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# Final Report

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Draft Regulatory Technical Standards

on the valuation of derivatives pursuant to Article 49(4) of the Bank Recovery and Resolution Directive (BRRD)

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# 1. Executive Summary

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The Bank Recovery and Resolution Directive<sup>1</sup> (BRRD) entrusts resolution authorities with a write-down and conversion power (bail-in) in relation to liabilities of an institution under resolution, including liabilities arising from derivative contracts. Article 49 of the BRRD lays down the conditions for bailing in derivative liabilities. In this context, resolution authorities must determine the value of derivative liabilities as part of the general valuation of assets and liabilities carried out pursuant to Article 36 of the BRRD and in accordance with methodologies and principles to be specified by the present regulatory technical standards (RTS) developed by the EBA. These draft RTS provide resolution authorities with the tools necessary in order to have the effective power to bail-in liabilities resulting from the close-out of derivative contracts and therefore ensure that the objectives of the BRRD are fulfilled, because such liabilities are in principle eligible for bail-in.

Resolution authorities and valuers must respect the perimeter of the relevant netting arrangement but apply a statutory valuation methodology laid down in the draft RTS without having to follow the methodology laid down in each and every contract. Derivative liabilities will be assessed as an early termination amount based on the costs (or gains) that would be incurred by a counterparty in replacing the contract. Counterparties will be given the possibility to file evidence of replacement trades within a deadline. If they do provide such evidence within the deadline, the authorities will endorse those trades as the relevant prices for the contracts. If not, resolution authorities will apply a valuation based on mid-prices and reasonable replacement costs calculated using bid-offer spreads adjusted to the exposure size and creditworthiness of the counterparty.

Resolution authorities will establish the value of derivative liabilities as at the close-out date or as at the date when a price is available in the market. A provisional valuation at an earlier date will also be possible. Before taking the decision to close out derivative netting sets, authorities will need to consider whether the loss-absorption capacity which will be liberated from the derivative contracts being closed out and bailed in will be offset by these additional costs that would result from the decision to close out (destruction in value). The draft RTS specify the terms of this comparison.

Liabilities of a bank under resolution to a central counterparty (CCP) are likely to fall under the exemptions from bail-in provided for under the BRRD (e.g. Article 44(2)(b)). To the extent that they would not, the default and valuation processes implemented as a result of the European Market Infrastructure Regulation, (EMIR<sup>2</sup>) for authorised EU CCPs and designated third-country

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<sup>1</sup> Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, OJ L 173/90 of 12.6.2014.

<sup>2</sup> Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories; OJ L 201, 27.7.2012, p. 1.

CCPs are deemed to allow for a swift and objective determination of value in most cases. The resolution authority will be able to rely on a statutory valuation in exceptional circumstances. Such a valuation will not undermine CCP default procedures.

These draft RTS respect the principle of proportionality. They only apply to institutions that have been placed under resolution and for which authorities are considering using the bail-in tool. They draw on common market practice for the determination of the close-out amount and derogate from common contractual practice only insofar as necessary to meet the constraints of the resolution process. The draft RTS will be supported by the provisions of the [draft RTS on detailed records of financial contracts EBA/RTS/2015/13].

## Next steps

These draft regulatory technical standards have been submitted to the Commission for endorsement. They will be subject to scrutiny by the European Parliament and the Council before being published in the *Official Journal of the European Union*.

The technical standards will enter into force on the 20<sup>th</sup> day following that of their publication in the *Official Journal of the European Union*.

## 2. Background and rationale

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### 2.1 Introduction and mandate

The resolution framework laid down in Directive 2014/59/EU (Bank Recovery and Resolution Directive, BRRD)<sup>3</sup> entrusts the resolution authority with a set of tools and powers to intervene swiftly and at a sufficiently early stage in a non-viable entity, in order to ensure the continuity of the entity's critical functions, while minimising the impact of its potential failure on the economy and the financial system.

The bail-in tool, through the write-down or conversion of certain of an institution's liabilities into equity, ensures that losses arising from the institution's failure are borne first by shareholders, followed by the claims of general creditors as per their ranking in the hierarchy. Bail-in powers extend to all liabilities of an institution within the scope of the BRRD, except certain liabilities specified in Article 44(2) and, absent exceptional circumstances as described in Article 44(3), liabilities arising from derivative contracts are subject to write down or conversion.

The BRRD requires resolution authorities bailing in derivatives to respect netting and collateral arrangements<sup>4</sup>, which may mean in many cases that the value of derivatives claims potentially subject to bail-in could be small or zero. Nevertheless, the possible application of the bail-in tool to derivative contracts enhances market discipline by creating incentives for shareholders and counterparties to properly scrutinise the risk profile and management practices of an institution in normal times. The bail-in tool must be in place no later than 1 January 2016 in all Member States.

Bailing-in derivative contracts can present unique and complex challenges to resolution planning and implementation. Institutions may have large values and volumes of outstanding derivative contracts and rely on these for risk-management purposes. Derivative contracts can be settled via a central counterparty (CCP)<sup>5</sup> or bilaterally between counterparties. They may be traded in an exchange venue or bilaterally (over-the-counter or OTC derivatives). The value of derivative contracts is linked to

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<sup>3</sup> Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, OJ L 173/12.6.2014, p. 190.

<sup>4</sup> Articles 44(2)(b) and 49.

<sup>5</sup> A CCP is a financial market infrastructure which interposes itself between two counterparties, becoming the seller to every buyer and the buyer to every seller, through the novation of the derivative contracts. This structure flattens out risk and uncertainty and increases efficiency and confidence in financial operations. This is because the CCP limits exposures among counterparties (each counterparty is essentially exposed only to the CCP) and requires collateral for its open positions from all counterparties and therefore allows each counterparty to be protected against credit and liquidity risks stemming from the other counterparty. A CCP usually deals only with a limited number of trusted counterparties, the 'clearing members'. The CCP does not take on market risk, i.e. the exposure to a change in the market value of the trades that it enters into, because it runs a 'matched book': any position taken on with one counterparty is always offset by an opposite position taken on with another counterparty.

underlying instruments, assets or entities, of which the value changes over time and only crystallises at maturity or upon termination (close-out). Also, most derivative contracts are subject to netting arrangements, allowing counterparties to close-out netted exposures across multiple contracts.

Experience in the administration of failed institutions following the 2008 crisis illustrates that the valuation of derivatives upon the failure of one of the counterparties is a complex matter that may take time and is prone to causing disagreement and litigation between the counterparties. This has been the case particularly for OTC derivatives, for which there was neither a clearly observable market price nor central clearing.

An orderly resolution process will avoid many of the costs and shortcomings experienced in previous, disorderly, liquidation proceedings. On the other hand, this process will only be achieved effectively if resolution authorities are equipped with appropriate methodologies to value derivative liabilities swiftly and on the basis of objective elements, avoiding the risks of counterparties overestimating their claims.

In recognition of these challenges, Article 49 of the BRRD sets forth requirements regarding the write-down or conversion of derivative contracts, especially with respect to the determination of the value of the liability at the point of intervention. Article 49 of the BRRD provides that resolution authorities may write-down or convert derivative contracts only 'upon or after closing-out the derivatives'. Where a derivative contract is subject to a netting agreement, Article 49 requires the liability to be determined on a net basis, in accordance with the terms of the agreement.

Derivative liabilities may fall under the general exclusions from the scope of the bail-in power under Article 44(2) of the BRRD, in particular the exclusion of secured liabilities to the extent that the value of the liability does not exceed the value of the collateral. Additionally, derivative liabilities may be excluded from bail-in using the resolution authority's discretion under Article 44(3) of the BRRD, in particular when it is not possible to bail-in that liability within a reasonable time or when the application of the bail-in tool would cause destruction in value, which would increase the losses borne by other creditors.

The EBA has a mandate pursuant to Article 49(5) of the BRRD to develop draft regulatory technical standards (RTS) specifying methodologies and principles to be applied by resolution authorities when applying write down and conversion powers to derivative liabilities. These methodologies and principles target three sets of issues:

- a) determining the value of classes of derivatives, including transactions that are subject to netting agreements;
- b) establishing the relevant point in time at which the value of a derivative position should be established; and
- c) comparing the destruction in value that would arise from the close-out and bail-in of derivatives with the amount of losses that would be borne by derivative liabilities in a bail-in.

## 2.2 Approach

### 2.2.1 Destruction in value

Resolution authorities are required under the BRRD to seek to minimise the cost of resolution, to avoid unnecessary destruction of value<sup>6</sup> and to avoid significant adverse effects on the financial system.<sup>7</sup> Accordingly, resolution authorities may exclude liabilities from bail-in under exceptional circumstances, notably where the exclusion is strictly necessary and proportionate to avoid giving rise to widespread contagion,<sup>8</sup> or where the application of the bail-in tool to those liabilities would cause a destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in.<sup>9</sup>

The circumstances which may lead to the exemption from bail-in laid down under Article 44(3) of the BRRD are to be further specified by Commission delegated acts and are therefore not within the scope of these draft RTS.

However, in line with Article 49(4)(c) of the BRRD, these draft RTS set out the approach to be followed by resolution authorities when making a comparison between, on the one hand, the destruction in value that would arise from the close-out and bail-in of derivatives and, on the other hand, the amount of losses that would be borne by those derivatives in a bail-in. Under the draft RTS, resolution authorities, on a case-by-case basis and in accordance with the BRRD and Commission delegated acts, will assess the potential destruction in value which would arise from the close-out and bail-in of derivatives. On the basis of this and other factors, resolution authorities will determine any liability exemptions that might follow as a consequence.

The close-out of derivative contracts may crystallise losses that are not fully reflected in the fair value of the contracts before close-out. These could stem, for example, from additional replacement costs incurred by the counterparty, or costs incurred by the institution under resolution to re-establish hedges left open by the close-out. Where the amount by which the corresponding liability could be bailed in (the bail-in potential) is less than the losses incurred by the institution under resolution stemming from the close-out of derivative contracts, the excess loss to the institution may increase the burden of bail-in for other creditors of the institution under resolution. In such cases, resolution authorities may consider employing the exemption to bail-in under the conditions of Article 44(3)(d) of the BRRD and the Commission delegated act adopted under Article 44(11) of the BRRD.

In order to compare the destruction in value that would arise from the close-out and bail-in of derivative contracts with the amount of losses that would be borne by derivatives in a bail-in, resolution authorities should compare (a) the amount of losses that would be borne by the derivative contracts in a bail-in as part of the valuation under Article 36 and taking account of the pro quota share of derivatives within equally ranking liabilities and all applicable exemptions that would reduce the loss-absorption capacity of the liability, and (b) an assessment of the amount of the costs, expenses or other impairment in value that would be incurred as a result of the close-out of the derivative contracts.

In order to assess the amount described in (a), authorities will multiply the share, within all equally ranked liabilities, of liabilities arising from the derivative contracts and not falling within exclusions from bail-in by the total losses expected to be borne by all liabilities ranking equally to derivatives,

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<sup>6</sup> Article 31(2), last subparagraph, of the BRRD.

<sup>7</sup> Article 31(2)(b) of the BRRD.

<sup>8</sup> Article 44(3)(c) of the BRRD.

<sup>9</sup> Article 44(3)(d) of the BRRD.

including the derivative liabilities stemming from the close-out. In order to assess the amount described in (b) above, resolution authorities should incorporate reasonable estimates of (i) the cost and expense for re-hedging, (ii) any reduction of the franchise value, or in the value of underlying assets, that would arise from the close-out and (iii) ancillary costs or other measures. It should be noted that the assessment of destruction in value is intended to inform the resolution authority's decision whether or not to close-out derivative contracts, and so must be determined prior to the point of close-out.

### 2.2.2 Valuation Methodologies

Article 49 of the directive sets out the procedure for bailing-in derivative contracts, with two main requirements:

- a) Derivative transactions subject to a netting agreement must be bailed in on a net basis in accordance with the term of the netting agreement. The valuer must therefore respect netting sets as defined in netting arrangements without being able to 'cherry pick' certain contracts and exempt others.
- b) Derivatives may only be bailed in upon or after close-out of the contracts. Therefore, methodologies must aim at enabling a timely valuation of the close-out amount, enabling the resolution authority to write-down and convert the unsecured, net amount due under the netting agreement.

