

## Response to Consultation paper

### Targeted consultation on the application of the market risk prudential framework

22 April 2025

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#### Main message and overarching comments

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to respond to the **EC's consultation on the application of the market risk prudential framework**.

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. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) 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) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

We very much appreciate that in its consultation the European Commission acknowledges the risks and challenges for internationally active banks – which constitutes the AFME membership – posed by uncertainty on implementation timelines across other jurisdictions. We also appreciate that the European Commission actively continues pursuing potential actions as prescribed by the empowerment to the Commission under Article 461a CRR and is seeking input on important questions via this consultation.

The Industry considers the need to make temporary changes to the framework highly relevant under any of the options, and we would encourage policy makers to pursue relevant adjustments under any given scenario. The Industry feels that the adjustments put forward by the EC go in the right direction, and could, if completed, lead to an effective adjustment of the framework with the view to ease operational burden and or maintain a level playing field in a time of heightened uncertainty. We note that any adjustments should be do-able in the timeframe envisaged by the Commission and allow for firms to implement the adjustments. Against this background, the list of temporary adjustments should include adjustments proposed in other jurisdictions and we would encourage policy makers to include additional issues as presented in the Annex to this response. Depending on developments in other jurisdictions, the list might need adjusting at a later date. It will also be necessary for the EBA and Commission to clarify their position with respect to the implementation of Trading Book/Banking Book boundary on 1 January 2026. We provide detailed comments under question 3.

#### **Question 1. Among the options outlined above, what would be your / your institution's preferred option?**

The Industry wishes to express their concerns about the international level playing field, worries about the future competitiveness of firms active in the EU, operational challenges and concerns about the appropriateness of the representation of risks under the FRTB (which is likely to be fixed in other jurisdictions). In light of the ongoing uncertainty in the US and in the UK, a majority of AFME's membership seeks a further one-year delay as it provides time and opportunity for a consistent timeline for implementation and, even more importantly, a consistently adopted set of rules for the market risk framework across the UK, US, and the EU. On the other hand a significant minority of AFME's membership favours an implementation of the FRTB framework on 1 January 2026 with the targeted relief measures proposed by the EC, to avoid

continued operational complexities of running in parallel FRTB (i.e. FRTB- SA for reporting purposes) and the current Basel 2.5 framework together while fixing the most pressing technical issues. It is worth noting that this outcome is not dependent on whether banks' headquarters are located within the EU or in a 3<sup>rd</sup> country.

**Regardless of whether banks are in favour of delaying or not, there is a consensus that the amendments as proposed (but not limited to) those set out in option 3 of the EC consultation should be pursued under the empowerment to the Commission under Article 461a CRR3.**

The following views prevail across the AFME membership.

- **Delay** without openness for an alternative approach
- **Delay** with openness to an alternative approach
- **No-delay** with openness for an alternative approach

One alternative option supported by a minority of members is presented under question 4.

### **Question 2. What would be the impact of your preferred option for your institution?**

Ultimately, the Industry wishes to avoid capital impact that is likely not to be observed by firms in other jurisdictions to preserve EU competitiveness in the context of high uncertainty of US and UK plans on implementation of Basel 3 and FRTB. At the same time, the banks wish to continue to put forward their services to clients without change of their business offering or increased costs in a manner which appropriately reflects the risks and safeguard financial stability.

The pressure on RWA efficiency in firms' capital and business planning has been intense for a number of years. In the absence of tangible plans to rectify the looming level playing field issues and the inappropriate assessment of risk under FRTB, banks will need, and have started, to adjust the RWA intensive business lines either by volume or by price. This would leave the EU economy and EU active banks at a competitive disadvantage.

The proposed targeted changes we propose for all options would help alleviate at least partially the level playing field concerns and competitiveness disadvantage albeit for only a limited amount of time. In the medium to long term, the FRTB framework would need to change in line with other jurisdictions' implementation assuming that other jurisdictions would divert from the internationally agreed standards (including further long-term delay or complete avoidance of Basel 3 implementation). While we welcome the Delegated Act as a constructive step forward, the ultimate objective remains a Level 1 intervention that would provide a stable and coherent legal framework for the long term.

### **Question 3. What are your / your institutions views on the temporary measures proposed under option 3?**

The Industry considers temporary measures highly relevant under any of the aforementioned options, and we would encourage policy makers to pursue relevant adjustments under any given scenario. We note that any adjustments should be do-able in the timeframe envisaged by the Commission and allow for firms to implement the adjustments. It will also be necessary for the EBA and Commission to clarify the position with respect to the TB/BB boundary on 1 January 26.

The Industry feels that the adjustments put forward by the EC are highly relevant and would in many cases lead to an effective adjustment of the framework with the view to ease operational burden and / or maintain a level playing field in a time of heightened uncertainty. We provide detailed comments under the relevant sections below.

We feel, however, that the cumulative effect of these adjustments might not be sufficient for a level-playing field, as banks in other jurisdictions, at least in the short and possibly long term, might have a very limited capital impact from FRTB. Therefore, level playing field can only be understood as introducing FRTB in a capital neutral way which was the overarching aim of the Basel 3 reforms. We believe that the EU has not fully

achieved that in their implementation<sup>1</sup>. We also note that the latest Basel III monitoring results<sup>2</sup> clearly point to Europe being highly capitalised compared to other major jurisdictions. We would reiterate that FRTB does inherently misrepresent risk and a correction of those flaws would be required in due course but in particular in the long-term. To this end, the measures provided by the consultation and additional suggestions provided by the Industry should be part of a full review of the FRTB framework and result in permanent adjustments.

Against this background, the list of temporary adjustments should include adjustments proposed in other jurisdictions and we would encourage policy makers to include additional issues, where the AFME Industry letter, including Annex 1, contains relevant points. In dependence of the developments in other jurisdiction, the list might need adjusting at a later date.

## **Measures to phase in and / or operationalise the own funds requirements calculation under the Internal Model Approach**

### ***1. Profit and Loss Attribution Test (PLAT) as a monitoring tool***

The industry supports the European Commission's assessment that credit institutions have faced challenges in consistently meeting PLAT requirements for many desks where they seek to use internal models. Additionally, we agree that failing PLAT creates volatility in banks' capital requirements and discourages investment in internal models.

The industry supports the targeted operational relief measure, allowing credit institutions and supervisors to use the PLAT as a monitoring tool. Under this approach, all trading desks within the scope of IMA would be deemed to meet the conditions for the green zone, with the monitoring period extending until 1 January 2029. Additionally, the industry acknowledges that the PLAT assessment should be conducted and reported to the competent authorities on a quarterly or semi-annual basis as specified in the European Commission consultation. During this monitoring period, supervisors should assess whether PLAT is fit for purpose, and whether it is still possible to calibrate reasonable tests that address the uncertainty and volatility in banks' capital requirements.

The PLAT is comprised of two statistical tests: the Spearman correlation test between hypothetical P&L (HPL) and risk-theoretical P&L (RTPL) time series and the Kolmogorov-Smirnov test. While the amber zone has mitigated cliff effects by removing the binary consequences of exiting the green zone, further consideration is needed regarding the potential failure of these tests. The Spearman correlation test could fail solely due to a portfolio being well-hedged. It is well known that directional desks pass the Spearman correlation test more frequently than well-hedged portfolios. Specifically, cases have been observed where desks with underlying positions and their hedges individually passing PLAT still fail the Spearman correlation test when applied to the hedged portfolio P&L time series. Hedging is intended to neutralize a portfolio's exposure to underlying risk factor movements. A well-hedged portfolio will exhibit relatively small P&L variations regardless of whether and to what degree the underlying risk factors rise or fall. However, because the Spearman correlation test evaluates P&L ranks over 250 scenarios<sup>3</sup>, the results may be dominated by minimal residual P&Ls left after hedging, leading to artificially low correlation levels between HPL and RTPL time series. This suggests that less well-hedged portfolios could have a higher likelihood of qualifying for IMA eligibility than fully hedged ones. Given these implications, a rigid, automatic approach to determining a trading desk's entry into or exit from the IMA perimeter based on the Spearman correlation test may not be appropriate.

The Kolmogorov-Smirnov test measures the similarity between RTPL and HPL distributions. However, even for large samples, it remains highly sensitive to statistical noise, particularly on days with relatively benign market moves. The primary objective of the model should be to accurately predict extreme losses under large

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<sup>1</sup> 2024 EBA Basel III monitoring report <https://www.eba.europa.eu/sites/default/files/2024-10/eee3e459-52f3-4fe5-a911-18f9adf1d6cb/Basel%20III%20monitoring%20Report.pdf>

<sup>2</sup> [https://www.bis.org/bcbs/publ/d592\\_highlights.htm](https://www.bis.org/bcbs/publ/d592_highlights.htm)

<sup>3</sup> To calculate the Spearman correlation metric for a trading desk, banks must use the time series of RTPL and HPL from the most recent 250 trading days.

market shocks, whereas the Kolmogorov-Smirnov test is less effective in detecting differences in the tail of the distributions.

### **Industry Recommendation:**

We recommend that the targeted operational relief should be granted for at least three years following the implementation of the own funds requirements calculation under the Internal Model Approach. Additionally, during the monitoring period, specific evidence should be collected from real portfolios to assess whether the statistical tests can be appropriately recalibrated or if PLAT should remain a supervisory reporting tool.

#### **2. Phase-in of the capital requirements for Non-Modellable Risk Factors (NMRF)**

The industry acknowledges that the limited development of third-party vendor solutions has contributed to a larger proportion of risk factors being capitalized as NMRFs<sup>4</sup> than initially anticipated when Basel calibrated the FRTB standards. However, fundamental issues within the NMRF framework – particularly regarding the aggregation of risk factors<sup>5</sup> – result in a general lack of diversification recognition, rendering the framework impracticable. Other aspects of the NMRF framework are problematic including the assumptions on correlations between non-modellable idiosyncratic and non-modellable non-idiosyncratic risk factors and the calibration of stress periods specific to each asset class. Additionally, there is concern about the procyclical nature of the NMRF framework, which may discourage effective risk management by concentrating risk across banks' portfolios and the broader financial system into a smaller set of risk factors. Overall, the multiple levels of conservatism inherent in the NMRF framework have contributed significantly to the lack of IMA adoption observed across the globe.

The European Commission's proposal to apply a flat stressed expected shortfall (SES) multiplier of 35%-45%<sup>6</sup> over a three-year period would provide some relief but ultimately serves as a temporary fix rather than addressing the underlying issues with the NMRF framework. Given its deficiencies – such as its lack of risk management utility, the loss of diversification and proxy hedging between modellable and non-modellable risk factors, and the capital uncertainty it creates – we believe the NMRF framework in its current form is unworkable. For these reasons, the NMRF framework should be temporarily discontinued and replaced with a solution that incorporates all risk factors that meet the data principles into IMCC, with performance assessed through back-testing. During this period, policymakers should conduct a more thorough review of the prudential treatment of less liquid risk factors. Additionally, the RFET framework should be temporarily discontinued, as it imposes an undue burden on banks to collect real price observations (RPOs) and results in an excessive number of risk factors being deemed non-modellable. We note that based on feedback received by the banks, the NMRF framework (including RFET) does not contribute to any improvements in the risk management framework. Since NMRF is a key driver of low IMA adoption, we strongly urge policymakers to develop a more effective alternative.

The flat SES multiplier serves as an alternative to delaying the full implementation of the NMRF framework. However, depending on the FRTB implementation timeline adopted by European regulators, as well as timelines in the US and UK, this could create a temporary imbalance where EU banks must run RFET and calculate SES while banks in other jurisdictions do not. To maintain a level playing field with non-EU jurisdictions and in case temporarily discontinuing the NMRF framework is not accepted, the NMRF

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<sup>4</sup> Note that we distinguish between non-modellable risk factors (NMRFs), and the capital measure associated with them –SES.

<sup>5</sup> A fundamental issue with the SES calculation is that it does not recognize netting between long and short positions in similar risk factors and assumes the same level of correlation between NMRFs, regardless of how closely related they are to each other.

<sup>6</sup> While we encourage the European Commission to temporarily discontinue the NMRF framework, we would note that the 35%-45% flat SES multiplier is comparable to the impacts from a collection of other amendments to the framework including reducing the correlation parameter in the SES aggregation formula from 0.6 to 0.25, extending non-modellable idiosyncratic risk factors to asset classes other than credit or equity, aligning the SES and ES stress windows, and improving the netting within risk classes or groups of similar risk factors.

framework (and RFET) would be better suited as a reporting requirement<sup>7</sup> provided to supervisors for an initial monitoring period aligned with the European Commission’s PLAT monitoring period. This would allow supervisors to collect data during a monitoring period to inform an assessment of whether the NMRF framework is fit for purpose and whether it should continue as a reporting tool. That said, we continue to believe that reporting a figure that lacks economic significance adds little value.

### Industry Recommendation:

While the NMRF framework was introduced to ensure the prudent capitalization of risk factors that fail to meet the RFET, the numerous issues associated with it suggest that the NMRF framework (including RFET) should be temporarily discontinued while regulators assess its suitability. During this period, the IMCC capital calculation and backtesting should include all risk factors that meet the prescribed data principles.

A secondary proposal is that banks conduct regular (i.e., quarterly or less frequently during the phase-in period) RFET exercises and report the results to regulators, but without the requirement to include SES capital in the own funds requirements. This would enable supervisors to re-design the framework while maintaining visibility into ‘illiquid’ risk factors – without imposing an excessive capital burden on banks. As with the initial proposal, the capital calculation for modellable risk and backtesting should encompass all risk factors that meet the prescribed data principles. Following the conclusion of the monitoring period, the data collected should inform whether a re-proposal of the NMRF framework (including RFET) is warranted or if the framework should be abandoned altogether.

If neither the primary nor secondary proposals are accepted, banks will be required to compute and include a surcharge for non-modellable risks in their own funds requirements. While efforts to address the excessively punitive RWA impact from the NMRF component is a step in the right direction, we believe the European Commission’s proposal to apply a flat multiplier to SES capital does not sufficiently align with risk. A similar capital impact can be achieved in a more risk-sensitive manner without calculating SES, which is a flawed and operationally costly measure. As a tertiary proposal, we suggest introducing a temporary multiplier on the IMCC measure, specifically applying a factor  $(1 + \alpha)$  to  $IMCC$  while removing  $SES$  from the capital formula entirely – within the aggregate (non-DRC) capital requirement for approved trading desks:

$$C_A = \max \{ (1 + \alpha) \cdot IMCC_{t-1}; m_c \cdot (1 + \alpha) \cdot IMCC_{avg} \}$$

where  $m_c$  is the backtesting multiplier for FRTB, typically set to 1.5. While definitive studies on this approach remain limited and would be difficult to conduct, preliminary indications suggest that selecting an  $\alpha$  of 0.2 is justified<sup>8</sup>. This is based on the premise that the European Commission’s proposed lower bound of 35% reflects the non-risk sensitive nature of NMRF, and the desire to address it. In this proposal, IMCC capital and backtesting would include all risk factors that meet the prescribed data principles, even if some of them do not pass RFET.

