

August 31, 2013

Sent by email to: EBA-CP-2013-16@eba.europa.eu

European Banking Authority
Tower 42
25 Old Broad Street
London EC2N 1HQ

Dear Sir or Madam,

Re: Draft Regulatory Technical Standards on non-delta risk of options in the standardised market risk approach under Articles 318(3), 341(6) and 347(4) of the draft Capital Requirements Regulation (CRR) (EBA/CP/2013/16)

This letter contains the response of the International Swaps and Derivatives Association, Inc. ("ISDA") and the Association for Financial Markets in Europe ("AFME") to the European Banking Authority's ("EBA") Consultation Paper on Draft RTS on non-delta risk of options in the standardised market risk approach under Articles 318(3), 341(6) and 347(4) of the draft Capital Requirements Regulation. The accompanying response is the result of a thorough three month industry consultation process involving a wide range of industry representatives. It is reflective of the industry consensus on this topic and aims at being as constructive as possible in seeking a proportionate outcome.

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76. For more information, visit www.afme.eu.

We look forward to working with the EBA to continue developing an approach that will ensure consistency in the practicality and applicability of the proposed framework across the industry.

Yours faithfully,



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European Banking Authority (EBA) Consultation Paper

On

**Draft Regulatory Technical Standards On non-delta risk of options
in the standardised market risk approach under Articles 318(3),
341(6) and 347(4) of the draft Capital Requirements Regulation
(CRR)
(EBA/CP/2013/16)**

Dated 22 May 2013

**Response of the International Swaps and Derivatives Association, Inc. (ISDA), and
The Association for Financial Markets in Europe (AFME)**

31 August 2013

A. Introduction

ISDA¹ and AFME² (“the Industry”) welcome the opportunity to comment on the above Consultation Paper (“the Paper”) issued by the EBA. The industry highlights below a number of overarching issues regarding the Paper, followed by answers to individual questions raised.

Overall Points:

The Industry welcomes the EBA draft RTS proposals, in particular the scenario approach and the delta-plus approach, as they mirror scenario matrices banks use widely internally. We have, however, some concerns with the practicality and applicability of the proposed framework which we express in our responses to the Paper’s questions below.

- Adopting a combination of approaches: The paper emphasises that sophisticated firms with large options portfolios should be using an internal model approach. The paper does not acknowledge the possibility of providing for a combination of approaches, where VaR approval may only cover some entities, trading locations, business lines or products, and one (or more) of the less advanced approaches applying to the remaining population.
- Exchange traded options: We acknowledge the precedence given in the level 1 text to deltas sourced from an exchange, however, we believe 1) these are not available in all circumstances and 2) own estimates of deltas are typically a more appropriate measure of risk. Option prices are more widely available, and can be used to derive a delta value. However, this value would generally embed the financing costs to hedge that option position and would reflect the cost of funds applicable to a particular institution. Naturally, this would vary from institution to institution based on the internal model and underlying assumptions, hence would not give rise to directly comparable deltas across the Industry. Therefore, we would request that the EBA reviews this section of the requirements in conjunction with Industry working groups to derive a suitable solution. Moreover, using a third party’s models (as discussed in response to Q5) for products (which will for almost all exchanges be relatively standard), does not seem to be warranted provided that the deltas are derived from the exchange option prices.

¹ Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

² The Association for Financial Markets in Europe (AFME) advocates stable, competitive and sustainable European financial markets that support economic growth and benefit society. AFME promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association). For more information please visit the AFME website, www.afme.eu.

- In order to mitigate against the risk of potentially inconsistent practices that could be used for expressing elements within the Gamma and Vega calculations we would appreciate the EBA supplying some worked examples of their formulas provided for the Delta plus and Scenario methods. An example of one inconsistency is where Gamma can be expressed as a change in delta due to a percentage change, or as a \$1 change, in the spot price of the underlying.
- Article 7 (a) requires the ‘integration of the scenario approach in the institution’s risk management process’. This suggests that firms must use exactly the prescribed delta-stripping methodology and price/vol shifts internally. In practice, firms often apply a range of similar, but not identical, scenario approaches for internal risk management purposes. We would urge the EBA to consider allowing competent authorities to recognize these internal scenarios for deriving Gamma and Vega, if they deem them sufficiently similar.