Contractual practice illustrates that netting agreements and standalone derivative contracts may contain different methodologies for determining the net amount due between counterparties upon close-out (for example market quotation, loss, close-out methods). In general, in an event of default by one of the parties, derivative contracts assign the power to determine the close-out amount or the termination date to the non-defaulting counterparties.

However, when the conditions for resolution have been met, resolution authorities are empowered to close out and bail in derivatives, and to determine a valuation of the derivative liability at the moment of the exercise of the resolution power.

As required under Article 49 of the BRRD, these draft RTS provide a methodology to be followed by resolution authorities in order to conclude the valuation of derivative contracts upon close-out. The methodology set forth in these draft RTS determine the close-out amount based on the principle of 'replacement cost'. In general, replacement cost represents the actual or hypothetical cost which the non-defaulting counterparty would incur in order to replace the terminated contract, after taking into account any collateral posted or received.

The principle of replacement cost as a determinant for the close-out valuation aims at achieving an outcome similar overall to valuations which are performed under contracts upon close-out. Consequently, the replacement cost approach will also minimise the risk of depriving counterparties of no-creditor-worse-off protection, as the approach to valuing the outstanding liability would be aligned with common market practice in insolvency proceedings.

When applying the replacement cost valuation methodology, resolution authorities should consider a full range of available and reliable data sources. Replacement trades or groups of replacements trades concluded by counterparties or other market transactions for similar contracts in order to



replace or re-hedge the risk exposure upon close-out would constitute a meaningful source for valuation as long as the replacement trades were concluded on commercially reasonable terms.

The draft RTS describe a process for determining the value of derivative liabilities (after netting and collateral) where derivatives have been closed out. To maintain consistency with standard netting agreements and the treatment of derivatives in insolvency, these draft RTS provide that resolution authorities shall notify the counterparty of the termination and close-out of the derivative contract, and give counterparties the possibility to provide evidence of commercially reasonable replacement trades within a set deadline. The counterparty is not obliged to enter into replacement trades, but if it does, and provides evidence of commercially reasonable replacement trades within the deadline, the valuer will endorse the trades as the price for the closed-out contract. If, in contrast, the counterparty does not provide evidence of commercially reasonable replacement trades within the deadline, resolution authorities will be authorised to construct their final, non-provisional close-out valuation on the basis of mid-prices and bid-offer spreads.

#### a. Articulation of these draft RTS with the valuation of assets and liabilities under Article 36 of the BRRD

Articles 36 and 49 of the BRRD should be read together and operate to provide a valuation process that is compatible with the swiftness inherent in the resolution process and allows for a valuation on the basis of prudential assumptions and objective elements.

As provided under Article 49(3) of the BRRD, the valuation of derivative liabilities should be made as part of the valuation of assets and liabilities carried out pursuant to Article 36 of the BRRD, and specifically form part of a valuation for the purpose of informing the extent of the write-down or conversion of eligible liabilities. In that context, the valuation of derivatives will be conducted by the valuer on a provisional basis, consistent with the processes described in Article 36 of the BRRD and the delegated acts adopted thereto, and will serve to inform the resolution decisions.

The methodologies contained in these draft RTS will ensure that, when employing the bail-in tool, losses under derivative contracts are fully recognised at the moment the resolution tools are applied, in accordance with Article 36(4)(g) of the BRRD.

Under Article 36(9) of the BRRD, valuations may be conducted on a provisional basis where it is not possible to fulfil all of the requirements in the time available. Under the BRRD a provisional valuation is also a valid basis for resolution actions. The draft RTS reflect this possibility in Article 8(2). Where resolution authorities decide to bail-in derivatives based on a provisional valuation, they should employ reasonable valuation methods under the prevailing circumstances, including reliance upon internal models of the bank under resolution and data available at the time of the determination.

As in all cases where they take resolution action based on a provisional valuation, resolution authorities will need to ensure that a final and definitive valuation is carried out after resolution, and will need to make arrangements to be able to adjust the treatment of creditors subsequently (e.g. by finalising the distribution of equity in the bailed-in bank after the final valuation is complete) or to provide alternative compensation if necessary, on the basis of the valuation of difference in treatment pursuant to Article 74 of the BRRD.

#### b. Treatment of CCP-cleared derivatives

Insofar as centrally cleared derivatives would not be exempted from bail-in, these draft RTS balance, on the one hand the interests of the resolution authority in conducting a bail-in of derivatives in line with the BRRD provisions and within a reasonable timescale, against, on the other hand, the specificities of centrally cleared derivatives and the protection accorded to CCPs. Indeed, CCPs active in the EU are subject to legislation and supervision (stemming particularly from the EMIR), requiring a CCP to apply sound risk management in its default procedures on the default of a clearing member.<sup>10</sup> In principle, such risk management ensures sufficient collateralisation and a prudent and transparent way to manage crisis situations, limiting the exposure and the costs for CCPs on the default of a clearing member. At any rate, avoidance of adverse effects on the financial system and contagion to market infrastructures are among the resolution objectives (Article 31 of the BRRD) and are therefore inherent in the decision-making procedure that the resolution authority should follow when taking any resolution action.

When derivative contracts between a clearing member and a CCP are closed out, for instance when the clearing member defaults, the CCP will seek to re-hedge its open positions and replace the trades it had with another – solvent – clearing member, thereby avoiding open positions and an ‘unbalanced book’. For the replacement of the defaulting member’s transactions, the CCP will apply its ‘default procedures’, which every authorised CCP in the EU is required to have in place pursuant to the EMIR and the relevant supervisory college. CCP default procedures generally require a series of steps to be taken by the CCP for the replacement of the defaulting member’s transactions, including recourse to a trading venue, an auction among the CCP’s non-defaulting clearing members or bids by selected clearing members.<sup>11</sup> The price offered will represent a cost or gain for the CCP, which the latter will offset against any collateral posted by the defaulting clearing member. The default procedures will therefore establish the CCP’s replacement cost. If risk mitigation policies are adequately followed, it is unlikely that a defaulting clearing member would face a liability to the CCP exceeding the collateral posted. Thus, bailing in such liabilities seems unlikely under normal risk-management conditions.

CCP default procedures, when conducted in accordance with the EMIR, provide a high level of transparency and soundness in risk mitigation and determination of replacement costs by CCPs. In addition, CCPs play a crucial role in the functioning of financial markets and are not risk-assuming entities *per se*. For those reasons, EU legislation, international initiatives and prudential supervision aim at protecting their operations from individual default events in order to ensure financial stability.

These draft RTS draw extensively on the CCP default procedures and timelines. Accordingly, the resolution authority will notify its decision to close out the contract and agree with the CCP and its competent authority on a deadline by which the CCP should provide its replacement costs, taking into account the CCP’s default procedures and the resolution timeline. That deadline may be extended by common agreement of the resolution authority, CCP and CCP’s competent authority.

In the exceptional case of the CCP not providing its replacement costs by the agreed deadline or where there is evidence that the CCP did not follow its default procedures, the resolution authority

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<sup>10</sup> When a CCP is not subject to the EMIR requirement on default procedures, a resolution authority should regard it as a normal counterparty.

<sup>11</sup> Article 48(5) of the EMIR also provides for, as a first step, a compulsory attempt to port assets and positions held by a defaulting clearing member for the account of its clients to another clearing member under certain conditions.

will be able to apply the statutory methodology otherwise applicable to non-centrally cleared derivatives, after consulting the CCP's competent authority.

Any valuation not based on the CCP's default procedures would only serve resolution purposes. CCPs will still be expected to run their default procedures according to their contractual and rulebook obligations.

As for any other type of liabilities, the resolution authority has the power to perform a provisional valuation where justified by the urgency of the situation under the conditions of Article 36(9) of the BRRD. In such cases, CCPs will also have the possibility to provide the valuer with estimates of the expected outcome of their default procedure and, if the resolution authority decides to wait, with the outcome of their default procedure. In case the resolution authority concludes the valuation not based on the CCP default procedure, any divergence between the two values will then be dealt with in the context of the no-creditor-worse-off valuation under Article 74 of the BRRD or subsequent legal proceedings.

### **2.2.3 Point in time**

The valuation approach seeks to employ replacement costs incurred by the counterparty in order to determine the close-out valuation of derivative contracts, while ensuring that the resolution authority's timeline to conclude a valuation remains consistent with the general resolution timeline and prevents unreasonable delay in determining the close-out amount incurred by counterparties.

Accordingly, Article 8(1) of the draft RTS defines a reference time and date on which the resolution authority shall determine the close-out amount. The close-out valuation should thus be determined as at the close-out date or, if that would not be commercially reasonable, the day and time at which a price is available in the underlying market for the derivative contract.

Establishing the derivative contract value on that reference date will secure maximum accuracy for resolution authorities. However, where the valuation of derivatives is part of a provisional valuation as described above, the resolution authority<sup>12</sup> will be able to establish a valuation of the close-out amount prior to the reference date. Such valuation will be based on the resolution authority's own estimates of the replacement costs that the counterparty would incur at the reference date, and taking into account the market conditions at that time. In line with the processes described in Article 36 of the BRRD and the delegated acts adopted thereto, the data subsequently recorded at the reference date will feed into the final valuation pursuant to Article 36(10) of the BRRD. Resolution authorities may then either adjust the treatment of creditors in bail-in – provided the necessary arrangements have been made – or provide alternative compensation if necessary, on the basis of the valuation of difference in treatment pursuant to Article 74 of the BRRD.

### **2.2.4 Contribution to BRRD implementation and the single market**

These draft RTS aim at providing resolution authorities with the tools to evaluate and close-out derivative contracts in the context of resolution. This is necessary in order to have the effective power to bail in liabilities resulting from closing out derivative contracts. They therefore ensure that the objectives of the BRRD are fulfilled, because such liabilities are in principle eligible for bail-in.

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<sup>12</sup> Article 7(2) of these draft RTS.

In addition, these draft RTS contribute to a harmonised framework for closing-out and bailing-in liabilities. They therefore contribute to the establishment of a single rulebook for the functioning of the internal market in the field of supervision and resolution of financial institutions.

### **2.2.5 Proportionality**

The draft RTS respect the principle of proportionality. Indeed, they refer only to institutions that have been placed under resolution and where the bail-in tool is used, and as such have met the conditions under Article 32 of the BRRD.

In addition, the draft RTS establish the right balance between the need to recognise market practice in the derivatives market and the need for objectiveness and swiftness, which is central to the resolution process.

Finally, the draft RTS take into account the specificities of centrally cleared derivatives and have specific provisions for closing out this type of derivative contracts.

These draft RTS will be supported by the provisions of the draft RTS on detailed records of financial contracts developed in the context of an EBA mandate under Article 71 of the (BRRD EBA/RTS/2015/13), which will ensure that resolution authorities have accurate and up-to-date information on derivative exposures at the point of failure.

### 3. Draft Regulatory Technical Standards on the valuation of derivatives pursuant to Article 49(4) of the Bank Recovery and Resolution Directive (BRRD)

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COMMISSION DELEGATED REGULATION (EU) .../..

of **XXX**

**Supplementing Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms with regard to regulatory technical standards for methodologies and principles on the valuation of liabilities arising from derivatives**

(Text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council<sup>1</sup>, and in particular Article 49(5) thereof,

Whereas:

- (1) Directive 2014/59/EU entrusts resolution authorities with the power to write down and convert liabilities of an institution under resolution.
- (2) Derivative contracts may represent a significant share of the liability structure of certain credit institutions. However, the valuation of such contracts is a complex process given that their value is linked to the value of underlying instruments, assets or entities, which evolves over time and only crystallises at maturity or upon close-out.
- (3) Past experience illustrates that the complexity of valuing derivative liabilities upon failure of one of the counterparties may make the valuation process time-consuming, involve enormous costs and give rise to litigation.

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<sup>1</sup>

OJ L 173, 12.6.2014, p.190.