### 3. Proportional data requirements for the risk factor eligibility test (RFET) of new instruments

RFET is used to identify which risk factors should be capitalized under expected shortfall (ES) and which need to be capitalized under SES. However, RFET is not suitable for all instruments, and the industry agrees with

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<sup>7</sup> If the NMRF framework (and RFET) is implemented as a reporting requirement, it is essential to clearly define the reporting requirements. It should include a reporting of the inventory of risk factors falling under the NMRF framework, along with the exposures to those risk factors. This is particularly important given the lack of experience among regulators and practitioners with SES capital results – unlike VaR, which has been well-established for over two decades. We would note that the frequency of generating SES capital should be less than daily, ideally occurring on a quarterly basis as mentioned in Annex.

<sup>8</sup> Basel Committee on Banking Supervision. *Revisions to the Basel III Framework*. Bank for International Settlements, March 2025. <https://www.bis.org/bcbs/publ/d592.pdf>  
Based on the latest Basel monitoring report, SES capital accounts for 21.3% of the FRTB IMA charge for Group 1 banks, while modelled capital represents 40.9%. Applying the European Commission proposed flat multiplier of 35%-45%, the SES-to-IMCC ratio would range from  $\frac{21.3\% \times 35\%}{40.9\%} = 0.18$  to  $\frac{21.3\% \times 45\%}{40.9\%} = 0.23$ .

the European Commission's assessment that under the current rules, newly issued instruments (e.g., bonds) cannot be capitalized under the internal models approach during the first year after issuance, regardless of their liquidity and relative simplicity. While we support the proposal for a targeted operational relief measure that would allow new instruments and issuances to start the observability period for RFET from the issuance date and prorate the number of real price observations required to pass RFET until one year after issuance date, we think that the entire observability process for sovereign (including EU government) and supranational bonds introduces unnecessary complexity and creates a counterproductive burden on European banks. Therefore, we believe that qualifying government and supranational debt risk factors (as per CRE20.7 to CRE20.15) should be excluded from the RFET process and automatically recognized as modellable. This will reduce operational burden on banks that are currently required to perform a series of modellability checks for a market that is very liquid.

It is worth noting that the European Commission's proposed treatment for new instruments is already permitted as part of the US Notice of Proposed Rulemaking (NPR)<sup>9</sup>. To ensure the proposed treatment applies comprehensively, we recommend extending it to new reference rates and commodities markets.

In cases where a full 12-month time series is not available for new instruments, but these instruments meet the modellability criteria based on proportional data requirements, their associated risks will be included in the ES using proxy time series, without requiring capitalisation for NMRF basis. Article 12(3) of the EBA RTS on Backtesting and PLAT<sup>10</sup> should clarify that the RTPL may be aligned with the HPL and fully reflect the impact of the new issuance, thereby avoiding residual noise in the PLAT.

#### **Industry Recommendation:**

While we support pro-rating the number of real price observations for new instruments and issuances, we also believe this approach should be extended to newly published reference rates and commodities markets.

In line with the goal of simplification and the European Commission's objective to reduce burdens on European banks, the industry also proposes that qualifying government and supranational debt risk factors should be excluded from the RFET process and automatically recognized as modellable. This adjustment would provide a significant operational simplification even if NMRF is implemented as a reporting-only measure.

Furthermore, to avoid failing the PLAT for new instruments, Article 12(3) of the EBA RTS on Backtesting and PLAT should clarify that the RTPL may be aligned with the HPL and fully reflect the impact of the new issuance, thereby avoiding residual noise in the PLAT for 12 months from the date of issuance.

#### **4. Phase-in of the own funds requirements for default under the internal default risk charge model for sovereign issuers**

The industry agrees with the characterization that the default risk charge for exposures to sovereign issuers under the market risk internal model approach yields more conservative results than the market risk alternative standardized approach, creating a discrepancy between the two frameworks and leading to regulatory arbitrage.

We support the exclusion of positions that qualify for a 0% risk weight under the standardized approach for credit risk. However, the European Commission's consultation proposes applying a multiplier of 0 to "the capital requirements calculated using the internal model default risk for exposures to issuers/obligors that would attract a 0% risk weight under the standardised approach for credit risk". It is not clear what this

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<sup>9</sup> ISDA and SIFMA. *Response to US Basel III NPR*. January 2024. <https://www.isda.org/a/1ElgE/ISDA-and-SIFMA-Response-to-US-Basel-III-NPR.pdf>

<sup>10</sup> European Banking Authority. *Final Draft Regulatory Technical Standards on Backtesting and Profit and Loss Attribution (PLA) Requirements* (EBA/RTS/2020/02). Available at: [https://www.eba.europa.eu/sites/default/files/document\\_library/EBA-RTS-2020-02%20Final%20draft%20RTS%20on%20Backtesting%20and%20PLA%20requirements.pdf](https://www.eba.europa.eu/sites/default/files/document_library/EBA-RTS-2020-02%20Final%20draft%20RTS%20on%20Backtesting%20and%20PLA%20requirements.pdf)

proposal means since the DRC under internal models is based on a single value-at-risk (VaR) calculation at the 99.9% confidence level, and there is no unique way to attribute the resulting capital to a subset of positions. Furthermore, the 0% risk weight of the standardised approach for credit risk applies to specific positions (typically local currency issuances) rather than at the issuer/obligor level. Therefore, the industry seeks clarification on how the 0 multiplier is intended to be applied in practice. The simplest solution would be to exclude the positions that would attract a 0% risk weight under the standardised approach for credit risk from the scope of IMA DRC.

#### **Industry Recommendation:**

While the industry supports the intention of the European Commission, we seek clarification on how the 0 multiplier should be applied to positions with a 0% risk weight in the calculation of internal models default risk charge. The simplest solution would be to exclude the relevant positions from the scope of IMA DRC.

#### ***5. Operationalisation of the capital requirements for Collective Investment Undertaking (CIU) exposures under the alternative internal model approach***

The European Commission consultation correctly highlights that banks have been unable to capitalize their CIU exposures using internal models due to the stringent requirements for weekly look through to individual components. The consultation addresses this issue by (a) permitting banks to apply the look through approach (LTA) on a quarterly basis, (b) allowing banks to calculate their own funds requirements on CIU exposures under the alternative internal model approach if they can look through 90% of the exposures by value (with the residual exposures being capitalized under the alternative internal model approach using the risk weight specified for the default option under the alternative standardized approach), and (c) allowing banks to use a supervisory approved conservative methodology.

The industry supports objective (a), as it provides the necessary relief for banks to effectively deploy the alternative internal model approach for CIU exposures. We also support objective (c), as it allows for a sensible approach to be proposed. However, it is unclear how helpful option (b) will be, given the 90% threshold.

We would also suggest that, similar to the way FRTB-SA permits the substitution of a CIU with a well-tracked index under CRR Article 325j(2)<sup>11</sup>, this same flexibility be extended to IMA. This would help incentivize the adoption of IMA for portfolios containing such CIUs. Since index data is more readily available, this approach makes it easier to perform look through.

#### **Industry Recommendation:**

While the industry welcomes the relief provided for CIUs to apply the internal model approach, we remain concerned with the 90% threshold specified as part of objective (b). In principle, no threshold should be required if credit institutions can demonstrate that the residual part of the fund is adequately capitalized to the satisfaction of supervisors. We note that the residual part would be subject to the standardized approach default option risk weight and aggregation, which are already conservative.

If the proposal to remove the threshold is not accepted, the industry suggests a threshold of 50% for objective (b), as this would allow banks to use the alternative internal model approach for the majority of funds where they can look through the material underlying positions but are unable to look through a small residual portion due to operational or other reasons.

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<sup>11</sup> European Commission. *Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms*, consolidated version as of 9 July 2024, Article 325j(2) – "Treatment of collective investment undertakings." Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02013R0575-20240709>

The industry also proposes that the option under FRTB-SA, as outlined in CRR Article 325j(2)<sup>12</sup>, to substitute a CIU tracking an index benchmark with a position in the index itself (if the annualized returns are similar) to be extended to IMA. This would help in situations where the index can be looked through, but precise information on the CIU composition is not readily available.

## **Measures to phase in and / or operationalise the own funds requirements calculation under the Alternative Standardised Approach**

### **6. Operationalisation of the capital requirements for Collective Investment Undertaking (CIU) exposures under the alternative standardised approach**

The European Commission consultation correctly notes that banks are unable to achieve perfect transparency of their CIU exposures, making it impractical to apply the look through approach (LTA) on a monthly basis for capital purposes. The industry welcomes the European Commission's proposal, which provides some operational relief by allowing banks to apply the LTA on a quarterly basis. However, for a number of mutual funds, the LTA even on a quarterly basis remains a challenge. Separately, the industry welcomes the permission to calculate their own funds requirements on CIU exposures using a partial look through if they are able to look through some of their CIU exposures.

However, we remain concerned with the restriction to look through of at least 90% of the fund. We will elaborate on this in the subsequent section.

Additionally, the industry seeks clarification on the requirement of Article 325j(3)<sup>13</sup> for its application on options on CIUs. Typically, an institution can, subject to the challenges discussed elsewhere in this document, apply a look through treatment to delta, curvature and DRC. However, look through of CIU vega is not practical or consistent with the risk management of such positions. If an institution is required to apply look through treatment to CIU vega whenever the delta/curvature/DRC is looked through, it will mean in practice that institutions are not able to utilise the look through approach at all, neither partially nor fully. This will result in the single equity treatment being applied across the board for such CIU positions and consequently extremely high, uneconomic RWA requirements.

Treating vega as a single sensitivity, when performing look-through delta and curvature, would be consistent with Article 325i (1) which describes the treatment of sensitivities under the look-through approach for multi-underlying instruments, which would also include CIU options, in addition to index options. This would allow look through treatment of only the delta/curvature/DRC components for CIU options and therefore more economically reasonable capital treatment.

#### **Industry Recommendation:**

The industry welcomes the relief allowing CIUs to apply the LTA a) on a quarterly frequency and b) partially. However, we remain concerned with the 90% threshold specified under objective (b). In principle, no threshold should be required if banks can demonstrate that the residual part of the fund is adequately capitalized – such as when the residual part is subject to the alternative standardized approach default option risk weight and a very conservative aggregation. This approach would also be more risk-sensitive than the current one, effectively treating a partially looked-through fund as two sub-funds: one subject to the LTA for

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<sup>12</sup> European Commission. *Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms*, consolidated version as of 9 July 2024, Article 325j(2) – "Treatment of collective investment undertakings." Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02013R0575-20240709>

<sup>13</sup> European Commission. *Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms*, consolidated version as of 9 July 2024, Article 325j(3) – "Treatment of collective investment undertakings.", 325i(1) – "Treatment of index instruments and other multi-underlying Instruments." Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02013R0575-20240709>



the fully transparent part and the other subject to the fallback approach for the non-fully transparent part<sup>14</sup>. An arbitrary, uniform threshold also poses the risk of funds frequently changing their capitalization method when their actual transparency rate fluctuates near the threshold, leading to large swings in RWA. Allowing banks to look through as much of the funds as is materially possible (which is their objective interest) – without a predefined threshold – would help mitigate this volatility and promote greater stability. We believe that the industry recommendation should be made on a permanent basis.

If the proposal to remove the threshold is not accepted, the industry suggests lowering it to 50% for objective (b). This would allow banks to use the partial LTA on a broader scope.

In the longer term, the industry highlights the need to also consider another approach as described in Annex 2.2 of this document (“Enhanced Mandate Based Approach”). Recognizing the short timeline of this consultation and issuance of the Delegated Act, a reduction of the CIU risk weight under the Fall-Back Approach should be considered, as explained in Annex 2.3.

#### **7. Allow a better recognition of economic hedges in the calculation of the capital requirements for default risk**

We welcome the European Commission’s proposal to recognise economic hedges in the calculation of default risk.

Under the current rules, the maturity scaling of derivative exposures creates broken hedges between the hedged and hedging instruments for positions with maturities of less than one year. Full capital relief is only granted when the maturities of the hedged and hedging instruments match exactly, which does not reflect common banking practices. In reality, banks frequently roll the hedging instruments until the maturity of the hedged instrument, creating an apparent maturity mismatch for DRC purposes. However, in a default scenario, this maturity mismatch is not utilised, as banks actively manage and roll their hedging instruments to align with the maturity of the hedged instrument. It is important to note that the hedging instruments – typically cash instruments, equity futures or bonds – are highly liquid, and access to them remains unaffected even as the obligor approaches a credit event. Additionally, the IMA DRC framework offers greater flexibility, as CRR Article 325bo(3)<sup>15</sup> allows banks to disregard for capital purposes the immaterial maturity mismatch risk across equity and credit positions. We believe banks should have the discretion to determine whether to account for maturity mismatches under SA DRC. Aligning the treatment across both frameworks would enhance comparability, reduce capital divergence, and improve the clarity of capital requirements.

Furthermore, the assumption that positions disappear from trading books upon expiry is unrealistic, particularly for market-making desks, which routinely replenish positions as part of their trading activities. This assumption also fails to consider that trading desks and independent risk control units actively manage risk to prevent one-sided exposures from growing excessively and breaching established risk limits.

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<sup>14</sup> For example, a fund with a residual part comprising 98% – meaning almost no transparency – would be fully capitalized using a single risk weight and a conservative aggregation.

<sup>15</sup> European Commission. *Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms*, consolidated version as of 9 July 2024, Article 325bo(3) – “Recognition of hedges in an internal default risk model.” Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02013R0575-20240709>

For equities, the current rules allow cash equities in the DRC capital calculation to be assigned a maturity of either three months or one year. Article 325x(4)<sup>16</sup> of the UK FRTB rules extends the three-month maturity assignment to equity derivatives to remove uneconomic maturity mismatches.

Beyond equities, significant maturity mismatches also arise in fixed income activities. A common example is short-term derivatives with longer-term underlying positions and corresponding hedges. To address this, we propose introducing a similar provision for credit positions, allowing banks to extend their assigned maturities to one year. While this would align with the equity treatment, a three-month option would not be included to maintain a conservative approach.