B. Responses to Consultation Paper Questions

General provisions

Question 1: Do you agree with the choice to use the Basel Framework to determine the capital requirements for the non-delta risks of options and warrants? Are there other approaches that can effectively be used for the purpose of these RTS? Which ones? Explain your reasoning.

Response: The approaches proposed are adequate given the constraints imposed by the level 1 text in CRR.

However, the Industry notes that:

- CRR requires option delta to be calculated for all options under standard rules, both long and short.
- CRR requires the local regulator to approve sensitivities derived from option pricing models.
- It is expected that the RTS will be formally adopted in November leaving only limited time to implement new capital calculations before Q1 2014.

Individual firms will therefore proceed with haste to discuss the conditions of this options pricing model approval bilaterally with local regulators.

We note that it is possible that the Basel position may change as a result of their work on the Fundamental Review of Trading Book, and we would hope that the EBA’s position would remain flexible to these changes.

Question 2: Do you prefer the first option (exclusion of a combination of methods within a single institution) or the second option (exact definition of the scope of the scenario approach)? Explain your reasoning. If you prefer the second option, what additional conditions and controls should be established?

Response: Option 2 is preferred.

Within many firms, sophistication of trading varies between products and locations, so flexibility is appropriate to cater for the different trading areas. Often firms apply internal model for most Trading Book options, so standard rules are applied in areas where internal model is being applied for or where this is not cost effective.

To prevent possible cherry-picking we suggest that the RTS makes it a condition that a selected approach is applied consistently in any form of application (meaning: location, system or product).

Conditions and controls that would be appropriate to this approach would be:

- Precise scope and justifications documented in a firm's trading book policy.
- Clear, non-capital efficiency-based, justification for the allocation of either the Delta-plus method, or the Scenario based method to each business.
- One method only should be applicable across a single portfolio (no mixing methods at portfolio level)

Simplified approach

Question 3: Do you believe that it is useful to implement the simplified approach established in the Basel text?

Response: Many firms typically hold positions in both long and short options, so the simplified approach is not applicable as it is appropriate for long options only.

Delta-plus method

Question 4: Do you agree with this prudential treatment, not contemplated in Basel Framework, for non-standard options?

Response: We disagree with the proposed treatment: we believe it is yet very simple but overly conservative. The proposal, as is, creates a disconnection in the capital treatment of non-continuous options on one side and the capital treatment of their vanillas hedges on the other side making the hedges inefficient in terms of capital relief and hence disincentivizing banks from hedging such non-continuous options.

Question 5: Do you agree that the RTS should require that the conditions of Articles 318 (1), 341 (1), 347 (3) of the CRR are met for the calculation of gamma and vega?

Response: Yes, we agree that the conditions being referred to for gamma and vega are the same as for delta: namely that the model is subject to permission by the competent authorities confirming that it appropriately estimates the rate of change of the option's value with respect to small changes in the relevant underlying factor (ie. market price of the underlying for delta; delta for gamma; volatility for vega).

However the draft RTS states, in section 3 point 4: "Where either gamma or vega cannot be calculated in accordance with the conditions of these Articles, the capital requirement on non delta risks shall be calculated according to paragraph 3." However the treatment outlined in paragraph 3 assumes the firm's ability to calculate to the Competent Authorities satisfaction (for OTC options) the correct delta. No fall-back position is provided for the scenario where a firm's internal modeling of a delta is not given clearance by the Competent authority.

Furthermore, in the case of Exchange traded options, we believe that the deltas for Exchange traded options are not available in all circumstances. Option prices are more widely available, and can be used to derive a delta value. However, this value would be a reflection of the financing costs to hedge that option position and therefore would reflect the cost of funds applicable to a particular institution. This would vary from institution to institution based on the internal model and underlying assumptions, hence would not give rise to a comparable number across the Industry. Moreover, using third party's models for products (which will for almost all exchanges be fairly standard) does not seem to be warranted provided that the deltas are derived from exchange option prices.