- (4) Furthermore, practice illustrates that derivative contracts may contain different methodologies to determine the amount due between counterparties upon close-out, some of them leaving the determination of the close-out amount or the close-out date, or both, entirely to the non-defaulting counterparty.
- (5) Accordingly, in order to avoid moral hazard and ensure the efficiency of the resolution actions, resolution authorities should adopt and implement appropriate methodologies to value liabilities arising from derivative contracts within a timeframe compatible with the swiftness of the resolution process and based on objective and, where practicable, readily available information. It is important that the valuation methodology sets out some procedural provisions on communication of close-out decisions by the resolution authority as well as on how to obtain replacement trades from the closed-out counterparties.
- (6) Derivative contracts subject to a netting agreement give rise to a single close-out amount in the event of a contractual early termination. Article 49 of Directive 2014/59/EU provides that the value of such contracts is determined on a net basis in accordance with the terms of the agreement. The resolution authority or independent valuer should therefore respect netting sets defined in the netting arrangements without being able to choose certain contracts and exempt others.
- (7) Pursuant to Article 49 of Directive 2014/59/EU, the value of derivative contracts is determined by the resolution authority or independent valuer as part of the valuation process carried out under Article 36 of that Directive. With respect to derivative liabilities, the valuation process should aim to determine a prompt and *ex ante* valuation for bail-in purposes, and at the same time allow the resolution authority adequate flexibility for *ex post* adjustment of claim amounts.
- (8) The assessment of whether to bail-in or to exclude derivative liabilities from the scope of bail-in pursuant to Article 44(3) of Directive 2014/59/EU should be made prior to the decision to close out as part of the valuation process under Article 36 of that Directive.
- (9) The valuation of derivative liabilities should enable resolution authorities to assess, prior to taking a decision to close out, the potential amount by which those liabilities might be bailed in following the close-out, as well as the potential destruction in value which might arise as a result of the close-out.
- (10) The close-out of derivative contracts may crystallise additional losses that are not reflected in the going-concern valuation, stemming for example from actual replacement costs incurred by the counterparty that would increase the close-out costs owed by the institution under resolution, or from costs incurred by the institution under resolution in re-establishing trades on exposures subject to open market risk resulting from the close-out. If the losses incurred or expected to be incurred from the close-out of derivatives exceed the share of the corresponding liabilities that would be effectively available for bail-in, the excess loss may increase the burden of bail-in for other creditors of the institution under resolution. In such cases, the amount of losses that would be borne by liabilities not arising from derivative contracts in a bail-in would be higher than without the close-out and bail-in of derivative contracts, and therefore the resolution authority may consider exempting derivative contracts from bail-in in accordance with Article 44(3)(d) of Directive 2014/59/EU and with the Commission Delegated Regulation

adopted under Article 44(11) of that Directive [note to the OJ, please include exact reference when such Regulation is adopted]. Any exercise of the bail-in power in relation to such liabilities should be subject to the exemptions set out in Article 44(2) of Directive 2014/59/EU and to the discretionary exemptions laid down in Article 44(3) of that Directive as specified in the Commission Delegated Regulation XXXXX.

- (11) Since there is a need for consistent interpretation of paragraphs (3) and (4) of Article 49 of Directive 2014/59/EU, this Regulation should specify methodologies and principles for the valuation of derivatives carried out by independent valuers and resolution authorities.
- (12) A valuation methodology relying on actual or hypothetical replacement costs for the closed out liabilities would achieve outcomes similar to predominant market practice and would be consistent with the principles governing the valuation required under Article 74 of Directive 2014/59/EU, which is aimed at establishing whether shareholders and creditors would have received better treatment if the institution under resolution had entered into normal insolvency proceedings (the “no-creditor-worse-off” principle).
- (13) In applying the valuation methodology, the resolution authority should be able to rely on various sources of data, including data sources provided by the institution under resolution, counterparties or third parties. This Regulation should nevertheless set out principles on the types of data that should be taken into consideration in the course of the valuation in order to ensure an objective determination of value.
- (14) Counterparties of derivative contracts closed out by resolution authorities may choose to conclude one or more replacement trades to replace their exposure upon close-out. Such replacement trades should constitute a privileged data source for the valuation as long as they are concluded on commercially reasonable terms as at the close-out date or as soon as reasonably practicable thereafter. Resolution authorities should therefore, when communicating the close-out decision, give counterparties the possibility to provide evidence of commercially reasonable replacement trades within a deadline consistent with the expected reference point in time for the valuation. Where counterparties have provided such evidence within the deadline, the valuer should determine the close-out amount at the prices of those replacement trades. If counterparties have not provided evidence of commercially reasonable replacement trades within the deadline, resolution authorities should be able to carry out their valuation on the basis of available market information, such as mid-prices and bid-offer spreads in order to assess hypothetical replacement costs, i.e. the loss or costs that would have been incurred as a result of re-establishing a hedge or a related trading position on a net risk exposure basis.
- (15) Derivative products and markets are very heterogeneous and it is not possible to identify a single market practice for entering into replacement trades. Therefore, the notion of ‘commercially reasonable replacement trades’ has to be broadly defined in order to enable the valuer to conduct the required assessment in all market contexts. That notion should thus be understood as a replacement trade entered into on a netted risk exposure basis, on terms consistent with common market practice



and making reasonable efforts in order to obtain best value for money. In particular, the valuer could consider, among other elements, the number of dealers approached by the counterparty, the number of firm quotes obtained, and whether the quote offering the best price has been chosen. The resolution authority should also be able to specify in the close-out notice the criteria that it will apply in its assessment.

- (16) Union legislation adopted in recent years has, in line with international standards, sought to increase transparency and risk mitigation in the market for derivative contracts by providing for (i) mandatory clearing through central counterparties ('CCP') for standardised over-the-counter ('OTC') derivatives; (ii) valuation and margining requirements for CCP-cleared derivatives and for a wide range of OTC derivatives; and (iii) mandatory reporting to trade depositories for all OTC derivatives.
- (17) Regulation (EU) No 648/2012 of the European Parliament and of the Council<sup>2</sup> requires CCPs authorised (in the case of CCPs established in the Union) or recognised (in the case of CCPs established in third countries) in the Union to have in place a sound risk-management framework and adequate procedures and mechanisms to deal with the default of a clearing member. The procedures laid down in that Regulation are meant to be a prudent and transparent way to manage the default of a clearing member.
- (18) In the event that a CCP clearing member is placed under resolution, and the resolution authority closed-out derivative contracts prior to a bail-in, that clearing member would qualify as a defaulting clearing member with regard to the CCP in relation to the particular netting set(s). The internal procedures and mechanisms governing the default of a clearing member ('CCP default procedures') implemented by CCPs in light of the requirements of Regulation (EU) No 648/2012, offer a reliable basis to determine the value of the derivative liability arising across the netting set from the close-out, also in the context of bail-in in a resolution process.
- (19) Conducting CCP default procedures may take several days or more following the trigger event. For the particular case of resolution, waiting for the completion of default procedures over a very long period in order to set the value of derivatives could undermine the resolution timeline and objectives and could result in unnecessary disruption in financial markets. It is therefore necessary for the resolution authority to agree with the CCP and the CCP's competent authority on a deadline by which the early termination amount has to be determined, taking into account both the constraints of the CCP and those of the resolution authority.
- (20) The early termination amount determined by the CCP in line with its default management procedures within the agreed deadline should be endorsed by the valuer. Where the CCP fails to determine the early termination amount within the agreed deadline or does not apply its default procedures, the resolution authority should have the possibility to rely on its own estimates to determine the early termination amount. The resolution authority should also be able to apply a provisional determination based on its own estimates where such action is justified

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<sup>2</sup> Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (OJ L 201, 27.7.2012, p. 1).



by the urgency of the resolution process and provided it updates its valuation upon completion of the CCP default procedure at the expiry of the deadline. The resolution authority should be able to consider information provided by the CCP after the deadline in the *ex post* definitive valuation, if available at that time, and in any event when performing the valuation of difference in treatment pursuant to Article 74 of Directive 2014/59/EU. This Regulation is without prejudice to the default management procedures run by CCPs in accordance with Regulation (EU) No 648/2012.

- (21) The provisions in this Regulation should not affect CCP internal procedures for the transfer of the assets and positions established between a defaulting clearing member and its clients, adopted in accordance with Article 48(4) of Regulation (EU) No 648/2012, and should be consistent with any other relevant provisions or conditions of authorisation which might affect the close-out of the relevant derivative contracts.
- (22) The point in time for the valuation of derivative contracts should reflect the valuation principle established by this Regulation which takes into account the actual or the hypothetical replacement costs incurred by counterparties. In order for the valuation to be as accurate as possible, it should be carried out on the close-out date or, if that would not be commercially reasonable, the first day and time on which a market price is available for the underlying asset. In those cases where the early termination amount is determined by a CCP or is determined at the price of replacement trades, the reference point in time should be that of the CCP determination or that of the replacement trades.
- (23) If the resolution authority, due to urgency, decides to carry out a provisional valuation pursuant to Article 36(9) of Directive 2014/59/EU, the resolution authority or the valuer should be able, as part of that provisional valuation, to produce a provisional determination of the value of derivative liabilities prior to that reference point in time, based on value estimates and available data as at that time. Where the resolution authority takes resolution action on the basis of the provisional valuation consistently with Article 36(12) of Directive 2014/59/EU, relevant market developments observed or evidence of actual replacement trades at the reference point in time would either be reflected in a subsequent provisional valuation or, in the final valuation carried out pursuant to Article 36(10) of Directive 2014/59/EU.
- (24) If the resolution authority takes resolution action on the basis of a provisional valuation, appropriate steps should be taken where necessary in order to ensure protection of creditors' rights. Such steps may consist either in the adjustment of the treatment received by creditors - if and to the extent the resolution authority has made necessary arrangements for holding sufficient equity - or creditors should be able to be entitled to compensation on the basis of the valuation of difference in treatment pursuant to Article 74 of Directive 2014/59/EU.
- (25) This Regulation is based on the draft regulatory technical standards submitted by the European Banking Authority to the Commission.
- (26) The European Banking Authority has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, has consulted the European Securities and Markets Authority, has analysed the

potential related costs and benefits and requested the opinion of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council<sup>3</sup>.

HAS ADOPTED THIS REGULATION:

*Article 1*  
*Definitions*

For the purposes of this Regulation, the following definitions shall apply:

- (1) “netting set” means a group of contracts subject to a netting arrangement as defined in Article 2(1)(98) of Directive 2014/59/EU;
- (2) “valuer” means the independent expert appointed to carry out the valuation in compliance with the requirements and the criteria set out in [Part/Chapter] of Commission Delegated Regulation (EU) No. xx/xxxx (Bundled BRRD RTS) ;
- (3) “central counterparty”, or “CCP”, means a CCP as defined in Article 2(1) of Regulation (EU) No 648/2012, to the extent that it is either;
  - (a) established in the Union and authorised in accordance with the procedure set out in Articles 14 to 21 of Regulation (EU) No 648/2012; or
  - (b) established in a third country and recognised in accordance with the procedure set out in Article 25 of Regulation (EU) No 648/2012;
- (4) “clearing member” means a clearing member as defined in Article 2(14) of Regulation (EU) No 648/2012;
- (5) “close-out date” means the day and time of the close-out specified in the communication by the resolution authority of the decision to close-out;
- (6) “replacement trade” means a transaction entered into on or after the close-out date of a derivative contract to re-establish, on a net risk exposure basis, any hedge or related trading position that has been terminated on equivalent economic terms as the closed-out transaction;
- (7) “commercially reasonable replacement trade” means a replacement trade entered into on a netted risk exposure basis, on terms consistent with common market practice and by making reasonable efforts to obtain best value for money.