### **Industry Recommendation:**

The industry recommends a practical approach to recognising economic hedging in DRC capital by allowing banks, at their discretion, to assign a maturity of three months to equity derivatives and one-year to credit instruments. This would better align the maturity of these instruments with their corresponding hedges, similar to the IMA framework. We believe that the below amendment to the CRR should be made on a permanent basis.

#### Article 325x:

*(4) For the purposes of paragraphs 2 and 3, the maturities of the derivative contracts shall be considered, rather than those of their underlyings. ~~Cash equity exposures~~ An institution shall ~~be assigned~~ assign a maturity of either one year or three months, ~~to cash equity exposures and may assign a maturity of three months to equity derivative exposures, in each case~~ at the institution's discretion.*

*(4a) For the purposes of paragraphs 2 and 3, an institution may assign maturity of 1 year to credit exposures, at the institution's discretion.*

### **8. Phase-in of the capital requirements for specific instruments in scope of the residual risk add-on (RRAO) charge**

We welcome the European Commission's proposal to remove RRAO charges for instruments with future realised volatility, such as variance swaps, and for options exercisable on a finite number of dates, such as Bermudan options. We agree with the Commission's rationale that these instruments should be excluded from RRAO, as banks can effectively hedge them in the market.

However, the industry remains concerned about the excessive RRAO charges applied to spread options, particularly Constant Maturity Swap (CMS) spread options<sup>17</sup>. Similar to variance swaps and Bermudan options, spread options can be effectively hedged, aligning with the EBA Regulatory Technical Standards

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<sup>16</sup> Bank of England. *Policy Statement PS9/24 – Implementation of the Basel 3.1 Standards: Appendix 2*. Prudential Regulation Authority, September 2024. <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2024/september/ps924app2.pdf>

<sup>17</sup> ISDA and AFME. *Response to EBA on FRTB Residual Risk Add-On*. June 2021. Available at <https://www.isda.org/a/r2EgE/ISDA-and-AFME-Respond-to-EBA-on-FRTB-Residual-Risk-Add-On.pdf>; European Banking Authority. *Final Report on Draft Regulatory Technical Standards on the Residual Risk Add-On (RRAO)*. October 2021. Available at [https://www.eba.europa.eu/sites/default/files/document\\_library/Publications/Draft%20Technical%20Standards/2021/RTS%20on%20residual%20risk%20add-on/1022462/Final%20Report%20on%20draft%20RTS%20on%20RRAO.pdf](https://www.eba.europa.eu/sites/default/files/document_library/Publications/Draft%20Technical%20Standards/2021/RTS%20on%20residual%20risk%20add-on/1022462/Final%20Report%20on%20draft%20RTS%20on%20RRAO.pdf)

(RTS)<sup>18</sup> framework, which excludes hedges of spread options from RRAO. Therefore, spread options should also be considered outside the scope of RRAO.

Spread options have simple payoffs based on the spread between two maturity points on the same underlying yield curve, which is both observable and liquid. Additionally, interest rate yield curve options serve as critical hedging tools for clients such as pension funds, life insurers, corporates, and asset managers. Banks trade CMS spread options as part of a strategy when they offer these options to clients while simultaneously hedging their exposures using other CMS spread options. Due to the nature of these products, a perfect offset of market risk is not feasible in practice, as small and second order risk mismatches are unavoidable. Therefore, banks cannot practically apply the derogatory treatment under Article 325u(4)(c)<sup>19</sup> (where both legs shall be exempted from RRAO). They are left with the option to exempt only the hedging leg (provided the hedging conditions required by the EBA RTS are met). This approach is not only overly conservative as it allows exemption for just one leg, but it also creates a cliff effect for very small second order risk mismatches regardless of whether a perfect hedge is practically achievable. Therefore, imposing RRAO charges on these instruments could significantly increase hedging costs for these end-users.

We reiterate our support for the exclusion of hedges and emphasize the need to lift the unnecessary restrictions introduced by the EBA's RTS. While the European Commission's proposal provides some relief, we believe further refinements to the targeted relief measures are necessary to exclude additional instrument types from RRAO.

Furthermore, if a risk is hedged, the RRAO charge applied to the original instrument being hedged should be proportionately reduced. For example, if 50% of the residual risk is hedged, the RRAO charge on the original instrument should be halved, while the hedge itself should remain exempt from RRAO.

It is also worth mentioning that the US NPR<sup>20</sup> already exempts all spread option trades, including client trades. This exemption is based on the recognition that the RRAO charge is disproportionately high relative to the actual risk, which is already captured in SBM. Whilst the EU could allow for these exemptions, regulatory approval is required.

### **Industry Recommendation:**

The industry remains concerned about the impact of the RRAO framework. To address this, we recommend that options without path-dependent payoffs or with two or fewer underlyings be excluded from RRAO. Additionally, we urge clarification that simple CMS spread options should be classified as vanilla instruments and therefore fall outside the scope of RRAO. Exempting these instruments would prevent disproportionately high RRAO charges on hedged positions, which can significantly exceed the much lower RRAO charge applied to unhedged positions. This misalignment may discourage prudent risk management and negatively impact end-users who rely on these products for hedging.

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<sup>18</sup> European Banking Authority. *Final Draft Regulatory Technical Standards on Residual Risk Add-On (RRAO) Hedges*. December 2024. Available at <https://www.eba.europa.eu/sites/default/files/2024-12/4db1f532-a589-4a2d-b65f-f6298a76f5a1/Final%20draft%20RTS%20on%20RRAO%20hedgies.pdf>

<sup>19</sup> European Commission. *Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms*, consolidated version as of 9 July 2024, Article 325u(4)(c) – "Own funds requirements for residual risks." Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02013R0575-20240709>

<sup>20</sup> Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation. *Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity*. Federal Register 88, no. 179 (September 18, 2023). <https://www.federalregister.gov/documents/2023/09/18/2023-19200/regulatory-capital-rule-large-banking-organizations-and-banking-organizations-with-significant#h-192>

Additionally, the hedging leg exemption is subject to a very cumbersome, overly prescriptive and impractical internal policy. Hence, banks face a complex process in terms of documentation and operationalization requiring significant resources across teams. Therefore, in order to simplify the operationalization for banks using widely adopted CMS spread options strategies, we recommend in the context of the targeted measures to set a multiplier of 0.

In the long term, we recommend amending CRR3 Article 325u(4) to include the following new paragraph (d).

#### **Article 325u(4)**<sup>21</sup>

*By way of derogation from paragraph 1, institution shall not apply the own funds requirement for residual risks to an instrument that meets any of the following conditions:*

*(a) the instrument is listed on a recognised exchange;*

*(b) the instrument is eligible for central clearing in accordance with Regulation (EU) No 648/2012;*

*(c) the instrument perfectly offsets the market risk of another position in the trading book, in which case the two perfectly matching trading book positions shall be exempted from the own funds requirement for residual risks.*

*(d) instruments that are options without path dependent payoffs or with two or fewer underlyings (for example CMS spread options)*

#### **9. Carbon trading exposures**

The Industry welcomes the European Commission's proposed changes, which appear to be informed by analysis conducted by ISDA<sup>22</sup> on the correlation parameter for aggregating carbon trading exposures. The analysis showed that the appropriate range should be between 99.5% and 99.9%, rather than the current 99%.

#### **Industry Recommendation:**

We recommend increasing the correlation parameter for aggregating carbon trading exposures to at least 99.6%. We believe that this industry recommendation should be made on a permanent basis.

#### **10. Temporary adjustment factor for own funds requirements under the alternative standardised approach for market risk**

In general, the sensitivity-based method (SBM) would strengthen the market risk capital framework by introducing a standardized approach to market risk within the European banking capital framework, serving as a credible alternative to the internal models approach.

We welcome the European Commission's proposal to introduce a multiplier in the FRTB SA framework, recognising the uncertainty around the adoptions (both in timing and content) of the global standard by other jurisdictions. However, it is worth noting that this measure is both temporary – limited to relief for three years – and not inherently risk-sensitive. We therefore believe that instead certain aspects of the SBM framework should be improved to better recognise diversification and align market risk capital requirements with common risk management practices.

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<sup>21</sup> European Commission. *Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on Prudential Requirements for Credit Institutions and Investment Firms*, as amended by Regulation (EU) 2021/558, Article 325u – "Own funds requirements for residual risks." Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02013R0575-20250101>

<sup>22</sup> ISDA. *Implications of the FRTB for Carbon Certificates*. July 2021. <https://www.isda.org/a/i6MgE/Implications-of-the-FRTB-for-Carbon-Certificates.pdf>

To facilitate a robust assessment of diversification effects across asset classes that leverages data, we propose a concept previously submitted in response to the US NPR<sup>23</sup>. The industry recommended incorporating a correlation parameter across risk classes within SBM, in accordance with the following formula:

$$capital\ requirement = \sqrt{\sum_b SBM_b^2 + \sum_b \sum_{c \neq b} \rho_{bc} SBM_b SBM_c} + DRC + RRAO$$

Under this formulation,  $SBM_b$  would represent the risk class-level capital requirement for each risk class under SBM;  $\rho_{bc}$  would represent a new inter-asset class correlation parameter or parameter set ('Rho Parameter').

The industry response to the US NPR advocated for the introduction of a rho parameter of 0.5, which led to an approximate reduction of 20% in SBM capital (or 10% in FRTB SA capital). However, historical industry correlation<sup>24</sup> analysis across asset classes indicates that this rho value is an overestimation. As shown in Figure 1 and Figure 2, a rho of 0.5 is unnecessarily conservative, with correlations distributed around 0% and with respect to the tail scenario of actual realised correlations.

This is further demonstrated by Figure 3 and Figure 4, which illustrate that even during periods of market stress since 2008, correlation levels have remained stable without significant spikes. Correlations are distributed around 0%. An extreme assumption – such as using the 99.9<sup>th</sup> percentile of the distribution – would correspond to calibrating rho at 30%, which is equivalent to an SBM multiplier of 0.7.

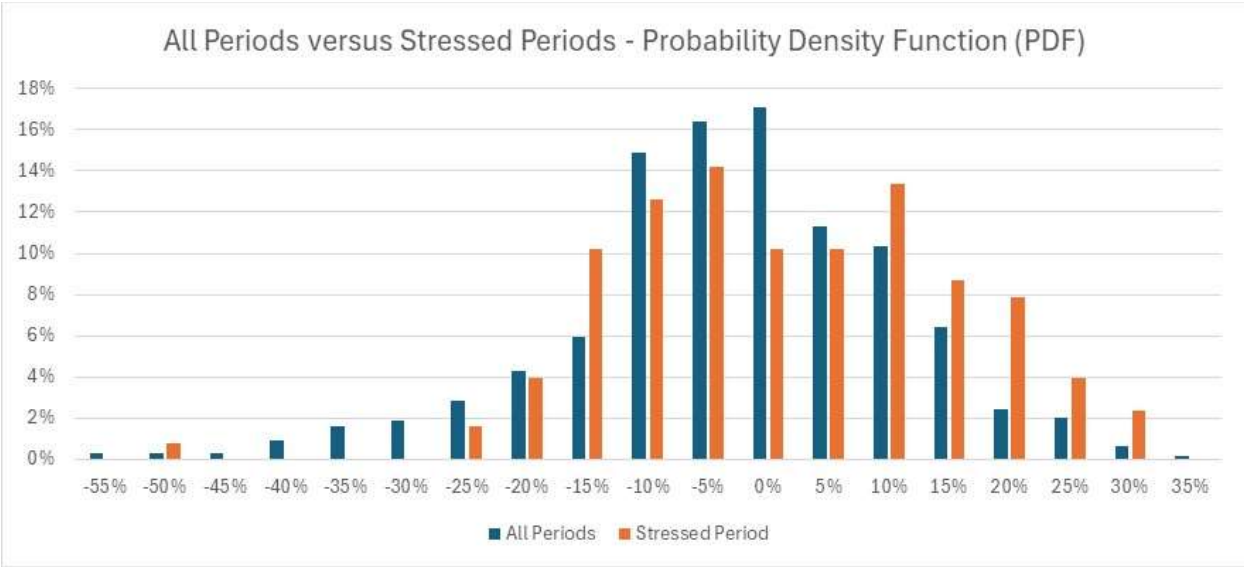


Figure 1 - Distribution of implied rho

<sup>23</sup> ISDA and SIFMA. *Response to US Basel III NPR*. January 2024. <https://www.isda.org/a/1ElgE/ISDA-and-SIFMA-Response-to-US-Basel-III-NPR.pdf>

<sup>24</sup> As the focus is correlation, historical VaR data from the industry can be used as a suitable proxy for SBM to back out the rho correlation parameter introduced. Data is obtained from public disclosures of EU & US banks' historical VaR figures from Q2 2008 to Q4 2024.

