Single Rulebook Q&A

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Status	Final Q&A
Legal act	Regulation (EU) No 575/2013 (CRR)
Topic	Own funds
Article	36
Paragraph	1
Subparagraph	f, h, i
COM Delegated or Implementing Acts/RTS/ITS/GLs/Recommendations	Regulation (EU) No 241/2014 - RTS for Own Funds requirements for institutions
Article/Paragraph	15a, b, c
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Disclose name of institution / entity	Yes
Name of institution / submitter	Association for Financial Markets in Europe (AFME)
Country of incorporation / residence	United Kingdom
Type of submitter	Industry association
Subject matter	Transactions in the banking book where no strike is available
Question	For a put option in the non-trading book, where there is no guaranteed minimum payment and the price will only be determined after the occurrence of specified events i.e. there is no strike price for the put option, how would the notional amount be calculated in accordance with Article 15(f)(1)(b)(ii) of Regulation (EU) No 241/2014? Should the notional be determined based on an equity delta equivalent amount?
Background on the question	Clarification is sought in relation to Q&A 2017_3292, specifically for put-option-like transactions in the banking book where no strike is available.The type of transaction we enquire about is not structured as a put option in a commercial sense. Nevertheless, the transaction is in the form of a derivative (i.e. an instrument that derives its value from an underlying reference asset) and the best way to describe such a transaction is that it will be a contract that give a right to sell shares at a variable strike price (i.e. not a “put

option” in a commercial sense as there is no fixed strike price, but still a “put option” in legal terms as it provides for a right to sell). Based on the guidance in Q&A 2017_3292 we consider this type of transaction to be a synthetic holding as the underlying is the equity of an insurance company. Therefore our view is that such transactions should be included in the scope of Article 36(1)(h) CRR.As indicated further in the background, the variable strike price means there is no guaranteed minimum payment obligation for the transaction. Given that these transactions should be included in the scope of Article 36(1)(h) CRR, we believe that the notional amount used for the calculation should be based on a measure which reflects the risk of the transaction. Therefore, we wonder if it would be correct to use the notional value which is determined based on an equity delta equivalent amount.The transaction in Q&A 2017_3292 has been reproduced below for reference:“Bank A enters in a contract with Firm B (an insurance company). The contract stipulates that, if any of the three events defined below occurs at any time within the next 3 years, Bank A is committed to buying for €10 million new shares of Firm B (conducting to a capital increase for Firm B).The new shares are generally issued with a discount (e.g. 5%) on the average market price recorded on the trading days following the event. In such a case, Bank A has to provide the cash to Firm B within a predefined timeline (e.g. 10 days).Event 1: Firm B incurs a technical loss above a threshold (e.g. € 1m) for a specific event (e.g. natural catastrophe).Event 2: The loss ratio of a given line of business is higher than 120% for 2 consecutive semesters.Event 3: The share price of Firm B falls below a given value. Bank A is not allowed to sell the financial instrument resulting from this contract to other entities.”Non-trading book and Put option:EBA in its response to Q&A 2017_3292 suggests the following points:•The transaction should be considered similar to a put option sold by the bank; and•The calculation of synthetic holdings for own funds for the case at hand should be completed as per Article 15(f)(1)(b)(ii) of Commission Delegated Regulation 2015/923, which refers to calculation for instrument in the non-trading book.In addition, for put options in the non-trading book, in the Draft RTS 2013-09 on own funds, part 3, pg. 28, the EBA suggested that for put options in the non-trading book, the calculation should be based the strike price of the options.Difference with the transaction given in Q&A 2017_3292There is one key difference from the above transaction, which is as follows:• The transaction does not guarantee a minimum payment obligation. Whilst the transaction is not structured as a put option, if one wanted to draw a parallel, it would have a similar profile as a put option with a variable strike price that is linked to the prevailing share price when exercised.• As a result, at the time that the exercise is triggered, if the share price of Firm B has fallen to zero, the strike price would also be zero, with the result of a payment obligation of Bank A equal to zero i.e. at the time when the commitment is triggered, if the price of Firm B shares falls to zero, then the commitment of Bank A will also be zero (10 million shares times zero).Given the lack of a guaranteed strike price and therefore guaranteed

	minimum payment obligation, there is lack of clarity as to how the notional amount should be calculated.
Final answer	The instrument is a put-option whose underlying asset is the equity in an insurance company. According to the provisions of Article 4(1)(126) CRR a 'synthetic holding' is defined as "an investment by an institution in a financial instrument the value of which is directly linked to the value of the capital instruments issued by a financial sector entity". In addition, Article 15b(1)(a) of Delegated Regulation (EU) No 241/2014 further provides that "derivative instruments that have capital instruments of a financial sector entity as their underlying" shall be considered synthetic holdings. Article 15b(2) of Delegated Regulation (EU) No 241/2014 further clarifies: "The financial products provided for in paragraph 1 shall include the following:... (c) put options sold by the institution on a capital instrument of a financial sector entity or any other actual or contingent contractual obligation of the institution to purchase its own own funds instruments;" In case the derivative described in the question is a put-option in the non-trading book sold by the institution, it is governed by the provisions of Article 15(f)(1)(b)(ii) of Delegated Regulation (EU) No 241/2014, i.e. the amount of the deduction from the institution's own funds is the nominal or notional amount of the derivative. The amount to be deducted in the specific example provided in the Q&A equals to the 'price of the underlying' multiplied by 'the number of shares to be bought in case the optionality is exercised' In case the derivative described in the question is bought by the institution (i.e. the institution has the right to sell the underlying asset), such instrument cannot be used for netting purposes under Article 45 CRR given that the absence of a fix strike price does not provide any protection against the decrease in value of the underlying asset.
Link	https://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2019_4517