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<sup>3</sup> Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

## Article 2

### *Comparison between the destruction in value that would arise from the close-out and the bail-in potential of derivative contracts*

1. For the purpose of Article 49(4)(c) of Directive 2014/59/EU, the resolution authority shall compare the following:
  - (a) the amount of losses that would be borne by the derivative contracts in a bail-in, obtained by multiplying:
    - (i) the share, within all equally ranked liabilities, of liabilities arising from the derivative contracts determined as part of the valuation under Article 36 of Directive 2014/59/EU and not falling within the exclusions from bail-in pursuant to Article 44(2) of that Directive; by
    - (ii) the total losses expected to be borne by all liabilities ranking equally to derivatives, including the derivative liabilities stemming from the close-out;with
  - (b) the destruction in value based on an assessment of the amount of the costs, expenses, or other impairment in value that is expected to be incurred as a result of the close-out of the derivative contracts, and obtained by calculating the sum of the following elements:
    - (i) the risk of an increased counterparty close-out claim arising from re-hedging costs expected to be incurred by the counterparty, by taking into account the bid-offer, mid-to-bid or mid-to-offer spreads in line with Article 6(2)(b) ;
    - (ii) the cost expected to be incurred by the institution under resolution in establishing any comparable derivative trades considered necessary in order to re-establish a hedge for any open exposure or in order to maintain an acceptable risk profile in line with the resolution strategy. The establishment of a comparable derivative trade may be achieved by taking into consideration initial margin requirements and prevailing bid-offer spreads;
    - (iii) any reduction to franchise value arising from the close-out of derivative contracts, including any valuation impairment for other or underlying assets that are linked to the derivative contracts being closed out, and any impact on funding costs or income levels;
    - (iv) any precautionary buffer against possible adverse implications from close-out, such as errors and disputes in respect of transactions or collateral exchange.
2. The comparison under paragraph 1 shall be made before a decision to close-out is taken, as part of the valuation to inform decisions about resolution actions required under Article 36 of Directive 2014/59/EU, and consistently with the requirements in Part III of [EBA RTS XX on valuation methodology].

### *Article 3*

#### *Communication of the decision to close out*

1. Prior to exercising the write-down and conversion powers in relation to liabilities arising from derivative contracts, the resolution authority shall communicate the decision to close out contracts pursuant to Article 63(1)(k) of Directive 2014/59/EU to the counterparties to those contracts.
2. The decision to close out shall take effect immediately, or at a later close-out date and time as specified in the communication.
3. In the decision referred to in paragraph 1, the resolution authority shall specify a date and time, taking account of the requirements in Article 8(1)(c), by which counterparties may provide evidence to the resolution authority of commercially reasonable replacement trades for the purpose of determining the close-out amount pursuant to Article 6(1). The counterparty shall also provide a summary of any commercially reasonable replacement trades.
4. The resolution authority may change the date and time by which counterparties may provide evidence of commercially reasonable replacement trades where such change is consistent with Article 8(1)(c).

Any decision to change the date and time by which counterparties may provide evidence of commercially reasonable replacement trades shall be communicated to the counterparty.

5. In the decision referred to in paragraph 1, the resolution authority may specify the criteria it intends to apply when assessing whether replacement trades are commercially reasonable.
6. This Article shall not apply to the close-out and valuation of centrally cleared derivative contracts entered into between the institution under resolution, acting as a clearing member, and a CCP.

### *Article 4*

#### *Role of the netting agreement*

For contracts subject to a netting agreement, the valuer shall determine, in accordance with Articles 2, 5, 6, and 7, a single amount which the institution under resolution has the legal right to receive or the legal obligation to pay as a result of the close-out of all the derivative contracts in the netting set, as defined in the netting agreement.

### *Article 5*

#### *Valuation principle for early termination amount*

1. The valuer shall determine the value of liabilities arising from derivative contracts as an early termination amount calculated as the sum of the following amounts:

- (a) unpaid amounts, collateral or other amounts due from the institution under resolution to the counterparty, less unpaid amounts, collateral and other amounts due from the counterparty to the institution under resolution on the close-out date;
  - (b) a close-out amount covering the amount of losses or costs incurred by derivative counterparties, or gains realised by them, by replacing or obtaining the economic equivalent of material terms of the terminated contracts and the option rights of the parties in respect of those contracts.
2. For purposes of paragraph 1, unpaid amounts means, in respect of closed-out derivative contracts, the sum of the following:
  - (a) amounts that became payable on or prior to the close-out date and which remain unpaid on that date;
  - (b) an amount equal to the fair market value of the asset which was required to be delivered for each obligation of the derivative contracts which was required to be settled by delivery on or prior to the close-out date and which has not been settled as at the close-out date;
  - (c) amounts in respect of interest or compensation accrued during the period from the date on which relevant payment or delivery obligations fell due through to the close-out date.

#### *Article 6*

##### *Determination of the close-out amount*

1. Where a counterparty has provided evidence of commercially reasonable replacement trades within the deadline set out in Article 3(3), the valuer shall determine the close-out amount at the prices of those replacement trades.
2. Where a counterparty has not provided evidence of any replacement trades within the deadline set out in Article 3(3), where the valuer concludes that the communicated replacement trades were not concluded on commercially reasonable terms, or where Articles 7(7) or 8(2) apply, the valuer shall determine the close-out amount on the basis of the following:
  - (a) the mid-market end-of-day prices in line with the business-as-usual processes within the institution under resolution at the date determined pursuant to Article 8;
  - (b) the mid-to-bid spread or mid-to-offer spread, depending on the direction of the netted risk position;
  - (c) adjustments to the prices and spreads mentioned in points (a) and (b) where necessary to reflect the liquidity of the market for the underlying risks or instruments and the size of the exposure relative to market depth, as well as possible model risk.
3. With regard to intra-group liabilities, the valuer may establish the value at mid-market end-of-day prices as referred to in paragraph 2(a), without regard to

paragraph 2(b) and 2(c), where the resolution strategy would imply re-hedging the terminated transactions via another intra-group derivative transaction or group of transactions.

4. For determining a value of the close-out amount pursuant to paragraph 2, the valuer shall consider a full range of available and reliable data sources. It may rely on observable market data or theoretical prices generated by valuation models aimed at estimating values, including the following sources of data:
  - (a) data provided by third parties, such as observable market data or valuation parameters data and quotes from market-makers or, where a contract is centrally cleared, values or estimates obtained from CCPs;
  - (b) for standardised products, valuations generated by the valuer's own systems;
  - (c) data available within the institution under resolution, such as internal models and valuations including independent price verifications performed pursuant to Article 105(8) of Regulation (EU) No 575/2013 of the European Parliament and of the Council<sup>4</sup>;
  - (d) data provided by counterparties other than evidence of replacement trades communicated pursuant to Article 3(3), including data on current or previous valuation disputes with regard to similar or related transactions and quotes;
  - (e) any other relevant data.
5. For the purpose of paragraph 2(b), the resolution authority may instruct the institution under resolution to perform an updated independent price verification as at the reference point in time determined pursuant to Article 8, using end-of-day information available on the close-out date.
6. This Article shall not apply to the determination of a close-out amount for cleared derivative contracts entered into between an institution under resolution and a CCP, except in the exceptional circumstances set out in Article 7(7).

#### *Article 7*

#### *Valuation of cleared derivative contracts entered into between an institution under resolution and a CCP*

1. The valuer shall establish the value of liabilities arising from derivative contracts entered between, on the one hand, an institution under resolution acting as a clearing member and, on the other hand, a CCP, based on the valuation principle specified in Article 5. The early termination amount shall be determined by the CCP, within the deadline specified in paragraph 5, in accordance with the CCP

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<sup>4</sup> 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 and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

default procedures, after deducting the collateral provided by the institution under resolution including initial margin, variation margin and contributions of the institution under resolution to the default fund of the CCP.

2. The resolution authority shall communicate to the CCP and the CCP's competent authority its decision to close out the derivative contracts pursuant to Article 63(1)(k) of Directive 2014/59/EU. The decision to close out shall take effect immediately, or on the date and time specified in the communication.
3. The resolution authority shall instruct the CCP to provide its valuation of the early termination amount for all the derivative contracts in the relevant netting set, in accordance with the CCP default procedure.
4. The CCP shall provide the resolution authority with the CCP default procedure documents and shall report the default management steps undertaken.
5. The resolution authority shall, in agreement with the CCP and the CCP's competent authority, set the deadline by which the CCP must provide the valuation of the early termination amount. For that purpose, the resolution authority, the CCP and the CCP's competent authority shall take both of the following into account:
  - (a) the default procedure, as established by the CCP governance rules in compliance with Article 48 of Regulation (EU) No 648/2012;
  - (b) the resolution timeline.
6. The resolution authority may change the deadline set under paragraph 5 upon agreement with the CCP and the CCP's competent authority.
7. By derogation to paragraph 1, the resolution authority may decide to apply the methodology laid down in Article 6, after consulting the CCP's competent authority, in either of the following cases:
  - (a) the CCP does not provide the valuation of the early termination amount within the deadline set by the resolution authority pursuant to paragraph 5; or
  - (b) the CCP's valuation of the early termination amount is not in line with the CCP default procedures set out in compliance with Article 48 of Regulation (EU) No 648/2012.

#### *Article 8*

##### *Point in time for establishing the value of derivative liabilities and early determination*

1. The valuer shall determine the value of derivative liabilities at the following point in time:



- (a) where the valuer determines the early termination amount at the prices of replacement trades pursuant to Article 6(1), the day and time of the conclusion of the replacement trades;
  - (b) where the valuer determines the early termination amount in accordance with the CCP default procedures pursuant to Article 7(1), the day and time when the early termination amount has been determined by the CCP;
  - (c) in all other cases, the close-out date or, where that would not be commercially reasonable, the day and time at which a market price is available for the underlying asset.
2. The valuer may, as part of a provisional valuation carried out pursuant to Article 36(9) of Directive 2014/59/EU, determine the value of liabilities arising from derivatives earlier than at the point in time determined pursuant to paragraph 1. Such early determination shall be made on the basis of estimates, relying on the principles laid down in Article 5 and Article 6 (2) to (5), and on data available at the time of the determination.
3. Where the valuer carries out an early determination pursuant to paragraph 2, the resolution authority may at any time request the valuer to update the provisional valuation to take into account relevant observable market developments or evidence of commercially reasonable replacement trades concluded at the point in time determined pursuant to paragraph 1. These developments or evidence, where available by the date and time specified pursuant to Article 3(2), shall be taken into account in the *ex post* definitive valuation carried out pursuant to Article 36(10) of Directive 2014/59/EU.
4. Where the valuer carries out an early determination pursuant to paragraph 2 in relation to derivative contracts entered into between an institution under resolution acting as a clearing member and a CCP, the valuer shall take due account of any estimate of expected close-out costs provided by the CCP.

Where the CCP provides a valuation of the early termination amount in accordance with the CCP default procedures by the deadline set pursuant to Article 7(5) and (6), that valuation shall be taken into account in the *ex post* definitive valuation carried out pursuant to Article 36(10) of Directive 2014/59/EU.

*Article 9*  
*Entry into force*

This Regulation shall enter into force on the twentieth day following that of its publication in the Official Journal of the European Union.



This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

*For the Commission*  
*The President*

On behalf of the President  
[Position]

## 4. Accompanying documents

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### 4.1. Draft Cost-Benefit Analysis / Impact Assessment

#### Introduction

Article 49(5) of Directive 2014/59/EU (the Bank Recovery and Resolution Directive, BRRD)<sup>5</sup> mandates the EBA to develop draft regulatory technical standards (RTS) to specify the methodologies and principles to be applied by resolution authorities and independent valuers for determining the value of liabilities arising from derivative contracts with a view to applying bail-in powers.

Article 10(1) of the EBA Regulation provides that when any regulatory technical standards developed by the EBA are submitted to the Commission for adoption, they should be accompanied by an analysis of ‘the potential related costs and benefits’. This analysis should provide an overview of the findings regarding the problem to be dealt with, the solutions proposed and the potential impact of these options. This annex presents the assessment of the policy options considered in these draft RTS.

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<sup>5</sup> Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, OJ L 173/12.6.2014, p. 190.