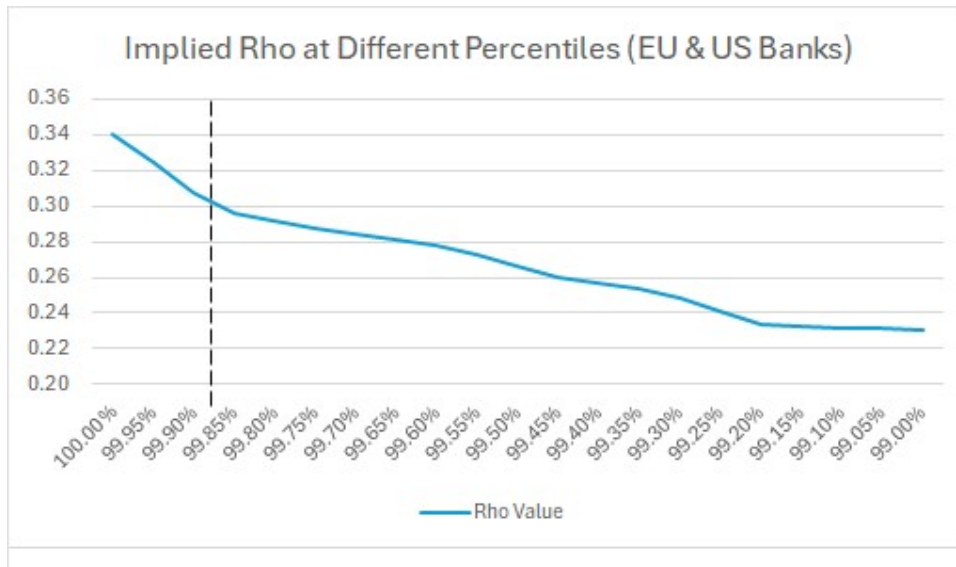


Figure 2 - Implied Rho at extreme percentiles

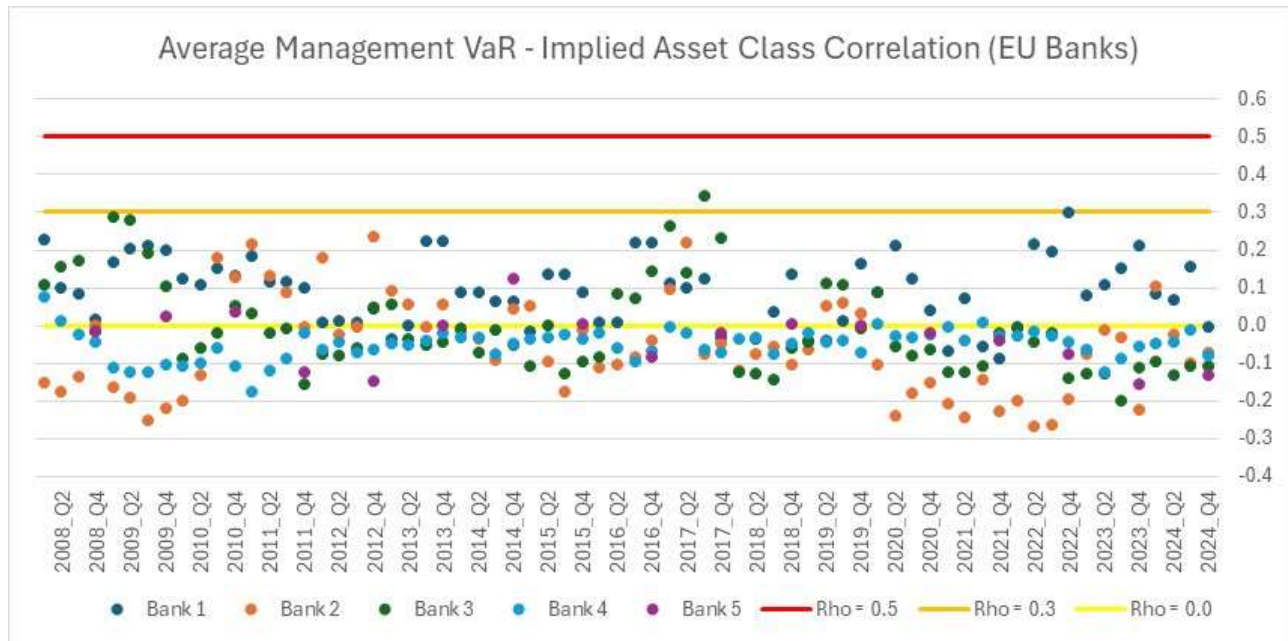


Figure 3 - EU banks implied asset class correlation obtained from management VaR since Q2 2008

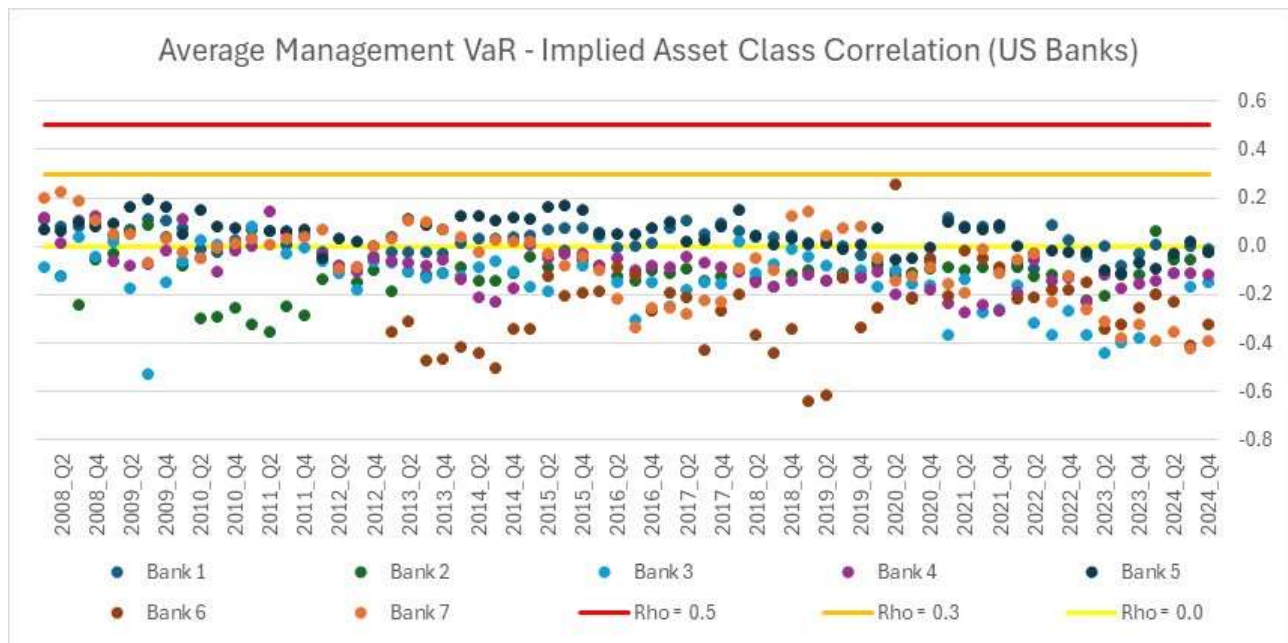


Figure 4 - US banks implied asset class correlation obtained from management VaR since Q2 2008

**Industry Recommendation:**

The industry recommends introducing an FRTB SBM capital requirement multiplier of **maximum 0.7**<sup>25</sup>. This corresponds to the reduction in SBM capital<sup>26</sup> using an SBM rho value of 30%<sup>27</sup>, which remains conservative – given that this implied rho represents the 99.9<sup>th</sup> percentile of historical implied rho values since 2008 – while historical data suggests that lower rho values, and thus a lower SBM multiplier, are more typical.

In the longer term, the industry encourages the European Commission to consider the more risk-sensitive approach outlined above, which better reflects diversification benefits across asset classes while also addressing level playing field concerns across jurisdictions. Until such time, the scalar approach should remain in place on a permanent basis.

The approach taken for SBM diversification also relates to the IMCC rho parameter outlined in Annex 1.1.1. Both approaches acknowledge the importance of recognising diversification while ensuring that banks are not disincentivised from utilising either IMA or ASA.

<sup>25</sup> Analysis was performed using the hypothetical portfolios identified in by ISDA Analytics™ solution.

<sup>26</sup> Not considering various changes highlighted in this paper, this would translate approximately into a 0.85 multiplier applied to the overall FRTB-SA capital charge.

<sup>27</sup> We note that the SBM rho value of 0.3 aligns with the average of the values in the cross-asset class correlation matrix used in the ISDA standard initial margin model (ISDA SIMM®. ISDA SIMM® employs a similar formula to the cross-asset class diversification approach proposed above. However, ISDA SIMM® alone is not enough to justify the rho value of 0.3 since it has two fundamental differences from FRTB SA: (1) it does not use a fixed set of parameters and instead undergoes concentric recalibration every six months based on updated market data; (2) it incorporates product-class netting (e.g., interest rate risks from an equity trade cannot be netted against interest rate risks from an interest rate swap, which influences the calibration.

### **Additional adjustments:**

As stated above, we welcome the adjustments proposed by the commission but would like to point out that a number of other critically important and long-standing issues in the FRTB framework have been left unaddressed. We believe that targeted adjustments aimed at these issues should also be included in case Option 3 is chosen by the commission. These additional adjustments are highlighted below. For the details of these adjustments please refer to the Annex.

### **Other FRTB-IMA Issues:**

1. Calibration of rho parameter for modellable risk factors
2. Capping of liquidity horizons
3. Calculation frequency of IMCC and NMRF
4. Actual P&L (APL) backtesting as a monitoring tool
5. Alignment of SES and ES stress windows
6. Changes to RFET
7. Requirement to audit third-party data providers
8. Non-negligible volume and bid-offer spread for verifiable price observations

### **Other FRTB-SA Issues:**

1. Alternative Correlation Trading Portfolio
2. Collective Investment Undertaking (CIU) – Enhanced Mandate Based Approach
3. Collective Investment Undertaking (CIU) – Risk Weights under the Fall-Back Approach
4. Collective Investment Undertaking (CIU) – Treat qualifying CIUs equivalently to existing Index buckets
5. Collective Investment Undertaking (CIU) – Remove the standalone aggregation for the Fall-Back Approach
6. Collective Investment Undertaking (CIU) – Fund mandates under the Fall-Back Approach
7. Collective Investment Undertaking (CIU) – Trading Book / Banking Book Boundary Criteria
8. Treatment of REITs / REIFs
9. Treatment of dividend derivatives under the RRAO framework
10. Extending exemptions from RRAO charge for options on indices
11. Clarification on perfectly offsetting trades subject to the RRAO
12. Clarification on identification and exemption of hedges from RRAO
13. FX & IR Vega risk weight
14. Linear trade curvature scope

### **Measures concerning standardised and internal model approaches**

1. Reporting SA and IMA

### **Question 4. What are your views about other additional or combined options?**

The Industry appreciates the openness of the European Commission to call for ideas for potential combinations and alternatives in the consultation given the breadth of views among the Industry. These views are shaped by concerns about maintaining a level playing field internationally, the potential impact on the competitiveness of firms operating within the EU, operational complexities, and questions surrounding the adequacy of risk representation under the FRTB – particularly as a framework different than the agreed international standards is expected in other relevant jurisdictions.

Our members have discussed the options and various possible combinations thereof. A minority of firms have arrived at the alternative option that we present below.

For this option to be an agreeable solution, the European Commission would have to, as soon as practicable, assess and confirm the viability (including from an operational perspective) of this solution under the



empowerment to the Commission under Article 461a CRR3. It will also be essential for the EBA and European Commission to clarify their position with respect to the implementation of Trading Book/Banking Book boundary on 1 January 2026.

**Alternative option: Partial FRTB-IMA/SA delay**

Banks currently using exclusively the standardised approach to market risk would move to FRTB-SA on 1 January 2026. However, firms that are currently using IMA (including firms that are partially using IMA) to calculate their own funds requirements for market risk can opt to delay the date of application to 1 January 2027 for both approaches used to calculate the own funds requirements for market risk (the alternative internal model approach and alternative standardised approach). This option would be workable if and only if current IMA banks and partially IMA banks (Basel 2.5) are entitled to continue to calculate and report own funds in line with current transitional arrangements. This means that those banks would compute required capital using CRR2 rules (for IMA perimeters and SA portfolios), with FRTB-SA used for output floor purposes only and the TB/BB Boundary still based on the CRR1 Boundary.

This option would be in tandem with the use of the empowerment under Article 461a in a new Delegated Act that introduces targeted amendments for up to three years to the market risk framework. Under a level playing field assessment, this alternative approach would automatically align the market risk calculations for own funds requirements for internationally active banks that chose to continue operating under the Basel 2.5 IMA/SA for another 12 months with international peers. It is crucial that the process of introducing changes to both the FRTB-IMA and FRTB-SA by the empowerment to the Commission under Article 461a CRR is started imminently in order to arrive at a medium-term solution in 2026 ahead of the 2027 implementation timeline, followed by a full review of the framework.

## Annex

### 1. Other FRTB-IMA Issues

#### 1.1. Changes to ES

##### 1.1.1. Calibration of rho parameter for modellable risk factors

The aggregate capital measure for modellable risk factors in the ES calculation (i.e., the IMCC measure) is calculated as the weighted average of the constrained (diversified) and unconstrained (non-diversified) ES-based measures, using an IMCC rho parameter of 0.5:

$$IMCC = \rho \times (IMCC(C)) + (1 - \rho) \times \left( \sum_{i=1}^B IMCC(C_i) \right)$$

This approach is overly conservative and does not sufficiently take into account the benefits of diversification in the portfolio. The IMCC rho parameter serves as a regulatory discretion tool, allowing regulators to adjust the modelled capital when correlations deteriorate, and historical correlations no longer hold.

However, empirical data does not support an IMCC rho value other than 1. As shown in Section 10 of our response, the implied correlation across firm's VaR models remains stable even during periods of market stress. If significant volatility in implied correlations were observed, additional conservatism might be justified – but the data does not indicate such a need.

Additionally, ES already incorporates multiple levels of conservatism:

1. The ES for the reduced set of risk factors ( $ES_{R,S}$ ) is based on the most severe 12-month period available within the observation horizon.
2. Liquidity horizons are scaled from a base horizon of 10 days.

Based on this, any weight other than 1 given to the diversified ES-based measure is overly conservative. A rho of 1.0 reflects prevailing diversification benefits without any additional assumptions. To incentivize IMA and mitigate the multiple levels of conservatism, we propose increasing IMCC rho from 0.5 to 1.0.

#### **Industry Recommendation:**

The calibration of IMCC rho should be increased from 0.5 to 1.0.

##### 1.1.2. Capping of liquidity horizons

The CRR3 requires banks to take into account the maturity of a position in determining its liquidity horizon. If the position's maturity is shorter than one of the prescribed fixed liquidity horizons, the effective liquidity horizon would be calculated as the next longest liquidity horizon from the position's maturity. We have deep concerns regarding the liquidity horizon capping to the maturity of related positions. Theoretically, the maturity cap implies that no position should be renewed beyond its expiry date. This requirement introduces unrealistic hedge breaks, negatively impacts capital and risk management, and contradicts market practices of rolling over hedges at contract maturity. Furthermore, it introduces a significant barrier to IMA adoption for desks trading in liquid instruments and actively hedging their risks.

We would note that the US NPR<sup>28</sup> provides flexibility by allowing banks to consider the next longest maturity-based liquidity horizon as the ‘minimum’ liquidity horizon thereby allowing banks to apply a longer liquidity horizon.

If this capping requirement were mandatorily imposed, it would have undesired impacts on risk management practices, including but not limited to the following:

1. **Unrealistic hedge breaks between the same risk factors across different instruments:** For example, short-dated index options are frequently used as liquid hedges against credit exposures of longer maturity.
2. **Unnecessarily volatile capital charges even when there is no change to the true underlying risk:** For example, the maturity of certain instruments tends to cluster around particular dates (e.g., listed futures maturing on the third Friday of expiring months, or monthly equity, index, or currency option expiration dates, or IMM dates), leading to drastically volatile capital changes near those dates.
3. **Incorrect representation of risk:** For example, physically delivered futures or options would continue to carry risk exposures to relevant risk factors beyond the expiration date. If capped at position maturity, the risk on those risk factors would not be correctly captured.

### **Industry Recommendation:**

Align EU rule with the draft US NPR draft to allow banks the option, but not the obligation, to consider the next longest liquidity horizon as the ‘minimum’ liquidity horizon. This would enable banks to apply a longer liquidity horizon beyond the maturity of the position. Alternatively, authorities may consider giving banks flexibility to develop their own methodology and opt for the longer liquidity horizon of a risk factor with appropriate justification and validation, regardless of the maturity of positions that give rise to the exposure.

