EBA FINAL draft Regulatory Technical Standards on the conditions for assessing the materiality of extensions and changes of internal approaches when calculating own funds requirements for market risk under Article 363(4) of Regulation (EU) No 575/2013 (the Capital Requirements Regulation- CRR)

INTRODUCTION

The Associations[1] on behalf of the industry participants would like to highlight specific sections in the final draft RTS on assessing the materiality of extensions and changes of internal approaches where the proposed text requires clarification to avoid any unintended consequences from inconsistent implementation of the proposed regulation.

Overall we support the aim of the EBA to introduce consistency in the determination of the conditions for assessing the materiality of extensions and changes to internal models for the banks. However we strongly believe that the technical suggestions outlined in this note are crucial to ensure that firms have the required clarity in order to implement the proposed rules.

Inability to apply consistently the conditions for models changes in line with regulatory mandate would result in unnecessary operational burden both for the firms and the regulators as both parties would have to continuously interact to obtain the required regulatory approvals with the risk of the proposed regulation to outweigh the benefits and do not meet regulatory objectives.

SECTIONS FOR CLARIFICATION

I) Definition of model change

In the main regulation bullet (7) states:

(7) The permission of competent authorities relates to the methods, processes, controls, data collection and IT systems of the approaches, therefore on-going alignment of the models to the calculation data-set used, correction of errors or minor adjustments necessary for the day-to-day maintenance of the models, which occur in the strict limit of the already approved methods, processes, controls, data collection and IT systems, should not be covered by this Regulation.

However the following criterion (bullet 5, Section2 of part II of Annex iii p.18) included with Annex III contradicts regulation (7):

[1] The International Swaps and Derivatives Association, Inc. ("ISDA"), the Association for Financial Markets in Europe ("AFME")

5. Changes in how shifts in market risk factors are translated into changes of the portfolio value, such as changes in instrument valuation models - used to calculate sensitivities to risk factors or

to re-value positions when calculating risk numbers -, changes from analytical to simulation-based pricing model, changes between Taylor-approximation and full revaluation, or changes in the sensitivity measures applied, according to Article 367 of Regulation (EU) No 575/2013.

Interpretation: The words "changes in instrument valuation models –used to calculate sensitivities to risk factors or to re-value positions…" imply that any change to a pricing model from which sensitivities or scenarios are constructed are in scope for pre-notification.

Industry Recommendation:
Clarity is needed in this section because this wording contradicts with bullet (7) in the regulation (referenced above), which excludes from the regulatory scope changes to the models that fall within the day to day maintenance. Changes to front office pricing models happen on daily basis and while some of these are clearly re-calibrations to the market valuations, there are often changes to payoffs and minor changes to contract details that will also affect sensitivities and valuations. Such changes would have immaterial impact on VaR but due to the requirement for a pre-notification period, it would be impossible to implement such small changes efficiently. Also the regulators would be overwhelmed with multiple notifications requests submitted by the firms on a daily basis. The problem can be remedied with the following amendment in the proposed rule.

Proposal:

Changes in how shifts in market risk factors are translated into changes of the portfolio value, ~~such as changes in instrument valuation models - used to calculate sensitivities to risk factors or to re-value positions when calculating risk numbers -~~, changes from analytical to simulation-based pricing model, changes between Taylor-approximation and full revaluation, or changes in the sensitivity measures applied, according to Article 367 of Regulation (EU) No 575/2013.

II) Hypothetical or Actual P&L

(bullet 11, Section2 of part II of Annex iii p.18)

Changes in the methodology for calculating either actual or hypothetical profit and loss when used for back-testing purposes according to Article 366(3) and 369(2) of Regulation (EU) No 575/2013.

Interpretation: Change in methodology for computing either hypothetical or actual P&L for back testing purposes should not include changes in the pricing models that are used to calculate P&L.

Implications: If any change for computing actual or hypothetical P&L for back testing purposes is considered a change in the pricing model, then regulatory approval must be obtained.

Proposal: Please confirm our interpretation is correct, this is consistent with bullet (7) in the regulation (referenced in point 1 above) that excludes the pricing models.

III) Parallel run post extension or change in the model

(bullet 11, Section2 of part II of Annex iii p.18)

For the purposes of paragraph (1)(c)(i) and (1)(c)(ii) the ratios referred to in paragraphs 2 and 3 shall be calculated for a period the duration of which is the shortest between (a) and (b):
(a) 15 consecutive business days starting from the first business day of the testing of the impact of the extension or change;

(b) until such day where a daily calculation of either one of the ratios referred to in paragraphs 2 and 3 results in an impact equal or greater than the percentages referred to in either paragraph (1)(c)(i) or paragraph (1)(c)(ii), respectively.

Implications: 15 days parallel run is considered too long by the industry and the marginal cost of these parallel runs far outweigh the marginal benefit. There is always a risk that changes may be portfolio dependent so that passing a materiality test on one day does not guarantee that the test would not fail at some future point if repeated again. However we believe that other validation methods may be superior to repeated parallel testing.

Proposal: Reduce minimum requirement for parallel tests to 2-5 days including the day-1 test. Regulators may ask for more tests if they deem it is necessary or alternatively request other forms of impact analysis. The burden might also be relieved if tests did not have to be conducted on consecutive days which allows runs over the weekend. There should be some scope for regulators to discuss appropriate testing with firms without such onerous minimum standards.