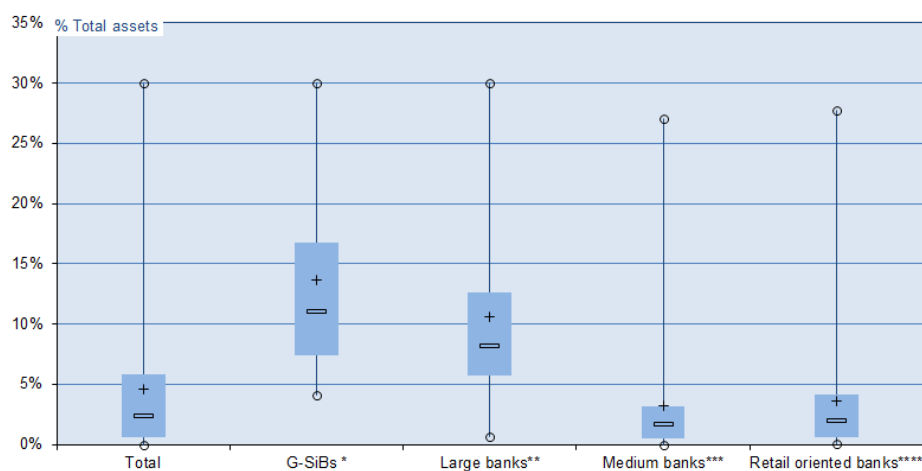
## Background and problem identification

*In some EU banks, derivative liabilities represent the category of liabilities that could absorb the largest fraction of losses beyond those covered by the equity and subordinated debt.*

The derivatives market is one of the largest segments of financial markets. As of December 2014, the global over-the-counter (OTC) derivatives market amounted to nearly USD 700 trillion in terms of notional amount outstanding (an increase of nearly 50% since 2007) and had an estimated gross market value (which represents the maximum loss that market participants would incur if all counterparties failed to meet their contractual payments and the contracts were replaced at current market prices) of EUR 17 trillion.<sup>6</sup>

Particularly in Europe, the derivatives market has been very dynamic thanks to the development of the EU single market and the introduction of the EU Investment Services Directive in January 1996.<sup>7</sup> Many European banks are currently global leaders in derivatives and some of them (i.e. G-SIBs and large banks) hold more than 13% of their total assets in the form of derivative liabilities (see Figure 1). As a result, in case of resolution, derivative liabilities could constitute a significant buffer to absorb potential losses.

**Figure 1: Derivative liabilities as a share of total assets (2013)<sup>8</sup>**



\*G-SIBs as classified by the FSB

\*\* Banks with Total assets > EUR 300 billion (including G-SIBs)

\*\*\* Banks with Total assets < EUR 300 billion

\*\*\*\* Banks with  $\frac{\text{Total retail and corporate deposits}}{\text{Total Assets}} > 30\%$

<sup>6</sup> BIS, 'Statistical release: OTC derivative statistics at end-June 2013', November 2013; [http://www.bis.org/publ/otc\\_hy1311.pdf](http://www.bis.org/publ/otc_hy1311.pdf)

<sup>7</sup> Council Directive 93/22 on investment services in the securities field, 1993 O.J. (L 141) 27, corr. at 1993 O.J. (L 170) 32 and (L 194) 27.

<sup>8</sup> Figure 1 indicates for each banking group the degree of dispersion (spread) in the share of derivatives over total assets. The bottom and top of the box represent the first and third quartiles. The band inside the box is the second quartile (the median) and the cross stands for the mean. Minimum and maximum values are displayed with a circle.

*Source: SnL, EBA calculation based on a sample of 132 largest banks within EU countries.*

*However, establishing derivative liabilities following a counterparty default is complex and there is no current framework that would allow an efficient bail-in of the derivative liabilities in case of resolution.*

The difficulties observed in large bank liquidations during the recent financial crisis have been partly attributed to poor bankruptcy planning and poor oversight of the derivatives market. The OTC derivative settlements following default have typically been long and complex procedures. The complexities involved can lead to legal disputes.

Indeed, a study by Michael J. Fleming and Asani Sarkar<sup>9</sup> shows that the complexity of Lehman Brothers' bankruptcy was mainly rooted in OTC derivative transactions. As a result, the creditors' recovery rate for such liabilities was far below historical averages observed in the US (28%) and below those of similar firms.

This situation raised concerns about the difficulties in bailing in derivative liabilities for an institution under resolution, which raised the need to define an efficient bail-in framework for derivative liabilities.

*In addition, the absence of a credible bail-in framework for derivatives could lead to moral hazard and negative externalities.*

OTC derivatives still constitute the largest fraction (91% in June 2013) of the total global derivatives market. Following global reforms (for instance the adoption of the EMIR<sup>10</sup> in the EU), a majority of them (60%) are now centrally cleared through a central counterparty (CCP) and collateralised due to the strengthening of the regulation to mitigate counterparty risks in many jurisdictions (see Figure 2). The global share of centrally cleared OTC derivatives is expected to further increase up to a potential of 75%, according to Eurex Clearing<sup>11</sup>.

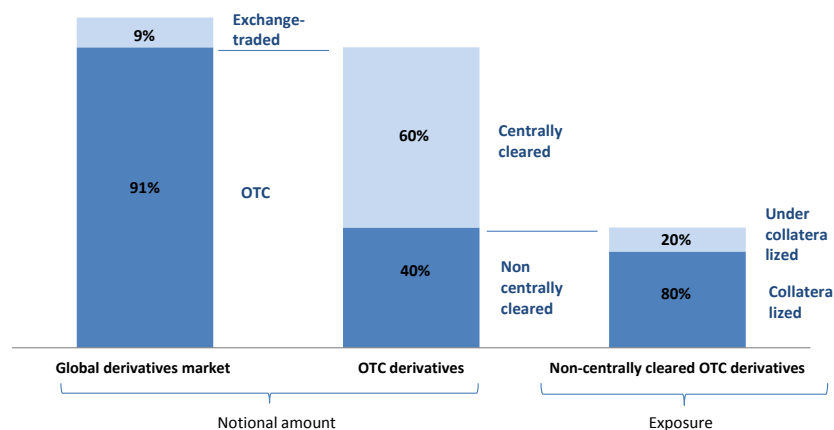
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<sup>9</sup> FRBNY *Economic Policy Review*, M. J. Fleming and A. Sarkar (December 2014), 'The failure resolution of Lehman Brothers'.

<sup>10</sup> Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories; OJ L 201, 27.7.2012, p. 1.

<sup>11</sup> Deutsche Börse Group and Eurex Clearing, White paper 'How central counterparties strengthen the safety and integrity of financial markets', July 2014.

Figure 2: The derivatives market in June 2013<sup>12</sup>



Sources: BIS 2013, FSB 2013a, ISDA 2013, ISDA 2014b.\*

In principle, central clearing improves price transparency and risk mitigation. CCPs are required to have in place sound procedures for dealing with defaulting counterparties (clearing members) and covering any open positions. They also have a strong incentive to revalue derivative contracts regularly in order to keep sufficient collateral against a potential default of a clearing member and the subsequent liquidation of the position.

Collateralised liabilities would in any event be exempted from bail-in, in accordance with Article 44(2)(b) of the BRRD. However, in the absence of a credible valuation methodology for bailing-in uncollateralised derivative liabilities, counterparties might expect such liabilities to be exempted. This could create incentives for banks such as disguised funding through insufficiently collateralised derivatives. Such behaviour would create moral hazard towards other creditors. In the event of a resolution and bail-in, counterparties could also misrepresent their exposure towards the institution under resolution or procrastinate in filing their valuation, thus jeopardising the efficiency of the resolution process.

## Objectives of the RTS

Against this background, the main objective of the draft RTS is to ensure an efficient bail-in of eligible derivative liabilities by 1) providing clear guidance to resolution authorities on how to perform the valuation and 2) ensuring maximum transparency for market participants.

The draft RTS also aim to:

- guarantee maximum legal safety for counterparties and resolution authorities by ensuring

<sup>12</sup> Deutsche Börse Group and Eurex Clearing, *ibid*.

- a smooth articulation between the draft RTS and the counterfactual no-creditor-worse-off principle;
- allow the valuation methodology to be practicable in a very restricted period (resolution period) while taking into account the broader context of the derivatives market and any concerns about financial instability.

## Policy options

While drafting the draft RTS, the EBA considered several policy options under three specific subject areas:

1. Reliance on derivative contracts to determine valuation methodology (i.e. extent to which the resolution authorities can deviate from the contractual terms)
  - Option A suggests that the resolution authorities fully apply the contractual terms, which, based on market practice, would often mean relying on the other (non-defaulting) counterparty for the termination and valuation.
  - Option B suggests that the resolution authorities apply contractual terms but can amend the valuation obtained under certain circumstances.
  - Option C suggests that the resolution authorities respect the netting set as defined in the netting agreement, but shall apply a specific methodology as defined in the draft RTS. The methodology would consider common market practice, such as calculating the close-out amount with reference to replacement costs.
  
2. Reference date for the valuation (reference date used by the resolution authorities to determine the value of the derivatives)
  - Option A: The resolution authorities would determine the valuation by reference to the moment when the institution was put into resolution.
  - Option B: The resolution authorities would determine the valuation by reference to the moment of a close-out.
  - Option C: The resolution authorities would determine the valuation by reference to the moment of a close-out or as soon as commercially reasonable thereafter.
  - Option D: The resolution authorities would perform the valuation at a moment which is convenient for the resolution objective, with an option to correct it at a later point in time.
  
3. Treatment of centrally cleared derivatives (resolution of a clearing member)
  - Option A proposes that the same valuation methodology is applied to all derivatives, regardless of whether they are centrally cleared.
  - Option B suggests that the CCP should implement its default procedure without any

intervention by the resolution authorities.

- Option C would allow for the implementation of the default procedure as defined by the CCP, but with a minimum level of intervention by and agreement with the resolution authorities, in order to ensure that the procedure is carried out within the resolution strategy timeline.

## Cost and benefit analysis

The following table shows the advantages and disadvantages of each of the options considered in these draft RTS:

Areas	Options	Advantages	Disadvantages
1 Reliance on derivative contracts to determine the valuation methodology.	A. Apply contractual terms to the letter	<ul style="list-style-type: none"> <li>• Full symmetry with insolvency counterfactual</li> <li>• Predictability for counterparties</li> </ul>	<ul style="list-style-type: none"> <li>• Can be time-consuming and complex to implement for RA (resolution authority)</li> <li>• Risk of misrepresentation of claims by counterparties</li> <li>• No control by the RA</li> <li>• Possible inconsistencies with BRRD (e.g. that the RA ‘determines’ the value)</li> <li>• Process would most likely exceed the resolution timeline and could undermine the resolution objectives</li> </ul>
	B. Apply contractual terms with possibility for corrections by RA	<ul style="list-style-type: none"> <li>• In principle symmetry with insolvency counterfactual</li> <li>• Possibility to avoid risk of misrepresentation of claims</li> </ul>	<ul style="list-style-type: none"> <li>• Can be time-consuming and complex to implement for RA (resolution authority)</li> <li>• Difficult for RA to scrutinise</li> </ul>
	C. Respect netting sets but apply a methodology in line with market practice	<ul style="list-style-type: none"> <li>• Easier implementation for RA</li> <li>• Transparency and clarity for counterparties, as in line with common market practice</li> <li>• In line with the resolution timeline and objectives</li> <li>• Avoids risk of claim misrepresentation</li> <li>• Limited risk of breaching the no-creditor-</li> </ul>	<ul style="list-style-type: none"> <li>• May require contracts to reflect special termination provisions in the context of BRRD resolution</li> </ul>

			worse-off principle as aligned to market practice	
2	Reference date for valuation	A. Moment of entry into resolution	<ul style="list-style-type: none"> <li>RA can perform all valuations (i.e. estimation of destruction in value and actual valuation) on the basis of a single value</li> </ul>	<ul style="list-style-type: none"> <li>Ignores the counterparty's actual replacement costs incurred in replacing the contract</li> <li>Increased risk of breaching the no-creditor-worse-off principle</li> </ul>
		B. Moment of close-out	<ul style="list-style-type: none"> <li>RA can determine the moment when the liability valuation would be most advantageous for the resolution</li> </ul>	<ul style="list-style-type: none"> <li>Ignores the counterparty's actual incurred replacement cost in replacing the contract</li> <li>Increased risk of breaching the no-creditor-worse-off principle</li> </ul>
		C. At close-out or as soon as commercially reasonable	<ul style="list-style-type: none"> <li>Transparency and clarity for counterparties, as aligned to market practice</li> </ul>	<ul style="list-style-type: none"> <li>Can delay the resolution process (e.g. if the valuation process is dependent on data observable only on the next trading day)</li> <li>Can expose counterparties to market volatility following resolution</li> </ul>
		D. At a moment convenient for the resolution objective, with an option to correct it at a later point	<ul style="list-style-type: none"> <li>RA can have a reliable valuation in order to take decisions on resolution</li> <li>May be necessary due to urgency of resolution</li> </ul>	<ul style="list-style-type: none"> <li>Valuation made without relying on observed market price changes for potential replacement trades – risk of breaching the no-creditor-worse-off principle</li> <li>Particular risk for CCPs (legal, financial)</li> <li>Possibility to correct it later might increase the RA's additional administrative costs</li> </ul>
3	Treatment of centrally cleared derivatives	A. Apply same methodology for all derivatives	<ul style="list-style-type: none"> <li>Consistency across the board</li> </ul>	<ul style="list-style-type: none"> <li>Legislation requires CCPs to have in place default procedures aiming at minimum liquidation/replacement cost</li> <li>Losses exceeding collateral can endanger CCP and the financial stability</li> <li>Increased risk of deviation between RA's close-out amount and actual close-out</li> </ul>

			amount <sup>13</sup>
	<b>B. Apply CCP default procedure without intervention</b>	<ul style="list-style-type: none"> <li>Justified by the quality of CCP's default procedures</li> <li>Respects systemic role of CCPs</li> <li>Ensures maximum predictability to market participants</li> </ul>	<ul style="list-style-type: none"> <li>May exceed resolution timeline</li> <li>May expose CCP to extreme market volatility, as market participants might be aware of the CCP being subject to close-out and have to re-hedge or replace open positions</li> </ul>
	<b>C. Apply CCP default procedure but with possible intervention of the RA</b>	<ul style="list-style-type: none"> <li>Justified by the quality of CCP's default procedures</li> <li>Respects systemic role of CCPs</li> <li>Grounds for alignment with resolution timeline and objectives</li> </ul>	<ul style="list-style-type: none"> <li>CCP may need to adjust its default procedures in order to perform default procedures outside market hours</li> </ul>