#### **1.2. Calculation frequency of IMCC and NMRF**

IMCC should be calculated less frequently than daily, in line with the Basel standards, considering the operational burden and computational cost introduced by the complexity of the IMCC calculation.

In the Basel text, MAR30.10<sup>29</sup> explicitly recognizes that internal models used to determine market risk capital requirements may differ from those used by a bank in its day-to-day internal risk management functions. As long as the core design elements of both the market risk capital model and the internal risk management model are the same, there is no requirement for the capital model to be fully recalculated each day.

Our interpretation of the Basel standards suggests that it is sufficient for the bank’s daily VaR model to share the core design elements with ES to meet the “risk management use” requirements. Moreover, the daily calculation of FRTB VaR for backtesting purposes, with results reported to senior management, provides a link between daily risk management practices and internal capital models.

CRR3 is somewhat more stringent than Basel standards, particularly in Article 325bi(1)(a)<sup>30</sup>, which states that any internal risk measurement model used to calculate capital requirements for market risk must be closely

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<sup>28</sup> ISDA and SIFMA. *Response to US Basel III NPR*. January 2024. <https://www.isda.org/a/1ElgE/ISDA-and-SIFMA-Response-to-US-Basel-III-NPR.pdf>

<sup>29</sup> Basel Committee on Banking Supervision. *Minimum Capital Requirements for Market Risk*. Bank for International Settlements, January 2019. <https://www.bis.org/bcbs/publ/d457.pdf>

<sup>30</sup> European Commission. *Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms*, consolidated version as of 9 July 2024, Article 325bi(1)(a) – “Qualitative requirements.” Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02013R0575-20240709>

integrated into the daily risk management process of the institution. However, it does not define this requirement precisely. We believe the same interpretation as applied to Basel should also apply here.

CRR3 prescribes daily IMCC calculations. However, if the primary intent is not to align with day-to-day risk management processes, the requirement likely serves to achieve the desired averaging effect – ensuring that the capital charge represents an average of the IMCC over the preceding 60 days, enhancing stability and reducing susceptibility to manipulation. To achieve the intended averaging effect, 12 weekly numbers should be sufficient, as required in the IMA DRC framework. Therefore, we conclude that relaxing the daily calculation requirement to a weekly basis would not undermine the spirit or intended outcome of the rules.

It is important to stress that running daily calculations are significantly more complex than weekly. Daily calculations require more computational power and impose stricter requirements to ensure timely completion for daily operational processes and signoffs. Additionally, calculating ES under different liquidity horizon scenarios poses challenges for both diversified and non-diversified portfolios. Given the novelty and complexity of the new capital framework, relaxing these requirements would significantly lower the barrier to adoption for banks that are well-advanced in their IMA implementation but need more time to productionize the operational process. We believe such improvement would be a sensible permanent change and could be implemented through a Delegated Act as a targeted operational relief measure.

In the event that the NMRF proposals in Section 2 are not accepted, we would like to enact operational changes to the NMRF framework including changing the frequency of NMRF calculations. The daily NMRF calculations, as required in the Basel standards, are operationally burdensome, especially since banks have indicated that NMRF calculations are not typically used as a risk management measure. Performing these calculations daily incurs significant operational costs and modelling challenges, particularly when only a few risk factors in a trade are deemed non-modellable, requiring numerous calculations for each trade – separately for ES and NMRF, and to account for different liquidity horizons of risk factors in ES. Since NMRF calculations are derived from stressed scenarios, it is expected to be relatively stable, with the stressed period calibrated quarterly and the NMRF population assessed through a quarterly RFET process. Furthermore, daily portfolio variations are already captured and monitored through risk management metrics such as VaR and backtesting against daily P&L.

#### **Industry Recommendation:**

Allow IMCC and NMRF calculations to be conducted less frequently than daily. Specifically, IMCC should be calculated weekly, using an average of 12 weeks for the capital calculation.

For SES, while we recommend suspending the framework, if it were to be retained for monitoring purposes, a frequency of quarterly or less would be appropriate. In case this recommendation is not accepted by policymakers and SES continues to be used in the capital calculation, it should not be calculated more frequently than weekly (e.g., using an average of 12 weeks for the capital calculation, similar to the IMCC recommendation).

#### **1.3. Actual P&L (APL) backtesting as a monitoring tool**

APL backtesting at the firm- and desk-level should be a reporting-only requirement, as its primary purpose is to assess model performance rather than capital adequacy. APL includes various P&L drivers that are independent of ES models – such as intraday P&L and non-daily valuation reserve recalibration – and may even include non-market risks, such as contingent features tied to non-market events. Hence, APL backtesting is susceptible to non-model related negative aspects, which could misrepresent the performance of ES models. This could lead to unwarranted removal of trading desks from IMA and discourage investment in IMA model development. Instead, APL backtesting should serve as a supplementary monitoring tool, complementing the more reliable HPL backtesting process.

## **Industry Recommendation:**

APL backtesting should serve as a supplementary monitoring tool.

### **1.4. Alignment of SES and ES stress windows**

If the industry proposals in Section 2 are not accepted, the operational challenges associated with the NMRF framework would still remain. Banks would be required to calculate a capital measure for each NMRF using a stress scenario that is calibrated to be at least as prudent as the ES-based measure used for modellable risk factors and must select a common 12-month period of stress for all NMRFs in the same risk factor class. If the bank cannot determine a stress scenario for a risk factor class or a smaller set of NMRFs acceptable to supervisors, the bank would be required to use the scenario producing the maximum possible loss as the stress scenario.

Given that the ES stress period effectively captures market stress for banks and considering the operational challenges of maintaining separate stress periods for each NMRF risk class, the rules should be revised accordingly. Utilizing different stress periods leads to a further breakdown of correlations among NMRF risk classes, compounding the already excessive conservatism in the aggregation formula.

## **Industry Recommendation:**

As an interim relief measure, we propose allowing banks to use the same stress period for SES as that used for the diversified ES measure.

### **1.5. Changes to RFET**

As noted in the European Commission consultation, the development of RFET data solutions by third-party vendors remains limited, resulting in a significant number of risk factors being classified as NMRFs. While the industry broadly supports the Commission's proposal on RFET, we wish to emphasize that implementing and operationalising RFET remains extremely challenging and costly, creating a barrier to the adoption of IMA. Below, we highlight some of the key outstanding issues within the RFET framework and propose amendments to regulatory requirements that do not offer any compliance benefit.

#### **1.5.1. Requirement to audit third-party data providers**

The Basel text in MAR31.12(3)<sup>31</sup> allows institutions to source prices and committed quotes from third-party vendors, trading platforms, or exchanges. When a bank uses real prices from a third-party data provider, the data provider must undergo an audit to validate its pricing information and satisfy the criteria in MAR31.14. Essentially, the Basel text distinguishes among the price information from third-party vendors, trading platforms, or exchanges.

However, Article 2, sub-paragraph 5 of the EBA RTS on Criteria for Assessing Risk Factor Modellability – mandated under CRR Article 325be(3)<sup>32</sup> – introduces a divergence by classifying exchanges, trading platforms, and data reporting service providers (DSRPs) as third-party vendors. Entities such as market exchanges, trade repositories, multilateral trading facilities, and DSRPs play a crucial role in ensuring market transparency and integrity within the EU and are already regulated by the European Securities and Markets Authority (ESMA).

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<sup>31</sup> Basel Committee on Banking Supervision. *Minimum Capital Requirements for Market Risk*. Bank for International Settlements, January 2019. <https://www.bis.org/bcbs/publ/d457.pdf>

<sup>32</sup> European Banking Authority. *Final Draft Regulatory Technical Standards on Criteria for Assessing the Modellability of Risk Factors under the Internal Model Approach (IMA) under Article 325be(3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR2)*. 27 March 2020. [https://www.eba.europa.eu/sites/default/files/document\\_library/EBA-RTS-2020-03%20Final%20draft%20RTS%20on%20Risk%20factor%20modellability.pdf](https://www.eba.europa.eu/sites/default/files/document_library/EBA-RTS-2020-03%20Final%20draft%20RTS%20on%20Risk%20factor%20modellability.pdf)

Moreover, the rules require third-party vendors – including exchanges and trading platforms – to be contractually obligated to provide verifiable price data and to undergo an independent third-party audit at least annually. Banks must also have access to these audit results and reports. As a result, if a bank independently sources data from such regulated platforms – for example, price information on listed equities or precious metals from recognised exchanges – it must still demonstrate compliance with the audit requirements and obtain access to audit reports. This requirement appears counterintuitive, given that these exchanges and platforms are already under regulatory supervision and are not contractually obligated to verify price data or perform audits for RFET compliance.

There is no principled reason to introduce a divergence from the Basel text in the EU by requiring an audit for verifiable prices sourced from venues like exchanges, trading platforms, or trade repositories – entities that are already subject to extensive regulatory oversight and supervision. Without access to the audit reports, banks may be prohibited from using data from these venues, resulting in a larger proportion of risk factors being classified as NMRFs than would have been originally anticipated during the Basel calibration.

### **Industry Recommendation:**

The EBA RTS requirements for third-party vendor audits should not be imposed when prices are sourced from the regulated sources such as exchanges, authorized data providers and multilateral trading systems. These sources are already subject to strict regulations for their processes, systems, and controls, and they are not contractually obligated to perform audits or provide access to audit reports for RFET purposes.

#### **1.5.2. Non-negligible volume and bid-offer spread for verifiable price observations**

Article 2 of the EBA RTS<sup>33</sup> also requires that verifiable price observations must come from transactions or quotations of a non-negligible volume compared to usual volume reflective of current market conditions. Additionally, it requires that the bid-offer spread of a quotation should not substantially deviate from the bid-offer spreads that reflect current market conditions.

The industry interprets the rule text to mean that real verifiable price observations must be based on transactions of non-negligible volume under current market conditions. When price observations for listed instruments (e.g., equity spot prices and precious metal prices) are sourced from regulated exchanges, they inherently reflect usual volumes in current market conditions. Trading activity for a given instrument, such as spot equity or listed options or futures, is typically concentrated in a single venue, thus representing the prevailing market conditions. This concentration is driven by the preference among market participants to trade on the venue that provides the deepest liquidity pool and the best execution price (e.g., under MiFID Best Execution<sup>34</sup>). The volume or transaction size of individual exchange transactions, such as spot equity or listed options or futures, is typically not significant given the instant matching of bids and offers during continuous trading sessions and the practice of splitting larger transactions into smaller tickets to minimize the impact on market prices. To quantify market liquidity, average daily volumes (ADVs) are frequently used, such as in the context of MiFID Best Execution requirements, to understand potential market impact for a given transaction size. As a result, checks against negligible volumes on real verifiable price observations are irrelevant for exchange trading. This proposal ensures that no exchange prices need to be excluded due to

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<sup>33</sup> European Banking Authority. *Final Draft Regulatory Technical Standards on Criteria for Assessing the Modellability of Risk Factors under the Internal Model Approach (IMA) under Article 325be(3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR2)*. 27 March 2020.

[https://www.eba.europa.eu/sites/default/files/document\\_library/EBA-RTS-2020-03%20Final%20draft%20RTS%20on%20Risk%20factor%20modellability.pdf](https://www.eba.europa.eu/sites/default/files/document_library/EBA-RTS-2020-03%20Final%20draft%20RTS%20on%20Risk%20factor%20modellability.pdf)

<sup>34</sup> European Securities and Markets Authority (ESMA), *Article 27: Obligation to execute orders on terms most favourable to the client*, available at: <https://www.esma.europa.eu/publications-and-data/interactive-single-rulebook/mifid-ii/article-27-obligation-execute-orders>

negligible volumes, aligning with existing practices across Risk and Finance, including time series for ES modelling or independent price verification (IPV).

Similarly, when bid-offer quotations are simultaneously sourced from an exchange's active order book for listed instruments (e.g., equity options), they inherently reflect the current market conditions on the observation date. The industry understands that the EBA RTS requirement to assess or monitor the bid-offer spread was introduced to prevent significant deviations in quotes from different counterparties (e.g., instances where the bid exceeds the offer) or the use of uncompetitive quotations. However, given that exchanges facilitate most of the trading in listed instruments, the order book naturally provides the most competitive quotations in current market conditions. According to exchange rules, any crossed quotations (i.e., instances where bids and offers match) are executed instantly. Furthermore, exchanges and their members are subject to stringent regulations to ensure high-quality quotations and prevent market abuse, such as quoting without the intent to trade (e.g., spoofing). As a result, when bid and offer quotations for listed instruments are sourced from exchanges' order books, additional analysis on spreads is unnecessary and should not be required.

The industry acknowledges that checks on volume and bid-offer spreads are relevant for over-the-counter transactions and quotations, including observations from trade repositories. However, these requirements for exchange-based prices and quotes are operationally burdensome and do not contribute to the verification of price observations, thereby increasing the cost of implementing the RFET.

#### **Industry Recommendation:**

- If daily prices, such as spot equity and precious metals, are sourced from regulated exchanges, they should be considered as verifiable prices that reflect market conditions, thereby meeting the non-negligible volume requirement.
- Additionally, if two-way quotes are sourced from the exchanges for listed instruments, the bid-offer spread should be considered reflective of current market conditions.

### **1.6. Changes to Default Risk Charge**

In accordance with CRR Article 325bl(1)<sup>35</sup>, IMA trading desks are subject to additional or incremental own fund requirements for the default risk of credit and equity exposures using the internal model-based DRC. Articles 325bm(2) and 325az(4) also require capitalisation under FRTB-SA if a bank no longer meets the criteria for using IMA, including the use of the IMA DRC model and if trading desks fail the backtesting and PLAT requirements.

Since the DRC is specifically designed to address the incremental charge for capturing the sudden jump-to-default (JTD) risk of issuers, the industry recommends that:

- a) The internal model-based DRC should be treated independently from the approval to use the IMA (ES and NMRF measurement model) at the trading desk level; and
- b) Banks should have the flexibility to use the regulatory-prescribed SA-DRC instead of being mandated to develop their own internal DRC model for IMA trading desks.

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<sup>35</sup> European Commission. *Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms*, consolidated version as of 9 July 2024, Article 325bl(1) – "Scope of the internal default risk model.", 325bm(2) – "Permission to use an internal default risk model.", 325az(4) – "Alternative internal model approach and permission to use alternative internal models.", and 325ba – "Own funds requirements when using alternative internal models." Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02013R0575-20240709>

The IMA eligibility tests primarily assess performance using risk metrics versus daily P&L, rather than evaluating JTD risk, which is separately captured by a DRC model. As such, penalising the DRC model when a trading desk fails the backtesting and PLAT tests is unjustifiable.

