ISDA Safe, Efficient Markets

afme/ Finance for Europe

The European Banking Authority
20 Avenue André Prothin
92400 Courbevoie
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14th March 2024

Subject: Public consultation on Regulatory Technical Standards on the standardised approach for counterparty credit risk[1]

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 Draft Regulatory Technical Standards amending Delegated Regulation on mapping of derivative transactions to risk categories, on supervisory delta formula for interest rate options and on determination of long or short positions in the Standardised Approach for Counterparty Credit Risk (SA-CCR) under Article 277(5) and Article 279a(3)(a) of Regulation (EU) No 575/2013 (Capital Requirements Regulation)

Executive Summary

We appreciate the EBA's effort to analyse the impact and relative calibration of the approaches to measure counterparty credit risk (CCR) exposure, however, the industry is still concerned with the significant impact on capital requirements based on the current SA-CCR calibration. The industry has previously raised concerns regarding the fragmentation of regulatory requirements pertaining to SA-CCR across jurisdictions. We believe it is crucial to perform a holistic review of the SA-CCR framework at international level to improve SA-CCR risk sensitivity and minimise the risk of market fragmentation. The issue has been previously raised at the international level in our letter to the Basel Committee on Banking Supervision (BCBS) on 21 April 2022[2] and through a letter shared with the EBA on 13th Oct 2023[3] highlighting how the impact of the alpha factor unduly impacts banks with an internal model method (IMM) permission. With respect to the issue addressed by this Draft Regulatory Technical Standards, the delta of commodity options, we also refer to the ISDA / AFME position paper on CRR III of February 2022[4] in which we made practical proposals to the determination of options deltas in general as well as in the specific case where the underlying price or strike is negative.

[1] https://www.eba.europa.eu/sites/default/files/2023-12/46c82ea5-ca5a-4b2b-aca8-00f26d1b5db3/CP%20on%20draft%20amending%20RTS%20on%20SA-CCR.pdf
[2] Letter-to-Basel-on-the-Standardized-Approach-for-CCR_April-22.pdf (isda.org)
[3] https://www.isda.org/2023/10/13/letter-to-the-eba-on-sa-ccr/
[4] https://www.isda.org/2022/03/25/isda-afme-publish-position-papers-on-crr-iii/ second document: "AFME ISDA CRR III CCR Position Paper(docx)"

Please do not hesitate to contact the undersigned associations with any questions you may have or in case you would like to discuss the recommendations further. We remain committed to assisting policymakers in achieving the objectives of this important RTS.

Yours sincerely,

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Q1. Do you agree with the proposed approach for the supervisory delta of commodity options (i.e. to apply a λ shift, determined at transaction level, in both price and strike values)?

The draft RTS approach to calculate the supervisory delta of commodity options is aligned to the one currently used for interest rates options when rates are negative.

The industry welcomes the application of deltas for options in scope of article 279a(1)(a), however, negative values of the instrument or risk factor underlying an option contract can occur in other asset classes as well. For example, whenever an option contract references the difference between the values of two instruments or risk factors, the underlying spread of this option contract can be negative. Such option contracts are commonly traded in the over-the-counter derivatives market, including option contracts on the spread between two commodity prices and on the difference in performance across two equity indices. Therefore, it is recommended to extend the application of λ shift to all asset classes.

Besides, under EU rules, options other than those in-scope of article 279a(1)(a) would attract a +1 or -1 delta [article 279a(1)(c)] unlike in the Basel text where the supervisory Black-Scholes formula applies to all options [CRE52.40]. We believe that the CRR should, consistently with Basel, allow the use of calculated deltas for all options. On the other hand, the Black-Scholes formula may be ill suited for some types of options. Therefore, the industry would advocate for the use of the actual Front Office (FO) deltas, or deltas derived from FO prices such as in the market risk framework (FRTB Alternative-Standardised Approach) at a minimum where the Black-Scholes formula is unsuitable (while where the BS formula is suitable, it should be using implied volatilities – see response to Q3). The use of such internal practices would be subject to a firm's internal model governance framework and supervisory oversight.

Considering this the industry would like to bring to the attention of the EBA, that the US Agencies have also proposed an extension of the λ shift to all Asset Classes not only Commodities. The industry would propose that the EBA align with the US NPR and extend the scope to all Asset Classes.

Q2. Which one of the three options (option a: EUR 0.1, option b: EUR 1 or option c: EUR 10) do you think is more appropriate as a threshold? Please provide the rationale for the chosen option.

Spot commodities, unlike rates, trade at prices at a range of magnitudes (Propane – 0.78 USD/gal, Crude Oil – 70 USD/bbl, Gold – 2,000 USD/oz), which combined with daily volatility determines the range of strikes for outstanding options, therefore we believe that none of the three offered options would provide an adequate threshold. Option 2a) EUR 0.1 – the range of daily volatility and prices commodities trade at is an order of magnitude higher than this for most commodities. Option 2c) EUR 10 would be too big – large distortion for cases such as propane. Given the examples provided above Option 2b: EUR 1 also fails to provide an adequate threshold for all commodities.

However, the industry would like to propose an alternative to a fixed threshold value when calibrating the λ shift which we believe would be more appropriate. We propose setting λ for a transaction according to the formula $\lambda = \max\{-1.1 * \min(P, K), 0\}$ where P is the spot price and K is the strike price. The purpose of multiplying min (P, K) by -1.1 is the same as that for adding 0.1% in case of interest rate derivatives. It is challenging to determine a universal additive offset value for all values of Commodity reference type or other non-interest rate instrument. Performing the offset via multiplication rather than addition provides a more proportionate solution.

The industry believes that there may be merit in an approach where lambda is dependent on commodity type, as is common when distinguishing volatility.

Q3. Do you agree with the proposed approach for the supervisory volatility (i.e. maintain 150% for electricity and 70% for other commodities)?

It is the industry view that supervisory volatilities are not reflective of the current market environment implied volatilities from which the true delta of an option may be calculated. Hence, we believe that instead of using supervisory volatilities in the determination of option deltas, the implied volatilities could be used. However, as expressed in our response to Q1, the best approach would be to use deltas derived from the Front Office prices.