## Preferred policy options

**Option 1C. The resolution authorities respect the netting set defined in the netting agreement, but shall apply a specific methodology as defined in the draft RTS by taking into account common market practice, such as calculating the close-out amount by reference to replacement costs.**

Taking into account the BRRD mandate and the very important risks that arise in delaying the conclusion of a resolution and the potential risk of counterparties misrepresenting their claims, option C appears to be the option that best serves the draft RTS objective.

**Options 2C+2D. The resolution authorities would determine the valuation by reference to the moment of close-out or as soon as commercially reasonable thereafter. However, the resolution authority would also have the ability to perform the valuation at the moment most convenient for the resolution objective, with an option to adjust it later, when justified by the urgency of the resolution.**

In respect of derivatives, the reference date for close-out valuation appears to be a very important

<sup>13</sup>The CCP must have a balanced book, which means that in principle any 'open position' resulting from a close-out will be re-hedged or replaced. This will result in an observable close-out amount. If the RA's valuation is different, as suggested by option C in area 1, then this observable close-out amount could give rise to litigation and a claim of breach of the no-creditor-worse-off principle.



element, as indicated by relevant jurisprudence.<sup>14</sup> It is therefore preferable to choose the option that is aligned to market practice. However, option D provides significant advantages, in particular catering for the urgency of resolution, while allowing subsequent correction. The EBA has therefore decided to follow option C as the main option in combination with option D, which can be pursued, when justified, and with a particular provision that the resolution authority will update its valuation at a later stage, to take into account the outcome of CCP default procedures.

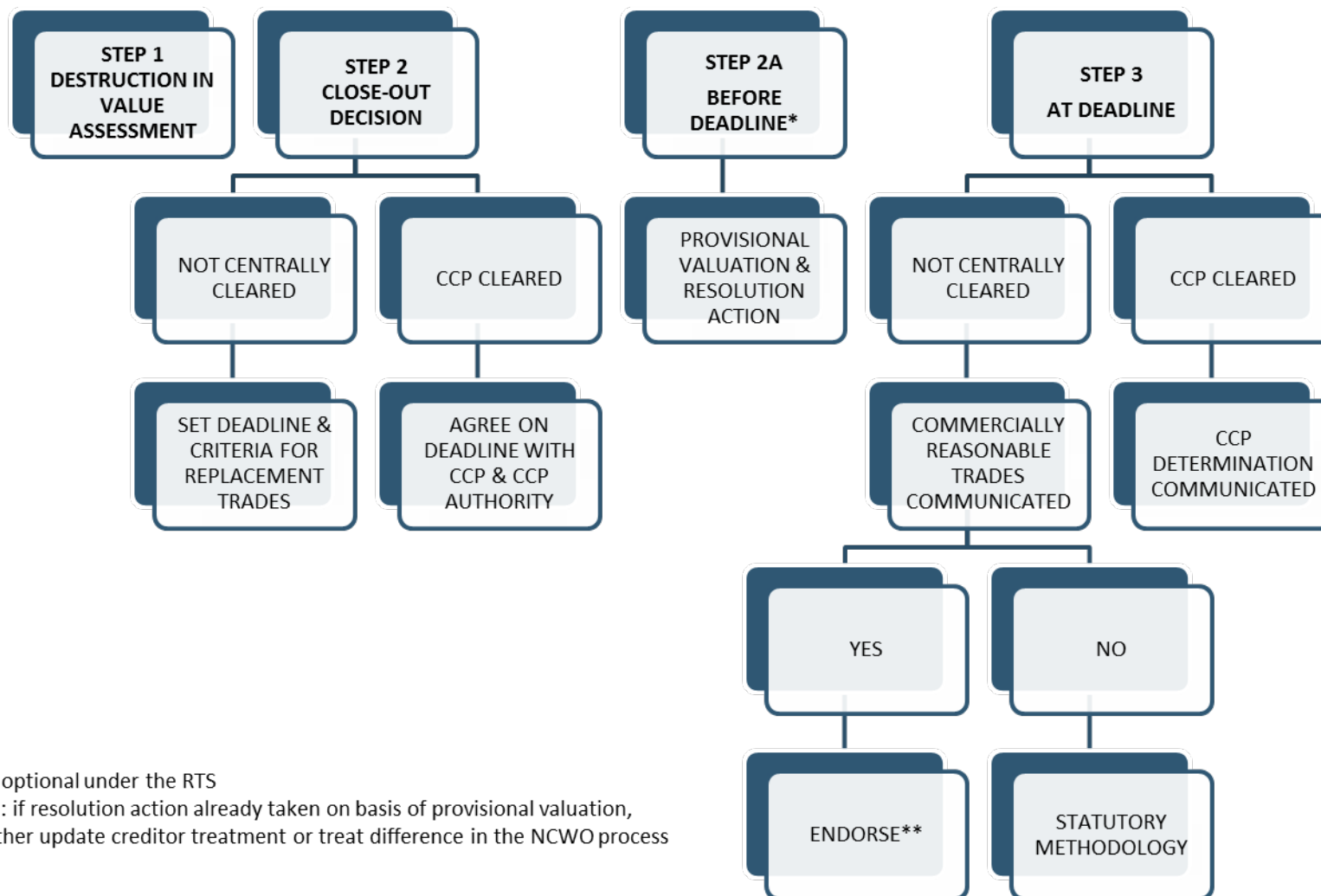
**Option 3C. Apply the default procedure as defined by the CCP, but with a minimum level of intervention by and in agreement with the resolution authorities. This is to ensure that the procedure is carried out within the resolution context.**

As described in this impact assessment in the sections on background and problem identification, the role of CCPs has been enhanced by recent legislation and is expected to significantly improve transparency and risk mitigation in the derivatives market. Their function should therefore not be undermined. The risk of litigation and breaching the no-creditor-worse-off principle was also judged as significantly high. It was on the other hand considered important to reserve a role for the resolution authority, to ensure, to the extent possible, consistency with the resolution timeline and objective.

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<sup>14</sup> See for instance *Lehman Brothers Finance S.A. (in liquidation) v. Sal. Oppenheim Jr. & Cie. KGAA*, [2014] EWHC 2627 (Comm).

### Summary of key decisions under the RTS



\*: optional under the RTS

\*\* : if resolution action already taken on basis of provisional valuation, either update creditor treatment or treat difference in the NCWO process

## 4.2. Views of the Banking Stakeholder Group (BSG)

Overall the Banking Stakeholder Group (BSG) supported the approach taken by the draft RTS and the guidelines and considered it appropriate to address the relevant aspects of the business reorganisation plan.

In particular, the BSG was of the same opinion, that both provisional and final valuations are necessary to cater for a smooth resolution process and a limitation of litigation risks. A close cooperation between the resolution authority and the valuer is crucial to update values regularly on the basis of obtainable data in order to enable resolution authorities to take their decisions on a best available information basis.

However, the BSG mentioned that the appropriate trade-off between the amount of information needed and the required swift decision is sometimes hard to achieve, especially with regards to the treatment of counterparties with claims that are difficult to assess. In any case, resolution authorities must have the possibility to manage the resolution process, e.g. by setting deadlines for the provision of information by counterparties.

With regard to the valuation methodology applied in the draft RTS, the BSG agreed with the aim of focusing on replacement costs as the counterparty's valid claim according to established market practices. Nevertheless, the BSG criticised the definition of 'commercially reasonable replacement trade' as it sets a too high a standard for the determination of replacement costs. Instead of only focusing on actual replacement trades, the draft RTS should additionally allow practical determinations, e.g. market quotations.

In addition to that, the BSG proposed incorporating a hierarchy of sources the valuer should use to perform the valuations, e.g. observable data before non-observable data, in order to achieve consistent and more objective valuations.

The BSG fully agreed with the treatment of CCPs. However, emphasis has been placed on the fact that valuers should respect CCP valuations if those are available and produced in accordance with appropriate default management procedures, in order to avoid litigation and the risk of breaching the no-creditor-worse-off principle.

With regard to the destruction in value assessment, the BSG agreed with the main drivers described in Article 8(1)(b) of the RTS by mentioning that this assessment will probably be based on insufficient information as part of a provisional valuation. Therefore, more guidance on the concepts and situation the precautionary buffer covers would be useful.

## 4.3. Feedback on the public consultation

The EBA publicly consulted on the draft proposal contained in this paper. It also consulted the European Securities and Markets Authority (ESMA), as per the relevant BRRD requirement (Article 49(5)).

The consultation period lasted for 3 months and ended on 13 August 2015. Ten responses were received, of which eight were published on the EBA website.

This paper presents a summary of the key points and other comments arising from the consultation, the analysis and discussion triggered by these comments and the actions taken to address them if deemed necessary.

In many cases several respondents made similar comments or the same respondent repeated its comments in response to different questions. In such cases, the comments and the EBA's analysis are included in the section of this paper where the EBA considers them most appropriate.

Changes to the draft RTS have been incorporated as a result of the responses received during the public consultation.

### **Summary of key issues and the EBA's response**

Respondents broadly supported the approach followed in the draft RTS, while expressing concerns or making suggestions on the following topics.

#### **1. Practical application of bail-in to derivatives**

Some respondents have pointed to the anticipated difficulties in the practical application of the powers of write down and conversion to derivatives, provided that derivatives more likely to be bailed in should be OTC, not collateralised contracts, which are more difficult to value and drawn up with non-financial counterparties, who could be less responsive to resolution authorities. Therefore, they have expressed a preference for resolution authorities to make a broad use of their discretionary exemption powers pursuant to Article 44(3) of the BRRD and set the deadlines in a flexible manner.

#### **EBA response**

The conditions for using powers under Article 44(5) are out of the scope of the draft RTS, whose main aim is setting a clear and feasible framework for valuing derivatives in the context of resolution, even the more complex ones. The draft RTS allow resolution authorities to set more flexible deadlines taking into account specific circumstances.

#### **2. Methodology for the determination of value**

Some respondents suggested that the methodology to value derivatives was not fully aligned with market practice, as it only recognised actual replacement trades and not quotations obtained by the counterparties of the institution under resolution. They also suggested a more detailed outline of the statutory methodology to be followed in case replacement trades are not available or commercially reasonable.

#### **EBA response**

The EBA believes that actual replacement trades, if concluded on commercially reasonable terms, are the most objective source for a valuation for resolution purposes. Nevertheless, the EBA has amended the draft RTS in order to include counterparties' quotations among the data sources to be used to carry out the statutory valuation. Amendments have been introduced to outline the statutory methodology more clearly.

### **3. Treatment of CCPs**

Only one respondent expressed concerns about the possibility for the resolution authority to depart from the CCP internal default procedure for the valuation, raising the risk of systemic risk. Some respondents suggested clarifications of the possibilities for deviation and the impact that it may have on the CCP default procedure and loss allocation.