Treating the DRC as a standalone component encourages the development of risk-sensitive DRC models, which are better able to reflect the impact of systemic defaults under stressed conditions. For instance, IMA DRC captures default correlations across issuers and simulates scenarios where multiple issuers default simultaneously, whereas the SA-DRC uses a single default metric (i.e., the risk of individual issuers). Additionally, the internal model-based DRC better recognizes portfolio diversification than the SA-DRC. For example, the hedge benefit ratio (HBR) used in SA-DRC does not accurately reflect diversification at the desk or portfolio level.

However, while developing an internal DRC model has its advantages, certain trading desks and instruments present challenges in modelling due to complex data and valuation requirements. For example, full revaluation may require a significant computation effort, and models may require simplifications to capture the default risk of complex multi-underlying products. This also requires intensive data for correlation modelling.

To address these challenges, banks should be allowed the flexibility to choose between using the regulatory-prescribed SA-DRC or an internally developed the internal model-based DRC to calculate the incremental default risk charge.

This proposal would ensure a level playing field with US banks, where the internal model-based DRC requirement was removed in the US NPR, while still aligning with the Basel framework. Moreover, Article 325az(2) prohibits capital arbitrage, meaning banks cannot choose between the internal model-based DRC and SA-DRC based solely on which would result in a lower capital requirement.

The industry recommends that the proposals outlined above be applied as both a temporary relief measure and as a long-term solution. This would include updates to the formula for own fund requirements under CRR Article 325ba<sup>36</sup> and the EBA RTS on backtesting and PLAT requirements<sup>37</sup>, calculated as the sum of the following components:

1.  $\min (IMA_{non-default} + Capital\ Surcharge + C_{non-default} ; SA_{all\ desks-non-default})$
2.  $\max (0; IMA_{non-default} - SA_{non-default})$
3.  $DRC_{IMA} + DRC_{SA}$

Where:

- $IMA_{non-default}$  is the non-default risk capital requirement for modelled desks;
- $C_{non-default}$  is the non-default risk SA capital requirement for non-modelled desks;
- $Capital\ Surcharge$ <sup>38</sup> is the add-on component based on PLAT results, derived from non-default risk capital;
- $SA_{all\ desks}$  is the non-default risk charge for the global portfolio;

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<sup>36</sup> European Commission. *Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012*. Consolidated version of 9 July 2024, Article 325ba – “Own funds requirements when using alternative internal models.” Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02013R0575-20240709>

<sup>37</sup> European Banking Authority. *Final Draft Regulatory Technical Standards on Backtesting and Profit and Loss Attribution (PLA) Requirements* (EBA/RTS/2020/02). Available at: [https://www.eba.europa.eu/sites/default/files/document\\_library/EBA-RTS-2020-02%20Final%20draft%20RTS%20on%20Backtesting%20and%20PLA%20requirements.pdf](https://www.eba.europa.eu/sites/default/files/document_library/EBA-RTS-2020-02%20Final%20draft%20RTS%20on%20Backtesting%20and%20PLA%20requirements.pdf)

<sup>38</sup> It is worth noting that the capital surcharge component would be irrelevant if the PLAT remains a supervisory monitoring tool.



- $SA_{IMA desks}$  is the non-default risk capital requirement for modelled desks;
- $DRC_{IMA}$  is the incremental default risk charge using the IMA DRC model;
- $DRC_{SA}$  is the incremental default risk charge using the SA-DRC;

### **Industry Recommendation:**

Given that the DRC specifically addresses the incremental charge for capturing the sudden JTD risk of issuers, the industry recommends the following:

- The internal model-based DRC should be treated independently from the approval to use the IMA (ES and NMRF measurement model) at the trading desk level; and
- Banks should have the flexibility to use the regulatory prescribed SA-DRC instead of being mandated to develop an internal DRC model for IMA trading desks.

## **2. Other FRTB-SA Issues**

### **2.1. Alternative Correlation Trading Portfolio**

Correlation trading instruments improve liquidity and price discovery in the corporate debt market, while also providing cost-effective hedging solutions for default risk. A reduction in access to effective hedging instruments, combined with higher hedging costs, could limit banks' ability to provide funding and risk management services to clients, ultimately slowing investment and economic expansion.

Banks remain concerned about the uncertainty surrounding the rules for the alternative correlation trading portfolio (ACTP), as well as the potential for disproportionate impacts from ACTP products. This is particularly the case if decomposition across credit spread risk (CSR) is not permitted, and the DRC decomposition approach remains unclear.

#### **Credit Spread Risk**

The best practice in bank risk management is to apply look through for ACTP baskets and indices, reflecting the actual underlying risks. We are concerned that CRR Article 325i(1)<sup>39</sup> does not permit such a look through approach (LTA) for ACTP. Implementing a capital treatment that excludes this approach would be inconsistent with the true risk, forcing banks to manage both the economic risk and the capital footprint in separate and inconsistent processes, leading to excessive capital requirements divorced from the actual underlying risk. Additionally, in the absence of decomposition, it is unclear where to map the undecomposed CSR sensitivity, as no index buckets exist.

For SBM, the LTA could be achieved by allowing banks to waive the provisions in Article 325i(1)(a)(b) – “*except for a position in an index included in the ACTP [for which they shall calculate a single sensitivity to the index];*” – during the transition period for global FRTB implementation across jurisdictions. This would be consistent with Article 325ak, which does not include any index bucket, as well as with the definition of risk factors in Article 325n(3), which states that “*risk factors shall be all the relevant credit spread rates of the issuers of the underlying exposures of the securitisation position*”, thereby implying a LTA.

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<sup>39</sup> European Commission, *Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on Prudential Requirements for Credit Institutions and Investment Firms*, as amended by Regulation (EU) 2021/558, Article 325i(1) – “Treatment of index instruments and other multi-underlying instruments.”, Article 325ac – “Jump-to-default amounts for the ACTP.” Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02013R0575-20250101>

It is also worth noting that the draft US NPR<sup>40</sup> already permits the decomposition of multi-underlying instruments under the ACTP CSR. This relief would ensure a level playing field even before a more comprehensive revision of the ACTP capitalisation rules can be implemented under EU law.

### Default Risk Charge

The rules for ACTP DRC remain unclear. While Article 325ac allows for decomposition using a valuation model in the context of DRC, it is unclear how this should be applied. To ensure transparency and consistency, we request confirmation that the DRC for all multi-underlying instruments can be calculated as follows:

- a. Decomposition into single-name JTDs, assuming that only the single-name defaults, without rescaling the single-name JTDs, so that the sum aligns with the JTD of the undecomposed multi-underlying instrument
- b. Decomposition into single-name JTD using the non-securitization supervisory LGD
- c. Netting against all other exposures in the same underlying name, including single-name CDSs and decomposed single-name exposures of untranching indices
- d. Bucketing of single name exposures should follow the non-securitisation approach as per article 325y(3)
- e. Assigning non-securitization risk weights to the netted single-name JTDs

The following example utilizes a 1<sup>st</sup>-to-default basket with notional €10MM hedged with a CDS on Name 1 with notional €5MM and illustrates why recommendations a) and b) are crucial to ensure a risk-sensitive capitalization of the ACTP:

	1 <sup>st</sup> to default basket				CDS Hedge	1 <sup>st</sup> to default basket partially hedged		
Names	Undecomposed JTD	Scaled Marginal JTD	Marginal JTD (100% LGD)	Marginal JTD (75% LGD)	JTD (75% LGD)	Net JTD Scaled	Net JTD (100% LGD)	Net JTD (75% LGD)
<b>Name 1</b>		€3.33MM	€10MM	€7.5MM	-€3.75MM	-€0.42MM	€6.25MM	€3.75MM
<b>Name 2</b>	€10MM	€3.33MM	€10MM	€7.5MM		€3.33MM	€10MM	€7.5MM
<b>Name 3</b>		€3.33MM	€10MM	€7.5MM		€3.33MM	€10MM	€7.5MM
<b>Sum</b>	<b>€10MM</b>	<b>€10MM</b>	<b>€30MM</b>	<b>€22.5MM</b>	<b>- €3.75MM</b>	<b>€6.24MM</b>	<b>€26.25MM</b>	<b>€18.75MM</b>

In the table above, the first red column represents a scenario where each of the marginal single-name JTDs would be scaled proportionally so that the total sum of the decomposed JTD equals the undecomposed JTD of €10MM. The second red column reflects the netting with the single-name CDS in relation to the first name. The first amber column relates to the scenario where the unscaled marginal JTDs are calculated with a 100% LGD. The second amber column reflects the netted JTD with the single name CDS where the latter is based on an LGD of 75% for senior unsecured whereas the decomposed marginal single-name JTDs would be based on

<sup>40</sup> Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation. *Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity*. Federal Register 88, no. 179 (September 18, 2023). <https://www.federalregister.gov/documents/2023/09/18/2023-19200/regulatory-capital-rule-large-banking-organizations-and-banking-organizations-with-significant#h-192>

a 100% LGD. The green columns are consistent with the amber columns with the exception that both the decomposed JTDs as well as the JTD of the single name CDS are consistently based on an LGD of 75%.

Regarding point a), scaling the JTDs would result in a significantly lower exposure (€3.33MM each in the “Scaled marginal JTD” column) compared to the actual exposure when each name defaults separately, which, without considering any recovery rate, is €10MM per name. The scaling method is arbitrary and inconsistent with the way single-name risk is managed.

Regarding point b), applying a consistent recovery assumption across both single-name and decomposed single-name exposures from multi-underlying instruments ensures an accurate net JTD representation. As per the example above, Name 1’s JTD should be €3.75MM (as shown in the last green column), rather than €6.25MM as in the second amber column, which exceeds the total remaining exposure of €5MM after applying the single-name hedge. The green column is reflective of the industry recommendations mentioned under a) and b) above as it ensures accurate and consistent single-name gross and net JTD exposures.

Recommendation d) is necessary as netting per c) would remove any attachment to a particular tranche. Any single name exposure for a given name would be indistinguishable from other single name exposures and therefore the bucketing applicable to single name exposures needs to be applied.

Similarly, recommendation e) is crucial because, after netting on a single-name basis, it becomes impossible to assign securitization risk weights as no net single-name exposure can be traced to a specific instrument.

It is worth mentioning that the industry has raised the need for the decomposition of multi-underlying instruments under the DRC, particularly in discussions with the US Agencies during the Basel III Endgame consultation process.

### **Industry Recommendation:**

We urge the European legislators to implement the targeted revisions outlined above to the capital treatment of correlation products, aligning it more closely with standard risk management practices. Without these changes, the current capital treatment could make it economically unfeasible for banks to engage in activities that support efficiency and liquidity in the corporate debt market. In this regard, it is crucial to make the targeted revisions related to CSR permanent and to clarify the rules for DRC to ensure transparency and consistency.

#### **2.2. Collective Investment Undertaking (CIU) – Enhanced Mandate Based Approach**

We must highlight that no improvements have been made as part of the European Commission consultation to the mandate-based approach (MBA) as a viable alternative when the look through approach (LTA) is impractical<sup>41</sup>. The proposed calibration remains extremely conservative and fails to consider that funds typically contain thousands of individual holdings diversified across geographies, asset classes, sectors or other attributes. Representing a diversified fund as a concentrated portfolio based on the lowest-quality constituents allowed by the mandate will materially misrepresent the fund’s risk profile.

The idea behind the MBA is fundamentally sound. Given the broad nature of most fund mandates, determining an appropriate risk weight becomes impractical. Consequently, banks are unlikely to adopt the MBA in its current form as it tends to systematically overestimate risk due to the following factors:

- Mandates are generally broad in prospectuses to allow flexibility for asset managers, making it impractical to seek investor approval for every new investment that might fall outside the mandate.

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<sup>41</sup> This comment does not include the Swiss Financial Market Supervisory Authority case where the 50% risk weight has been introduced in cases where LTA is possible but not practicable.

- Regulations assume the worst-case (i.e., most risky) composition, meaning the fund must allocate positions to the maximum extent permitted by its mandate in exposures with the highest capital requirements, and then continue in descending order until the maximum loss limit is reached.
- The combination of these two factors creates ambiguity regarding the assumption banks need to make when calculating the risk weight. For example, banks would be required to assume the worst possible duration for securities in a particular sector, even if this does not align with the actual investment profile of the fund.
- The fund's primary strategy is described in the prospectus; given this, the MBA should be adjusted in a more economical and pragmatic way by considering this typical portfolio (rather than a worst-case scenario), as per the LTA.

Furthermore, the magnitude of the issues surrounding fund capitalization may not be fully recognized by supervisors and regulators. There is a clear disconnect between the theoretical expectations for CIU capitalization and the practical outcomes observed. This is evident from adjustments made to submitted data from 19 banks, which resulted in a capital reduction of 80% for CIUs, as noted in the EBA Basel III monitoring report<sup>42</sup>. A similar adjustment practice has been reported in the BIS Basel Monitoring Exercise<sup>43</sup>, though the number of banks involved was not disclosed.

A more improved and transparent approach would involve prescribing a limited number of fund buckets specifically for CIUs, along with corresponding risk weights<sup>44</sup>. The enhanced MBA remains a central industry proposal that aims at fixing the issue of CIUs permanently.

An additional delay will certainly provide us with valuable time to effectively develop a fair and economically sound approach that will help us maintain the level playing field. However, if the postponement is not granted, a proposal for a less conservative fall-back approach would be greatly appreciated.

### **Industry Recommendation:**

As a long-term measure, enhance and simplify the mandate-based approach such that it becomes a viable alternative to capitalize CIUs.

Additionally, the MBA should be aligned with the LTA concept, which corresponds to the typical portfolio strategy of the fund. The MBA can be further enhanced with new CIU buckets<sup>45</sup> which removes the practical difficulties of using fund mandates to derive risk weights by implementing an enhanced and transparent approach that prescribes a limited number of fund buckets specifically for CIUs, each with corresponding risk weights. This proposal would serve as a credible alternative to the LTA, offering a more capital intensive but less operationally demanding option. By specifying the risk weights and the criteria for allocating CIUs to appropriate buckets, the rules would be more practical to implement, while still allowing regulators to maintain control over risk weight calibration.

