. With regard to the second paragraph of the Article, this specifies that the notional amount of instruments falling under Article 325w(5) of the CRR that are not cash equity instruments shall be zero. For cash equity instruments Article 325w(5) of the CRR specifies instead that their notional amount is the fair value of the equity.

Q3. Do you agree with the proposed specification of the notional amount of instruments for the purposes of the mandate in point (c) of Article 325w(8) of the CRR? If not, please explain why and how you would determine the notional amount of instruments falling in scope of the mandate, including the rationale for your proposal.

Response:

The Industry welcomes the proposed definitions as these ensure identical outcomes between the BCBS rules and its EU implementation. In order to avoid undue operational burden, institutions should not be asked to report the quantities separately as this might lead to unnecessary implementation efforts. If it is required, a cost-benefit analysis should be carried out.

Q4. Do you have any other comments that you wish to highlight on these draft RTS?

Response:

There is a lack of clarity around the treatment of equity and credit indices. In the SBM calculations a method of how to treat equity and credit indices without looking through to the constituents has been introduced, whereas this has not been done for DRC, resulting in an inconsistency. This is problematic because constituent data is often costly and performing the look-through can be burdensome. In particular, if the data is not of high quality or the number of constituents for all indices in a portfolio is large, the process can be challenging, or even unmanageable. Furthermore, for indices that institutions hold for only a short period of time and which are not part of the core business for the institution, the look-through approach is not feasible.

We therefore recommend that alternatives to the look-through approach in the DRC are introduced for equity and credit indices.

1. For equity

Given that the main equity indices of advanced economies are composed predominantly of high solvency companies, to assign them to an unrated rating, which is equivalent to a BB rating on average (non investment grade with a RW=15%), will not be consistent with the credit quality and solvency that most of the constituents behind these indices have, resulting in an over-punitive calculation. Therefore,

to provide a figure more in line with the credit quality that these indices carry, we propose that a BBB bucket should be used to be more representative with the risk these indices have. It would still be a sufficiently conservative approach, as it is the lowest investment grade rating bucket, and, in general, companies that have heavier weights in these indices usually have superior credit conditions, since there is a link between their economic characteristics and the volumes traded, which is reflected in their index weight. Furthermore, if their situation deteriorated, a reduction in their index weight would follow, and if an index constituent defaults then it is replaced by another constituent of the same index. For indices such as the S&P 500, Nikkei 225, Eurostoxx 50, FTSE 100, and so on a BB credit rating on average would not be realistic.

2. For Credit

Where there is a condition to be met by an index in terms of a minimum credit rating (for example, investment grade) that has to be met by all its constituents, then that rating may be used as a floor and extended to the whole position.

In all these cases a restriction from any offsetting effect with other positions on other underlyings will be kept but there would be a diversification between all corporate exposure positions including non-looked-through indices. Since the SBM approach allows firms not to perform look-through at all on some indices, the same approach could be introduced in DRC as well. I.e. institutions can choose not to do the look-through on some indices.

In addition to the matters raised above, we also want to mention additional points concerning the LGD for Senior Secured Debt under the SA DRC. These points were also made in response to the recent EC consultation paper on CRR3 Implementation.

FRTB SA DRC separates LGD into non-senior (100%), senior (75%) and covered bonds (25%) – however the framework is missing an appropriate LGD for senior secured debt.

Currently the framework has no bifurcation between secured and unsecured LGD assumptions. Senior secured debt experiences lower losses on default owing to the senior (first lien) pledge of specific assets, details of which can be seen in the table below.

Senior secured vs senior unsecured long-run avg recoveries²

	Moody's
1st Lien Loan	64%
1st Lien Bond	54%
Sr. Unsec Loan	Na
Sr. Unsec Bond	33%

The traded loan market is a significant component of the global credit market. In the US as of year-end 2018 the market totalled \$1.15 trillion, and \$181bn in Europe (source: S&P Leveraged Loan Primer). The market is the predominant source of funds to lower rated (BB and lower) corporate borrowers.

Failing to factor in the higher recovery rate for secured debt unfairly penalises lower rated corporates. These corporates already see very high default probability (risk weights) in the SA DRC, leading to excessive RWA and increased costs.

² Source: iMoody's Annual Default Study 2017: Volume-weighted recoveries 1983-2017

Additionally, the FAQ³ specifying 75% LGD for Agency MBS is very punitive. Similar to covered bonds, Agency MBS are backed by pools of mortgages that provide significant credit enhancement over senior unsecured debt. High DRC capital charges for holding Agency MBS will raise costs associated with issuance and secondary trading of these securities, likely resulting in additional mortgage costs for homeowners.

Industry Recommendation

- Agency MBS should use 25% LGD like covered bonds.
- Add an addition LGD category for senior secured debt with an LGD of 40%.

Calibrating LGD for senior secured. Indicates a 40% LGD⁴

	Moody's	Volume
1st Lien Loan	36%	291bn
1st Lien Bond	46%	136bn
Weighted Average LGD	39%	427bn

Proposed Text (new bullet 3 added in italics):

22.12 For calculating the gross JTD, LGD is set as follows:

- (1) Equity instruments and non-senior debt instruments are assigned an LGD of 100%
- (2) Senior debt instruments are assigned an LGD of 75%
- (3) *Senior secured debt instruments are assigned an LGD of 40%*
- (4) Covered bonds, as defined within [MAR21.51], are assigned an LGD of 25%
- (5) When the price of the instrument is not linked to the recovery rate of the defaulter (e.g. a foreign exchange-credit hybrid option where the cash flows are swap of cash flows, long EUR coupons and short USD coupons with a knockout feature that ends cash flows on an event of default of a particular obligor), there should be no multiplication of the notional by the LGD.

³ https://www.bis.org/basel_framework/chapter/MAR/22.htm?tldate=20230103&inforce=20230101

⁴ Source: Moody's: Annual Default Study 2017: Volume-weighted recoveries 1983-2017. Where LGD = 1 – recovery