#### **EBA response**

Avoidance of adverse effects on the financial system and contagion to market infrastructures is among the resolution objectives (Article 31 of the BRRD) and is therefore inherent in the decision-making procedure that the resolution authority should follow when taking any resolution action. The draft RTS have been amended with additional flexibility before deviating from the CCP default procedure. Any valuation not based on the CCP default procedure would only serve resolution purposes. CCPs will still be expected to run their default procedures according to their legal and contractual obligations and determine the losses or gains stemming from the close-out of the derivatives in question. In case of a provisional valuation, CCPs will also have the possibility to provide the valuer with estimates of the expected outcome of their default procedure.

#### **Use of provisional valuations**

The vast majority of respondents were of the opinion that provisional valuations and early determinations are necessary to ensure a swift resolution process. Nonetheless, respondents argued that any negative deviation of provisional valuations from the final values would probably trigger litigation. Therefore, an update of provisional values and thereby of the bail-in quota at a later stage, when market developments and (hypothetical) replacement cost evidence provided by the counterparty are available, would be very useful in order to avoid litigation.

#### **EBA response**

According to the updated draft RTS, resolution authorities and valuers will have the possibility to update their provisional valuations, and consequently adjust the extent of the write down and conversion, until the definitive values pursuant to Article 36(10) of the BRRD have been determined.

### **4. Destruction in value**

Most respondents agreed with the main drivers described in Article 8(1)(b) of the RTS, noting that this assessment will probably be based on insufficient information as part of a provisional

valuation. Some respondents requested more guidance on the concepts and situation of the precautionary buffer.

**EBA response**

An attempt to provide an exhaustive list of all possible factors would risk hindering the ability of the resolution authority to take into account the circumstances of each case. The list includes provisions for any precautionary buffer against possible adverse implications from close-out, such as errors and disputes on transactions or in respect of collateral exchange.

## Summary of responses to the consultation and the EBA's analysis

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
<b>General comments</b>			
BRRD rules on exemptions from bail-in	Some respondents suggested an exemption of derivative liabilities from the scope of the bail-in resolution tool.	Such a general exemption is not included in the BRRD and it would be out of the scope of these draft RTS.	No amendments to the draft RTS.
<b>Responses to questions in Consultation Paper EBA/CP/2015/10</b>			
1. Do you agree with the definitions above? Do you consider it necessary to specify some of them further, and in particular the definitions of 'commercially reasonable replacement trades' and 'unpaid amounts'?	<p>Some respondents suggested clarifying that replacement prices can be given for a group of closed-out transactions that can be netted, rather than necessarily for each transaction.</p> <p>Several comments suggest including in the 'unpaid amounts' interest or compensation accrued during the period from the date on which the relevant payment or delivery obligations fell due through to the relevant close-out date.</p> <p>Some respondents requested clarification of the term 'collateral'.</p> <p>One respondent suggested broadening the reference to porting so as to also consider 'partial porting', which is one of the options currently used by CCPs.</p> <p>The majority of respondents argued that requiring</p>	<p>Nothing in the original draft indicated that contracts should be replaced on a trade-by-trade basis, nor that exposures should be replaced by one (and only one) single trade. The EBA does not see any objection to the possibility that one replacement trade may replace more than one derivative contract, to the extent the counterparty provides evidence of a matching between the replacement trade occurred and the more than one contract having been replaced.</p> <p>The EBA does not consider that there is a need to define the term 'collateral', as this follows the definition and provisions of Directive 2002/47/EC on financial collateral arrangements.</p> <p>No explicit provision on porting is included in the main text of the draft RTS because porting will mechanically cancel an exposure to the extent a</p>	<p>Clarification in recitals that counterparties may choose to conclude one or more replacement trades to replace their exposure upon close-out.</p> <p>Amendment to broaden the definition of unpaid amounts.</p> <p>Deletion of the definition of porting, as the term is not used anywhere in</p>

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	<p>a counterparty to have made best efforts to obtain best value for money sets too high a standard in relation to ‘commercially reasonable replacement trade’. It is suggested to define a more realistic standard either accepting two different offers from dealers, or requiring ‘commercially reasonable efforts’ and ‘a price that is commercially reasonable’.</p> <p>Some respondents suggested adjusting the definition of close-out amount and early-termination amount in relation to derivatives cleared through a CCP to the results of the CCP’s own procedure to manage a member default (in particular, they suggested adopting a definition referring to the net amount that would result from the actions taken by a CCP to neutralise the risk associated with the defaulter’s portfolio and close out or transfer clients’ positions in accordance with its default procedures, after applying the collateral resources of the defaulter including initial margin, variation margin and its contributions to the default fund).</p>	<p>contract is taken over by a solvent member. <i>Mutatis mutandis</i> partial porting would also be taken into account as partially reducing the exposure between the parties. Therefore, while the EBA shares the objective of the respondents to ensure partial porting is covered as much as total porting, it believes this is already the case.</p> <p>The EBA is in favour of integrating the definition of unpaid amounts with the interest or compensation accrued until the close out date in line with common contractual practice.</p> <p>The EBA understands that it should not set an excessively high standard that would not be consistent with predominant market practice. It also notes that it is difficult to set a comprehensive definition of ‘commercially reasonable’ that would fit all the legal traditions in Europe as well as the very different market conditions and circumstances under which counterparties would have to replace. In practice, it is true that a party will often be able to demonstrate it has deployed reasonable efforts if it has contacted a sufficient number of dealers, obtained enough firm quotes and selected the best price. However, the resolution authority should remain in control of assessing these elements in the given circumstances.</p> <p>It is not appropriate to integrate a reference to the CCP inside the definitions of close out amount and of early termination amount, as it would introduce confusion between the valuation principle and the manner in which (or the entity from which) it is</p>	<p>the text of the draft RTS. Proper reference to porting is, however, included in a recital and a reference to partial porting has been added.</p> <p>Amendment to the definition of commercially reasonable replacement trade to requiring ‘reasonable efforts’, rather than ‘best’ efforts, to obtain best value for money.</p> <p>New recital supporting this change, emphasising the discretion of resolution authorities, and providing guidance as to the type of criteria that would typically be considered.</p>



Comments	Summary of responses received	EBA analysis	Amendments to the proposals
<p>2. Should the deadline given by the resolution authority to the counterparty be further framed? If yes, explain why and how? Does this drafting allow the resolution authority to conclude resolution actions in a sufficiently swift manner?</p>	<p>Some respondents suggested a flexible approach when setting deadlines, especially in relation to uncleared, uncollateralised, structured or illiquid derivatives with non-financial counterparties, which will be difficult to value within a business day. In any case, both close out date and deadline should be set on a business day.</p> <p>Some respondents suggested fleshing out in more detail the requirements regarding the notification of close-out (indication of netting agreement and transactions to be closed out, pre-defined period between the notification and the close out date, contractually agreed form). It was recommended to state explicitly that the notification of closing-out is to be undertaken at the same time as the bail-in announcement. It was suggested to also specify clearly that the master agreement will be terminated.</p> <p>One respondent suggested clarifying the sequencing among the provisional valuation, the bail-in action and the adjustments based on replacement trades data.</p>	<p>obtained.</p> <p>Nothing in the draft RTS obliges resolution authorities to set one-day deadlines for providing replacement trade. On the contrary, it is expected that the deadlines, as well as the point in time, will be set on a case-by-case basis depending on the characteristics of the derivatives (e.g. type of product, contractual features, nature of the counterparty, existence of netting agreements, complexity and so on).</p> <p>The EBA believes it is preferable not to introduce excessive specification in the RTS, in order to allow them to apply in different procedural environments across Member States.</p> <p>Sequencing between provisional valuations, definitive valuation and the no-creditor-worse-off valuation are already or will be outlined in the relevant draft RTS (Articles 36 and 74 of the BRRD). These RTS and the two abovementioned RTS should be considered jointly.</p>	<p>No amendments to the draft RTS.</p>
<p>3. This valuation principle is intended to be aligned with common market practice that recognises replacement costs in an early termination event, whilst giving certainty to the</p>	<p>Several respondents suggested aligning the valuation principle even more with contractual standards by not only taking into account replacement trades but also quotations provided by counterparties.</p> <p>One respondent considered that requiring</p>	<p>Securing valuations as close as possible to valuations performed upon close-out according to contracts is one of the main aims of the draft RTS, as it minimises the likelihood that differences from the insolvency counterfactual might arise. However, only actual replacement trades, which represent</p>	<p>Changes to Art. 6(4) to include data quotations provided by counterparties according to market standards</p>

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
<p>resolution authority on the methodology to be followed. Do you agree that this valuation principle would result in a fair valuation for the closed-out netting set and as such avoid a breach, from the counterparty's perspective, of the no-creditor-worse-off principle?</p>	<p>counterparties to enter into replacement trades would put pressure on markets and could lead to predatory pricing, with subsequent increase of losses of the bank in resolution. It suggested novation of derivatives to another bank as a better way of preserving value for counterparties and respecting the no-creditor-worse-off principle.</p> <p>Further guidance was sought as to the notion of 'obtaining the economic equivalent on material terms of the contract'.</p>	<p>replacement costs actually incurred by the counterparties, present such probing force, as unequivocal and objective elements that, if they are concluded on commercially reasonable terms, can be considered as values for resolution purposes. This does not mean that quotes, or replacement trades concluded after the deadline, may not be provided by counterparties and considered by the valuer in determining its valuation. However, in such cases these elements will only form part of the broader range of data sources laid down in Article 6(4) of the RTS.</p> <p>Given that the concept of economic equivalent commonly features in predominant contractual practice, it does not seem necessary to further define it. Furthermore, novation has as its effect to remove the need to value derivatives for bail-in purpose and therefore is out of the scope of these draft RTS.</p>	
<p>4. Do you agree with the preferential status given to commercially reasonable replacement trades? Should there be also a prioritisation among other sources of data?</p>	<p>The majority of respondents agreed with the preferential status given to 'commercially reasonable replacement trades', even though some of them underlined the practical difficulties of getting such data in a short timeframe.</p> <p>Some respondents were in favour of setting a hierarchical order between the data sources to be considered by the valuer when no commercially replacement trade had been provided by the deadline. Priority should be given to independent third parties data sources and valuation</p>	<p>Valuers should be able to consider the data sources that they consider best conducive to a prudent valuation considering the circumstances and the availability and reliability of data. Therefore it has been chosen not to excessively constrain the discretion of the valuer by introducing a hierarchy of data sources. Instead, some language has been introduced to reflect the objectives pursued by the valuer in considering data sources.</p>	<p>Amendment to Article 6(4) to recall the objectives pursued by the valuer in considering data sources. The order of data sources has also been revised, only for presentational purpose and without implying a</p>

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	techniques based on observable market variables.		hierarchical order.
<p>5. Do you agree with the method described under paragraph 2 for the resolution authority to calculate the close-out amount? Is there a reason to believe that mid-market prices might not always be available or possible to derive from other data sources? And under which circumstances? In that case, what do you consider as an appropriate reference for calculating the close-out amount?</p> <p>6. Should adjustments to the bid-offer spread, other than those specified under Article 6(4)(c), be considered?</p>	<p>Several respondents considered that the method described under Art. 5(2) of the draft RTS was appropriate in case a current market exists but in case of OTC products, especially structured ones, for which there is not a market or the market does not express reliable data due to high volatility, models have to be used.</p> <p>As for the factors for adjusting the bid-offer spread, some respondents suggested including additional valuation adjustment (AVA), in order to be aligned with CRD definitions.</p> <p>Others respondents suggested:</p> <ul style="list-style-type: none"> <li>- making reference to credit valuation adjustment (CVA) to estimate creditworthiness of the counterparties;</li> <li>- considering factors such as creditworthiness of the institution under resolution, market depth, liquidity risk, concentration risks, differences between collateral terms applicable to the terminated and new transaction, differences of trading documentation, cost of exit-novation and of re-hedging, funding cost for the counterparty.</li> </ul> <p>One respondent argued that for certain derivative products it would be preferable to determine close out amount over a period of more than one day (e.g. five days) rather than using a firm deadline.</p>	<p>The draft RTS already cater for the use of models (see Art. 6(4)(b)). It is also implicit that valuers may have to provide for longer deadlines for providing replacement trades or establishing valuations where pricing is difficult to obtain. In certain cases resolution authorities may even consider applying the exemption in Article 44(3)(a) if it is impossible to value, and therefore to bail-in, derivatives within a reasonable time.</p> <p>Other possible adjustment factors may be added such as the degree of liquidity of the market, the cost of funding for the counterparty or model risk.</p> <p>The point of the methodology in Article 6(2) is not to assess the price of actual replacement trades but that of hypothetical replacement 'costs'.</p>	<p>Amendments to Article 6(2) on the possible adjustments to mid-prices and bid offer spreads.</p>