### **2.3. Collective Investment Undertaking (CIU) – Risk Weights under the Fall-Back Approach**

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<sup>42</sup> European Banking Authority, *Basel III Monitoring Exercise Results Based on Data as of 31 December 2023*. October 2024. <https://www.eba.europa.eu/sites/default/files/2024-10/eee3e459-52f3-4fe5-a911-18f9adf1d6cb/Basel%20III%20monitoring%20Report.pdf>

<sup>43</sup> Basel Committee on Banking Supervision, *Basel III Monitoring Report*. March 2025. <https://www.bis.org/bcbs/publ/d592.pdf>

<sup>44</sup> ISDA and SIFMA, *Basel III Endgame Addendum Comment Letter* (April 2024), <https://www.isda.org/a/q8wgE/ISDA-SIFMA-Basel-III-Endgame-Comment-Letter-Addendum.pdf>

<sup>45</sup> ISDA and SIFMA, *Basel III Endgame Addendum Comment Letter*. April 2024. [www.isda.org/a/q8wgE/ISDA-SIFMA-Basel-III-Endgame-Comment-Letter-Addendum.pdf](https://www.isda.org/a/q8wgE/ISDA-SIFMA-Basel-III-Endgame-Comment-Letter-Addendum.pdf)

To provide immediate relief within the delegated act, the industry proposes reducing the risk weight applied to diversified funds, thereby avoiding the overly conservative 70% risk weight currently applied.

Notably, CRR Article 350 already includes an MBA for CIUs. However, while the MBA remains impractical, defaulting to worst-case assumptions results in a less conservative treatment than under FRTB.

For instance:

- If a CIU is assumed to be invested in equities, the risk weight would be 8% for General Market Risk and 8% for Specific Risk, totalling 16% (as per Articles 342 and 343).
- If a CIU is assumed to be invested in credit positions, the risk weight would be 12.5% for General Interest Rate Risk and 12% for Debt Specific Risk, totalling 24.5% (as per Articles 339 and 336).

Both scenarios result in significantly lower risk weights compared to the 70% risk weight under FRTB, highlighting the excessive conservatism of the FRTB framework. Additionally, while the standardised specific risk is typically notional-based, the FRTB framework requires the calculation of sensitivity measures (e.g., interest rate- and credit spread-01 measures). This significantly increases complexity, as it necessitates the use of an internally approved valuation model and the booking of hypothetical positions in valuation systems.

Table 8 in Article 325ap<sup>46</sup> could be amended to distinguish between different risk weights within Bucket 11 (“Other sector”) by introducing:

- A 70% risk weight for single equity names
- A [25% - 35%] risk weight for funds

The 25% risk weight for funds is justified by the high level of diversification typically observed in mutual funds, particularly in Undertaking for Collective Investment in Transferable Securities (UCITS), which contrasts with the concentrated risk exposure of single equities. This recommendation remains conservative, as it is still higher than the 15% risk weight for most equity indices, in line with the 25% risk weight for certain emerging market and small-cap indices as defined in Article 325ap, higher than and the 10-20% risk weight for bond funds (e.g., HYG and LQD)<sup>47</sup> which can be derived by calculating a ratio of non-equity delta derived via look-through to EQ delta (fund’s market value). Additionally, this adjustment would align with the upper range of the FRTB risk weight with the current CRR’s range of 16% to 24.5% as outlined above.

Alternatively, another but more conservative calibration approach would be roughly halving the 70% risk weight to 35%. Given the high level of caution previously expressed by European regulators on this matter, defaulting to such a conservative risk weight would be acceptable as a temporary relief measure.

Implementing this temporary relief measure would help prevent an unnecessary spike in capital requirements until a more risk-aligned mandate-based approach becomes available.

### **Industry Recommendation:**

In Table 8 of Article 325ap, which can be amended by the delegated act since it is “pursuant to the delegated act referred to in Article 461a”, Bucket 11 should distinguish between the risk weights for single name equities and CIUs by applying a scalar of 0.5 to equity Bucket 11 risk weight for CIUs as follows:

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<sup>46</sup> European Commission, *Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on Prudential Requirements for Credit Institutions and Investment Firms*, as amended by Regulation (EU) 2021/558, Article 325ap – “Risk weights for equity risk.” Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02013R0575-20250101>

<sup>47</sup> ISDA and SIFMA, *Basel III Endgame Addendum Comment Letter*. April 2024. [www.isda.org/a/q8wgE/ISDA-SIFMA-Basel-III-Endgame-Comment-Letter-Addendum.pdf](http://www.isda.org/a/q8wgE/ISDA-SIFMA-Basel-III-Endgame-Comment-Letter-Addendum.pdf)

	Bucket number	Market capitalisation	Economy	Sector	Risk weight for equity spot price	Risk weight for equity repo rate
<b>Current</b>	11	Other sector			70%	0.70%
<b>Proposed</b>	11 <sup>48</sup>	Other sector – Single Equities			70%	0.70 %
		Other sector – CIUs			35%	0.35 %

#### 2.4. Collective Investment Undertaking (CIU) – Treat qualifying CIUs equivalently to existing Index buckets

To recognise the diversity in risk profiles and the transparency of holdings data within the CIU market, an allowance is proposed for those CIUs that align with index risk and transparency characteristics to be treated consistently with indices. This could be achieved by introducing new criteria for CIUs that would be equivalent to the existing index criteria, such as Article 325i(2) and (3) in the EU CRR, adjusted to reflect the specific properties and characteristics of CIUs.

For CIUs, it is recommended that criteria are prescribed that if met would result in own funds requirements calculated in a manner equivalent to that of index instruments under FRTB. This would not only align CIU capital more closely with how banks manage risk and report official P&L, but also significantly reduce the computational effort and data sourcing required to apply a full LTA, allowing banks to compute a single sensitivity for a position in a CIU when calculating delta and curvature risks. Furthermore, if at least 75% of the CIU constituents fall within a single bucket, the total CIU exposure could be treated as a single-name sensitivity.

##### Industry Recommendation:

Allow CIUs that meet all of the below diversification criteria to be treated equivalently to existing Index buckets, utilising the allowance of Articles 325i(1-2). We believe that this industry recommendation should be made on a permanent basis.

New diversification criteria:

- The banking organization can look through all constituents of the fund, with their respective weightings known.
- There must be a minimum number of constituents.
- There should be percentage limits on the concentration of fund holdings relative to a single constituent or a minimum number of constituents as a percentage of the whole fund.
- There must be a minimum size for the fund.

Alternatively, the same index diversification criteria used in Article 325i(3) could be adopted.

#### 2.5. Collective Investment Undertaking (CIU) – Remove the standalone aggregation for the Fall-Back Approach

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<sup>48</sup> We would note that in CRR Article 325ah, the use of two risk weights within a single bucket is already implemented for CSR Bucket 10, where covered bonds are assigned risk weights of either 1.5% or 2.5%.

Under the FBA, the risk associated with a CIU is allocated to the “Other” bucket, which incurs the most conservative risk weight of 70%. Risk factor aggregation is performed by summing the absolute weighted sensitivities for each risk factor to derive the “Other” bucket exposure which is then aggregated with zero inter-bucket correlation. This approach is overly conservative, as it fails to recognise any diversification among the constituents of the fund, which is unlikely for many funds.

The EU adds an extra layer of conservativeness in CRR3 Article 325j(1a)(b) when aggregating the risks of the portfolio and FBA CIUs. This additional conservatism stems from a standalone aggregation treatment that simply adds the FBA capital requirement of each CIU to the portfolio’s own funds requirement, thereby decoupling the CIUs under FBA from the rest of the risk class-specific own funds requirement for delta/vega:

**EU CRR3:**

$$\sqrt{\sum_b K_b^2 + \sum_b \sum_{c \neq b} \gamma_{bc} S_b S_c} + \sum_J K_J$$

Where

$K_b$  = bucket-specific sensitivity for buckets 1-13 (bucket 11 does not contain any CIUs under FBA); and

$K_j$  = CIU risk-weighted sensitivity for CIUs under the FBA.

**Other jurisdictions & BCBS:**

$$\sqrt{\sum_b K_b^2 + \sum_b \sum_{c \neq b} \gamma_{bc} S_b S_c}$$

Where

$K_b$  = bucket-specific sensitivity for buckets 1-13; CIUs under FBA are included under bucket 11 along with everything else in bucket 11.

**Industry Recommendation:**

The additional layer of conservatism in the EU FBA could lead to a significant increase in the required capital. The existing conservative approach of applying a large risk weight and zero correlation for the “Other” bucket should be sufficient to ensure safety and soundness, without the need for separate aggregation. Furthermore, standalone aggregation is not mandated in the Basel rules. Therefore, we recommend removing the standalone aggregation requirement on a permanent basis, as per the below amended CRR text.

Article 325j (1a)(b)

*For the purposes of the approaches referred to in paragraph 1, point (b) the institution shall:*

...

*(b) for all positions in the same CIU, use the same approach among the approaches set out in paragraph 1, point (b), to calculate the own funds requirements. ~~on a stand-alone basis as a separate portfolio;~~ Additionally, for positions utilising the approach set out in paragraph 1, point (b)(ii), to calculate the own funds requirements on a standalone basis as a separate portfolio.*

## 2.6. Collective Investment Undertaking (CIU) – Trading book classification of funds under the Fall-Back Approach

It is a requirement for banks to have knowledge of the content of a CIU's mandate to apply the trading book treatment when using the look through approach (LTA), mandate-based approach (MBA) and the fall-back approach (FBA). Whilst this obligation is sensible for the LTA and MBA, it is disproportionate for the FBA, which is already calibrated conservatively and utilised by banks that cannot deploy the LTA or the MBA.

Fund mandates are often purposefully broad to provide flexibility to fund managers. While the mandate essentially defines broad parameters such as the fund's overall strategy, objectives, and constraints, in practice a fund might never hold certain eligible investments covered by its mandate.

Adding this operational burden for CIU positions that may only be held for a short period or may not be held at all, incurs unnecessary costs without providing prudential benefits. This requirement contradicts the spirit of the trading book, where turnover of CIU positions may be high.

Accordingly, CIU positions when subject to the fall back approach should be allowed to remain in the trading book as long as firms have daily pricing based on observable market data, such as price volatility, liquidity, and trading volumes and the ability to trade or hedge those positions as per their trading intent, rather than being forced into the banking book due to unnecessary operational demands.

### Industry Recommendation:

Permanently remove the requirement for banks to have knowledge of the content of a CIU's mandate when classifying funds into the trading book which are subject to the fall-back approach. The requirements for applying the look through approach and mandate-based approach would mandate the bank to determine the composition or mandate of the fund, as applicable. Whereas the fall-back approach already prescribes punitive SBM and DRC capital requirements treating the whole CIU as a single name equity exposure with no diversification benefit, therefore should not be subject to additional residual risk add on requirements.

The CRR text should be amended to include the following derogation:

*By way of derogation from Article 104(8)(b), an institution may assign to the trading book a position in a CIU, that is held with trading intent, where the institution is able to obtain daily price quotes for the CIU and calculates the own funds requirements for market risk using the approach specified in Article 325j(1)(b)(i) and Article 325j(1a).*

Article 325j(1a) should be modified as follows:

*For the purposes of the approaches referred to in paragraph 1, point (b), of this Article the institution shall:*

*(a) apply the own funds requirements for default risk set out in Section 5 and the residual risk add-on set out in Section 4 to a position in a CIU, where the mandate of that CIU allows it to invest in exposures that shall be subject to those own funds requirements. ~~when using the approach referred to in paragraph 1, point (b)(i), of this Article the institution shall consider the position in the CIU as a single unrated equity position allocated to the bucket 'unrated' in Article 325y(1), Table 2; and~~*

*(aa) when using the approach referred to in paragraph 1, point (b)(i), of this Article, the institution shall apply the own funds requirements for default risk set out in Section 5 and consider the position in the CIU as a single unrated equity position allocated to the bucket 'unrated' in Article 325y(1), Table 2; and*

Article 325j (5) should be modified as follows:



An institution may use the approaches referred to in paragraph 1(a) and 1(b)(ii) only where the CIU meets all of the conditions set out in Article 132(3). For the purpose of these approaches, where the CIU does not meet all of the conditions set out in Article 132(3), the institution shall assign its positions in that CIU to the non-trading book.

## 2.7. Collective Investment Undertaking (CIU) – Trading Book / Banking Book Boundary Criteria

Funds may include a small percentage of alternative assets, such as real estate, which are not eligible for inclusion in the trading book. Under the CRR rules, if a fund contains banking book positions, the entire fund is classified under the banking book.

We believe that banks should be allowed to include certain de minimis compulsory banking book instruments in the trading book, provided they are managed as part of an integrated trading strategy alongside similar instruments already in the trading book.

### Industry Recommendation:

We recommend introducing a materiality threshold that will allow CIUs to remain in the trading book if they hold only an immaterial amount of banking book holdings. In the EU, the materiality threshold for UCITS<sup>49</sup> limits investments in a single entity to 10% of NAV. Applying a similar 10% threshold for CIUs would not only account for immaterial banking book holdings in CIUs but also mitigate RWA volatility that can arise from the movement of CIUs or corresponding hedges between the trading and banking books due to exogenous changes in the characteristics of CIU constituents, such as corporate actions in the case of listed equities.

Additionally, the CRR currently restricts the use of the LTA or MBA for third-country overseas funds, leading to a 1,250% risk weight due to reclassification to the banking book. These restrictions should be removed, as they are not included in comparable jurisdictional frameworks (e.g., UK PS 17/23<sup>50</sup>). Maintaining these restrictions would limit the ability of EU banks to invest in third-country funds.

We believe that this Industry recommendation should be made on a permanent basis.

## 2.8. Treatment of REITs / REIFs

Real estate investment trusts (REITs) or real estate investment funds (REIFs) are designed to be liquid and give exposure to real estate without direct ownership of the real estate, therefore they should not be viewed or treated in the same way as a direct real estate holding. If REITs / REIFs are not allowed to be assigned to the trading book, it would result in a material loss of liquidity in real estate markets.

Whilst the current regulations do not specifically mention real estate investment trusts or real estate funds, the general exclusion of “real estate holdings-related instruments” in Article 104(3)(b) would inadvertently capture such exposures and force them into the non-trading book. It should be noted that this has been addressed across other jurisdictions, where amendments have been made to specifically address this issue, thus increasing level playing field concerns within the industry.