We have discussed this informally with several major exchanges who have said they do not publish greeks. In some cases, affiliated companies produce Greeks for information but this is not a value the exchange itself takes

responsibility for in the same way as a publicly-quoted prices. If not available from the exchange itself, we believe it is more appropriate to use our own values of the Greeks, reflecting our own funding costs, rather than those of a third party.

Question 6: Do you think that the unified treatment of interest rate risk is sound? Could there be difficulties in implementing it in practice?

Response: The 'unified' approach is appropriate to the products for which the Industry expects to apply this approach (interest rate options under standard rules).

However, as noted in the response to question 1, there will be reliance on local regulators to approve option pricing models for interest rate risk. The Industry will therefore follow up bilaterally with local regulators.

For interest rate risk sensitivity measurement the Industry recommends the use of zero coupon rate yield sensitivities (PV01) rather than yield to maturity (YTM) sensitivity as a better basis for measuring interest rate exposure. Although the results are not usually materially different, PV01 is general industry practice and is routinely applied to portfolios with bond options, IROs and swaptions as well as their underlying instruments.

Question 7: How many hybrid options does your portfolio account for in terms of number of options and notional amounts (i.e. options which can be assigned to more than one underlying type as defined above)? Should the RTS specify the treatment of these hybrid options?

Response:

Quanto equity options are similar to the corresponding equity option except that the client prefers to receive the pay-off in a different currency from the underlying equity. So it is a hybrid of equity and FX risk.

Each firm will submit individual data separately.

Scenario approach

Question 8: Scenario approach: allowance for significant option traders

The Basel framework [718(Lxiii)] proposes that Banks that are significant option traders can be allowed to aggregate some time bands in the treatment of interest rate options. The EBA believes it is not clear why institutions that are significant traders (and are therefore rather sophisticated) should be allowed to use a similar approach than other banks. Such a provision is contrary to the proportionality principle (the approach shall be proportionate to the scale and the complexity of the operations of an institution).

Advanced institutions should be expected to use the internal model approach which is more risk sensitive and considers such correlations. The EBA believes that the Basel provision, by reducing own funds requirements for option traders, does not create the right incentives for the use of an internal model. For the exposed reasons EBA proposes not to implement this Basel provision in the RTS.

Do you agree with the rationale behind the exclusion of this provision contemplated in the Basel accord in the RTS? If not, please provide arguments in favor of its implementation.

Response: We would expect the majority of less complex firms to apply the delta plus approach; hence this question would not be relevant. However, some more sophisticated firms may have limitations to their internal models meaning they may need to apply this approach in some circumstances and for whom the proposed time bands are not appropriate or will lead to a disproportionate amount of complexity in implementation.

Additional submission regarding Article 7(a)

After raising this point at the EBA public hearing, the EBA representatives encouraged the Industry to submit in writing the following.

Article 7 (a) requires 'Integration of the scenario approach in the institution's risk management process'. This suggests that firms must use exactly the prescribed delta-stripping methodology and price/vol shifts internally. In practice, firms (like the industry) often apply a range of similar, but not identical, scenario approaches for internal risk management purposes.

We would therefore recommend that Article 7 (a) be amended slightly as below, to permit more flexibility in regard to the scenario matrices applied internally, without undermining or contradicting the commitment to the scenario matrices defined for standard rules regulatory capital purposes.

(a) Integration of ~~the~~ a scenario approach in the institution's risk-management process in accordance with Article 368(1)(a) of Regulation (..) No xx/xxxx [CRR];

Note that capital would be calculated exactly as Article 8, so this flexibility is only regarding the internal use of the scenario matrix. This is analogous to CAD2 internal model [CRR4 Article 368(1)(a)], where firms apply internal model VaR at 95% or 97.5% confidence level and 1-day holding period for internal purposes, consistently with 99%/10-day for regulatory purposes.