### Industry Recommendation:

We recommend permanently amending the below regulatory text as follows:

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<sup>49</sup> European Parliament and the Council of the European Union, *Regulation 49 (1) (a) of the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations (2003)*, <https://service.betterregulation.com/document/93183>

<sup>50</sup> Bank of England. *Policy Statement PS9/24 – Implementation of the Basel 3.1 Standards: Appendix 2*. Prudential Regulation Authority, September 2024. <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2024/september/ps924app2.pdf>

## Article 104(3)

*Institutions shall not assign positions in the following instruments to the trading book:*

- a) *Instruments designated for securitisation warehousing*
- b) *Real estate holdings-related instruments other than holdings in real estate investment trusts or real estate funds*
- ...
- f) *Derivative contracts and CIUs with one or more of the underlying instruments referred to in points (a) to (d) of this paragraph, excluding CIUs that are real estate investment trusts (REITs) or real estate funds*

### **2.9. Treatment of dividend derivatives under the RRAO framework**

The RRAO is designed to offer a simple and conservative capital treatment for any risks that are **not covered by the SBM/DRC**. The industry would like to raise a concern regarding the treatment of dividend derivatives under the RRAO. CRR Article 325u(5) mandates the EBA to draft Regulatory Technical Standards (RTS)<sup>51</sup> to clarify the scope of exotic underlyings. Specifically, the EBA is tasked with examining whether longevity risk, weather, natural disasters, and future realised volatility should be considered as exotic underlyings<sup>52</sup>.

However, neither the CRR nor the RTS on the RRAO explicitly includes dividend underlyings within the scope of exotic underlyings. Additionally, Article 3(e) of the RTS states that “dividend risk arising from a derivative instrument whose underlying does not consist solely of dividend payments” should not result in the instrument being classified as bearing other residual risks under CRR Article 325u(2)(b).

As a result, the list of exotic underlyings in CRR Article 325u(5) and the guidance in the RTS suggest that it is not included in the list of exotic underlyings, consistent with the Basel framework.

In the preamble to the US NPR, the US Agencies confirm that dividend risk should not be subject to RRAO, as material risks are adequately captured under other aspects of the proposed market risk framework (see point H(7) – c(ii) excluded positions by Federal register)<sup>53</sup>.

Furthermore, CRR Article 325v(2) stipulates that “own funds requirements for the default risk shall apply to debt and equity instruments, to derivative instruments having those instruments as underlyings and to derivatives, the pay-offs or fair values of which are affected by the default of an obligor other than the counterparty to the derivative instrument itself”. This implies that derivatives with dividend underlyings should fall under the scope of own funds requirements for DRC.

Since dividend underlyings will be captured in the DRC, they cannot, by definition, be classified as “exotic underlyings” under CRR Article 325u(2a), which defines exotic underlying instruments as “trading book instruments referencing an underlying exposure that is not in the scope of the delta, vega or curvature risk

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<sup>51</sup> European Banking Authority. *Final Report on Draft RTS on RRAO*. October 2021. [https://www.eba.europa.eu/sites/default/files/document\\_library/Publications/Draft%20Technical%20Standards/2021/RTS%20on%20residual%20risk%20add-on/1022462/Final%20Report%20on%20draft%20RTS%20on%20RRAO.pdf](https://www.eba.europa.eu/sites/default/files/document_library/Publications/Draft%20Technical%20Standards/2021/RTS%20on%20residual%20risk%20add-on/1022462/Final%20Report%20on%20draft%20RTS%20on%20RRAO.pdf).

<sup>52</sup> Article 1 of Commission Delegated Regulation (CDR) 2022/2328 on the RRAO confirms this scope.

<sup>53</sup> Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation. *Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity*. Federal Register 88, no. 179 (September 18, 2023). <https://www.federalregister.gov/documents/2023/09/18/2023-19200/regulatory-capital-rule-large-banking-organizations-and-banking-organizations-with-significant#h-192>

treatments under the SBM laid down in Section 2 or the own funds requirements for the default risk set out in Section 5”.

Additionally, we note that pricing models for dividend derivatives contribute to both SBM (Equity/Rates) and DRC charges. It is possible to model instruments with dividend underlyings in such a way that they generate equity sensitivities, which are captured in delta/vega/curvature and DRC calculations, further reinforcing the point that they do not meet the criteria outlined in CRR Article 325u(2a). Thus, dividend risk and other market risks from dividend derivatives are treated similarly to any other equity instrument (e.g., futures, forwards, vanilla options). More importantly, dividend risk is managed (i.e., hedged) across all instruments and should not be capitalized on a gross basis. It is also worth noting that some dividend derivatives are currently traded on exchanges, enhancing liquidity and pricing transparency.

#### **Industry Recommendation:**

To maintain a level playing field, we propose that dividend derivatives be explicitly, and permanently, exempted, aligning with the treatment in the United States, where NPR does not subject instruments with dividend risk to the RRAO.

If such an exemption is not feasible, we propose that dividend derivatives should be included in the list of instruments eligible for Targeted Relief Measures under Option 3, with a multiplier of 0 in the RRAO.

#### **2.10. Extending exemptions from RRAO charge for options on indices**

The industry has expressed concerns regarding RRAO charges on options with index underlyings. Article 325i(3) raises conditions under which options will be exempt from the RRAO charge, provided all conditions are met. While most of these conditions seem reasonable, the requirement that 10% of the index constituents must be below 60% of the total market capitalisation can lead to undesirable consequences. Additionally, this condition diverges from other jurisdictions, increasing level playing field concerns.

As an example, in February 2025, the S&P 500 index breached the 60% threshold, causing OTC options (including plain vanilla options) on the index to be subject to a RRAO charge (0.1% of the gross notional amount). It is worth noting that this was the only criterion that was not met, highlighting an unintended consequence of the regulation. The result is a disproportionate impact on very liquid instruments tied to the most liquid and widely recognised index in the world.

#### **Industry Recommendation:**

The industry recommends that the RRAO exemptions be further aligned with other jurisdictions, such as the US and UK. This could be achieved by exempting from the RRAO charge positions that exhibit correlation risk arising from instruments referencing indices. We believe that this Industry recommendation should be made on a permanent basis.

#### **2.11. Clarification on perfectly offsetting trades subject to the RRAO**

The industry seeks more clarity on the identification of perfectly offsetting positions. Article 325u(4)(c)<sup>54</sup> allows RRAO exemption for instruments that perfectly offset the market risk. It is understood that a position can comprise of more than one trade. In this context, these positions would have the same economic parameters which generate market risks but could differ in their notionals.

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<sup>54</sup> European Commission. *Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms*, consolidated version as of 9 July 2024, Article 325u(4)(c) – "Own funds requirements for residual risks." Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02013R0575-20240709>

As per the rule, it is understood that offsetting instruments/positions must eliminate intrinsic market risks of the payoff. Other risks may originate at transaction level, for example from differences in discounting due to different counterparty collateral agreements/counterparty spreads but these should not affect the RRAO exemption.

In practice, banks will offer different prices to different counterparties for the same instrument (same payoff, strikes, barriers, optionality, exotic features, maturity, underlying). The industry believes that this provision should be explicitly clarified as not being restricted to one-to-one trades but allowed for a set of trades/positions sharing the same payoff, including payoff features like strikes, barriers, optionality, exotic features, maturity etc. The risk profile of offsetting positions should be directly proportional to the notional (i.e., a trade with twice the notional size will have double the risk). In many cases, banks will take on a large trade and offset it in the market with trades of smaller size. As long as the offsetting trades are on the same instrument, banks should be allowed to partially offset (based on net notional) for RRAO purposes.

To explain further our request for clarification, we would like to distinguish between the following cases:

- **A Fully perfect offset case** is where we only have two trades where the market risk completely offsets and there is no residual risk left on the books. Both trades share the same payoff, strikes, barriers, optionality, exotic features, maturity, underlying and same notional.
- **A Partial perfect offset case** is where we have a selection of transactions that are sharing the same payoff features, with fully offsetting sources of market risks subject to RRAO, but not notional. They could be further divided into two cases:
  - a. The total notional of the short and long transactions is matched, resulting in zero market risk.
  - b. The total notional is not matched, resulting in some residual market risk. In this case, the portion of the notional that is matched is not different to a) above. While the remaining unmatched notional is subject to RRAO (and delta/vega/curvature/DRC) as per any other position on the book.

### **Industry Recommendation:**

The industry requests clarification on its understanding that Article 325u.4(c) allows the calculation of RRAO on a consolidated basis for positions having the same payoff and associated features which fully offset sources in scope of RRAO ("residual risks"), but not notional.

In the long term, and on a permanent basis, we recommend amending CRR3 Article 325u(4)c to explicitly clarify that the rule does not intend to penalize the current market practice of hedging a position with multiple trades on the same instrument:

#### Article 325u(4)<sup>55</sup>

*By way of derogation from paragraph 1, institutions shall not apply the own funds requirement for residual risks to an instrument that meets any of the following conditions:*

...

*(c) the instrument **or position** perfectly offsets the market risks of another position in the trading book, i.e. they have the exact same payoff features exposed to the same "residual risks", in which case the ~~two~~ perfectly matching trading book positions shall be exempted from the own funds requirement for residual risks. **Where the market***

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<sup>55</sup> European Commission. *Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms*, consolidated version as of 9 July 2024, Article 325u(4) – "Own funds requirements for residual risks." Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02013R0575-20240709>

*risk is perfectly offset on a portion of the trade due to a mismatch in the notional alone, the amount subject to the own funds requirement for residual risks shall be the net notional position of the matching trading book positions*

## **2.12. Clarification on identification and exemption of hedges from RRAO**

The industry supports the principle underpinning Article 325u(4a) and the associated RTS<sup>56</sup> to identify and exclude hedging instruments booked solely to hedge residual risk of trading book positions from the own funds requirements for residual risk. However, the industry believes that the RTS does not recognise the risk reducing effect of these hedges as it only removes the hedging instruments (with severe constraints attached) and not the original instruments from residual risk add-on.

The industry believes that if the residual risk of a set of instruments in the trading book can be unambiguously removed by another set of instruments such that the combined position would not be subject to RRAO, then all the underlying instruments should be exempt from RRAO. Here, the two sets of instruments need not have exactly matching economic parameters (same payoff, strikes, barriers, optionality, exotic features, maturity, or underlying), but the combined payoff could still be replicated by vanilla instruments and hence would not be subject to RRAO.

As an example, a bond with payoff contingent on longevity could be hedged with a longevity swap hedging only the longevity risk, essentially compressing the combined position to a vanilla bond with no residual features. This treatment is consistent with sound risk management practices, where banks would typically hedge the more esoteric residual risks while actively managing market risks. As such, they should not be penalised for hedging.

The industry also recognises that there could be cases where the residual risk is not fully offset but is partially hedged – thus reducing the residual risk. Banks should still be allowed to take the benefit of these hedges by removing them as well as the corresponding portion of the notional of the original position from the RRAO.

In addition, the industry also believes that the criteria and categorisation of the hedging instruments defined in the RTS makes it very cumbersome and impractical to implement in practice. We recommend that the RTS be re-proposed, after taking into consideration the proposed amendments to Article 325u(4a) as below. We also believe that applying a sunset clause by specifying an expiry date to the derogation defeats the purpose of recognising sound risk management practices, and the article should be a permanent derogation rather than a temporary one.

### **Industry Recommendation:**

Amend Article 325u(4a) such that it recognizes the risk reducing effects of hedges to residual risk more effectively. The industry also recommends that the RTS be re-proposed after taking into consideration the amendment proposed below, and that the derogation be made permanent.

#### Article 325u(4a)

~~*By way of derogation from paragraph 1, until 31 December 2032, an institution shall not apply the own funds requirement for residual risks to instruments that aim solely to hedge the market risk of positions in the trading book that generate an own funds requirement for residual risks and are subject to the same type of residual risks as the positions they hedge.*~~

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<sup>56</sup> European Banking Authority. *Final Report on Draft RTS on RRAO*. October 2021.

[https://www.eba.europa.eu/sites/default/files/document\\_library/Publications/Draft%20Technical%20Standards/2021/RTS%20on%20residual%20risk%20add-on/1022462/Final%20Report%20on%20draft%20RTS%20on%20RRAO.pdf](https://www.eba.europa.eu/sites/default/files/document_library/Publications/Draft%20Technical%20Standards/2021/RTS%20on%20residual%20risk%20add-on/1022462/Final%20Report%20on%20draft%20RTS%20on%20RRAO.pdf)

*By way of derogation from paragraph 1, for positions in the trading book whose residual risk is either fully or partially offset by hedging instruments, the own funds requirements for residual risk would be applied subject to the below conditions:*

- (i) When the residual risks of positions in the trading book are completely offset by a set of hedging instruments, institutions shall not apply the own funds requirement for residual risks of these positions as well as the hedging instruments.*
- (ii) If the hedging instruments reduce, but do not completely offset, the residual risks of the original trading book positions, institutions may apply the own funds requirement only to the unhedged portion of the combined notional value of these positions and the hedging instruments.*

*The competent authority shall grant permission to apply the treatment referred to in the first subparagraph if the institution can demonstrate on an ongoing basis to the satisfaction of the competent authority that the instruments comply with the criteria to be treated as **having** hedging positions.*

*The institution shall report to the competent authority the result of the calculation of the own funds requirements for the residual risks for all instruments for which the derogation referred to in the first subparagraph is applied.*

### **2.13. FX & IR Vega risk weight**

IR/FX vega risk weights need to be re-calibrated down to 50-60% (instead of current 100%) in order to better reflect observed market shocks in volatility. A more appropriate solution would be to introduce a term-structure in risk weights of vega, but this seems hard to achieve as part of the DA.

### **2.14. Linear trade curvature scope**

Partial inclusion of linear curvature into capital charge should be allowed (e.g. based on desk and subject to regulatory approval) as otherwise the operational burden on the banks is so high that this desirable feature (that makes capital charge more in line with economic risk) is extremely difficult to use in practice. Failure to adopt this simple adjustment would mean that in practice banks may be capitalizing curvature risk coming from options only, which may lead to misleading and wrong capital numbers (and in some cases not sufficiently conservative)

## **3. Measures concerning standardised and internal model approaches**

### **3.1. Reporting SA and IMA**

We would like to refer to the ITS of Reporting of FRTB SA (EBA/ITS/2024/002), released by EBA following the mandate in 430b CRR II, that have been delayed to 2026 by the Commission's Delegated Act.

These ITS require entities to report the positions by offsetting group (entities within the group for which the authority has granted permission to offset positions) and risk factors (Interest Rate, Equity, Credit, FX, Commodities, Securitizations).

This level of detail is very burdensome, particularly in the case of large banking groups with a large number of subsidiaries, which may have some type of exposure which is not material for the purpose of the group's solvency and at the same time requires an excessive effort which is not offset by the benefit.

#### **Industry Recommendation:**

A materiality threshold should be set in relation to the size of the net position or own funds requirements, so that net exposures or own funds requirements below a certain threshold at the level of the offsetting group would be aggregated linearly in a simpler template. The 5% threshold applying offsetting groups with one legal entity should also be applied to offsetting groups with more than one legal entity.