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	<p>Another respondent highlighted the importance that resolution authorities verify the ability of market participants to trade at the indicated bids.</p>		
<p>7. Do you agree with the treatment of CCPs as laid down in this Article? Are the conditions laid down in this article compatible with a swift and efficient valuation of cleared derivatives within the context of a resolution process? Do you see any material risk that the treatment of CCPs as laid down in this Article could conflict with the requirements for a sound risk-management framework to deal with the default of a clearing member?</p>	<p>Several respondents emphasised the systemic role of CCPs and suggested further deferring to CCP default procedures. For some respondents it should be for CCPs, in agreement with the resolution authorities and the CCPs' competent authorities, to determine the deadline for submitting the early termination amount.</p> <p>Two respondents suggested more flexibility in the deadline agreed under Article 6(5) of the draft RTS and that the CCP's best endeavours in managing its default procedure should be considered.</p> <p>Some respondents emphasised the need to avoid any adverse impact on the default management process of a CCP, while respecting the bail-in procedure.</p> <p>One respondent suggested that the resolution authority should consult with the CCP and the CCP's competent authority before the notification to close-out.</p>	<p>The draft RTS need to balance the specificities of CCPs and their systemic role with the resolution objectives and swiftness. Avoidance of adverse effects on the financial system and contagion to market infrastructures is among the resolution objectives (Article 31 of the BRRD) and is therefore inherent in the decision-making procedure that the resolution authority should follow when taking any resolution action. The EBA considers that it is necessary to allow for flexibility in the deadline agreed by stakeholders in justified cases, although a compulsory consultation before the close-out could undermine the swiftness inherent in resolution action.</p> <p>The EBA agrees that any deviation from the CCP default procedure could risk adverse impacts. The EBA clarifies that any determination made by the resolution authority pursuant to Article 6(8) of the RTS, and therefore not based on the CCP determination, would only serve resolution purposes.</p> <p>Furthermore, the draft RTS will acknowledge that, in case of provisional valuation pursuant to Article 8, the CCP may provide to resolution authorities any information or estimation that is relevant.</p>	<p>Changes to Art. 6(2) and (4), Article 7 and Article 8(3).</p>
<p>8. Article 7(1) is intended to be</p>	<p>According to the consultation feedback received, it</p>	<p>It is possible derivative close-out decisions, as well as</p>	<p>No amendments.</p>

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
<p>aligned with market practice in early termination events. Do you see a risk of increased market volatility on the first market day following the close-out notification, which could adversely affect the termination value? Do you consider the notion of 'commercially reasonable' date sufficiently self-evident or should it be further specified?</p>	<p>is highly likely that a default of a significant derivatives market participant, e.g. of the magnitude of Lehman, will increase market volatility. In addition to that, in cases where the resolution authority does not take its decisions on the close-out of derivative contracts immediately after the resolution decision, e.g. on the same resolution weekend, market uncertainty with regards to which derivative contracts will be closed out will very likely affect market volatility negatively.</p> <p>One respondent was of the opinion that what is deemed to be a 'commercially reasonable date' should be further defined. The test of commercial reasonableness should not be linked to whether a price is available, but whether it is reasonable for a closed-out counterparty to be replacing trades in the market on that day.</p> <p>Another respondent was of the opinion that the volatility after the close-out date should not be included in the determination of value as it is an effect, but not the cause, of the resolution.</p>	<p>resolution decisions in general, may affect market volatility. The resolution process is meant to avoid systemic contagion and improve the situation on financial markets in comparison to a normal insolvency of the defaulting institution. The valuation methodology designed in the draft RTS aims at identifying actual, or estimating hypothetical, replacement costs for the counterparty in line with established market practices. In order to cater for the fact that actual replacement costs or even best estimates are only available after the close-out decision, the draft RTS leave it to the resolution authority's discretion to set a deadline to provide evidence of actual replacement trades. This deadline should on the one hand cater for the necessities of a suitable resolution process, as it should not last forever, and on the other hand incorporate the counterparty's chance to calculate its replacement costs either on the basis of actual or hypothetical replacement costs. In any case, resolution authorities will determine the value of closed-out derivatives pursuant to Art. 49(4) of the BRRD on the basis of all available information.</p> <p>As the identification of the commercially reasonable date largely depends on the nature of the derivatives as well as on the circumstances and market developments of the single resolution situation, resolution authorities and valuers should be in charge of determining the deadline and thereby deciding on the commercially reasonable date on a case-by-case basis.</p>	

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<p>9. As provided for under Article 7(2), the resolution authority will have the possibility to produce a valuation at a date or time earlier than the earliest commercially reasonable date as part of a provisional valuation carried out pursuant to Article 36(9) of the BRRD. This possibility is intended to allow for a swifter resolution process as resolution authorities will be able to apply the write down and conversion powers on the basis of the early determination. As in all cases where taking resolution action based on a provisional valuation, resolution authorities will update their determination either as part of a subsequent provisional valuation or the final valuation. At that point they will either adjust the write down and conversion of creditors, provided they have previously made the necessary arrangements such as holding sufficient equity, or provide alternative compensation, if</p>	<p>The vast majority of respondents were of the opinion that provisional valuations and early determinations were strictly necessary to ensure a swift resolution process.</p> <p>Notwithstanding the above, respondents argued that any negative deviation of provisional valuations from the final values would probably trigger litigation. Therefore, an update of provisional values at a later stage, when market developments and (hypothetical) replacement cost evidences provided by the counterparty are available, would be very useful to avoid litigation.</p>	<p>The EBA takes note of the overall support for the provisional valuation reference.</p> <p>Pursuant to Articles 36(6) and (9) of the BRRD, resolution authorities have an explicit right to conduct provisional valuations and take resolution actions (including bail-in) on the basis of those provisional valuations. With regards to derivative contracts it could be necessary to take resolution action within a short time period, even within a resolution weekend, in order to re-establish market stability. This right cannot be limited by these draft RTS.</p> <p>According to the current wording of the draft RTS, resolution authorities and valuers have the possibility to update their provisional valuations, and consequently adjust the extent of the write down and conversion, until the definitive values pursuant to Art. 36(10) of the BRRD have been determined.</p> <p>Even if counterparties have not provided the relevant information within the set deadline, resolution authorities will have a strong interest in avoiding litigation and no-creditor-worse-off claims, and taking into account, in their definitive valuation, all available evidence of actual or hypothetical replacement costs, including evidence provided by the counterparty. Only in exceptional circumstances, where it is necessary to finalise the resolution process as soon as possible, e.g. to re-establish market stability, resolution authorities may decide to determine the final values on the basis of available</p>	<p>Amendment to recital 23:</p> <p>Where the resolution authority takes resolution action on the basis of the provisional valuation consistently with Article 36(12) of Directive 2014/59/EU, relevant market developments observed or evidence of actual replacement trades at the reference point in time would either be reflected in a subsequent provisional valuation or, in the final valuation carried out pursuant to Article 36(10) of Directive 2014/59/EU.</p> <p>Amendment to RTS by adding new Art. 3(4): 4.</p> <p>The</p>

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<p>necessary, on the basis of the final valuation of difference in treatment pursuant to Article 74 of Directive 2014/59/EU. Do you consider this optional early determination appropriate, or do you consider that this option would unreasonably increase the risk of litigation or ex post compensation according to Article 74 of the BRRD?</p> <p>10. Alternatively, should resolution authorities always wait until there is pricing available in the market before producing their valuation, and therefore wait until that date before applying the bail-in tool?</p>		<p>information at or shortly after the deadline.</p> <p>CCPs should indeed have the possibility to provide the valuer with estimates of the expected outcome of their default procedure, as an additional safeguard against possible deviations.</p> <p>In any event, all available information will be taken into account by the independent valuer when conducting the valuation of difference in treatment pursuant to Art. 74 of the BRRD.</p>	<p>resolution authority may change the date and time by which counterparties may provide evidence of commercially reasonable replacement trades where such change is consistent with Article 8(1)(c).</p>
<p>11. The possibility to produce an early determination is available also in relation to claims of a CCP. In this case the final valuation will reflect the CCP claim as determined pursuant to Article 6, on the basis of the CCP default procedures if provided under the conditions of that Article.</p>	<p>Only one respondent argued that – with regard to CCP traded derivatives – a provisional valuation would endanger systemic stability if resolution authorities did not wait until the result of CCPs’ internal default management procedures is available.</p> <p>One respondent suggested restricting the resolution authority’s power to rely on early determination in cases where the CCP does not</p>	<p>In general, the valuations need to be conducted taking into consideration the following interests:</p> <ul style="list-style-type: none"> <li>• The resolution authority needs values for resolution/bail-in purposes within a short time period.</li> <li>• Counterparties want their claims to be valued properly and on the basis of their actual replacement costs.</li> </ul>	<p>No amendments to the draft RTS.</p>

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<p>Do you consider it appropriate to also allow an early determination in relation to CCP claims?</p> <p>12. If so, do you consider that, with regard to CCP claims, resolution authorities should always be obliged to adjust the bail-in treatment of the CCP if and once the CCP provides its determination pursuant to Article 6? In that case, how do you assess the risk that the CCP determination process could hold back the finalisation of the bail-in process also for other claims? Alternatively, does the assessment of difference in treatment pursuant to Article 74 of the BRRD provide a sufficient safety net for CCPs?</p>	<p>successfully finalise its internal default management procedure within the agreed deadline. This would enable resolution authorities to conduct their resolution measures within a suitable time period in order to re-establish market stability and reliability.</p> <p>On the other hand, the majority of respondents argued that the CCP's internal default procedures must not be disturbed by the resolution authority, as they are crucial for the stability of the CCP and therefore of the entire financial market. Resolution authorities should therefore use the values produced by the CCP within the deadline, and if produced after the deadline, always update previous values with the value achieved through the CCP internal procedure. This would also reduce the probability of violating the no-creditor-worse-off principle and thus of litigation.</p> <p>The assessment of the difference in treatment pursuant to Art. 74 of the BRRD was, according to one respondent, unlikely to provide a sufficient safety net, as the operational burden on a CCP to reclaim the value it had lost and then distribute it to its service users would probably lead to significant difficulties and litigation. However, other respondents were of the opinion that the no-creditor-worse-off valuation can work as a 'backstop' for CCP claims.</p>	<p>Any valuation not based on the CCP's default procedures would only serve resolution purposes. CCPs will still be expected to run their default procedures according to their contractual and rulebook obligations and determine the losses or gains stemming from the close-out of the derivatives in question.</p> <p>At the same time, pursuant to Article 36(6) and (9) of the BRRD, resolution authorities have an explicit right to conduct provisional valuations and take resolution actions (including bail-in) on the basis of those provisional valuations. With regards to derivative contracts it could be necessary to take resolution action within a short time period, even within a resolution weekend, in order to re-establish market stability. This right cannot be limited by these RTS, including in relation to CCPs.</p> <p>Avoidance of adverse effects on the financial system and contagion to market infrastructures is among the resolution objectives (Article 31 of the BRRD) and is therefore inherent in the decision-making procedure that the resolution authority should follow when taking any resolution action. Indeed, resolution authorities are by definition bound to have regard to resolution objectives as defined in Article 31(2) of the BRRD, including preventing contagion to market infrastructures. It is in this context that resolution authorities, taking into account expectations concerning e.g. the systemic risk and the estimated amount of unsecured liabilities, may come to the conclusion that</p>	



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		<p>derivative contracts should be exempted from the close-out if provisional valuations indicate the risk of jeopardising the CCP's stability.</p> <p>A crucial issue is whether resolution authorities should be obliged to update a provisional valuation if the CCP provides its valuation in line with its internal default management procedures even after the agreed deadline.</p> <p>In this regard it is likely that in most cases the resolution authority will factor into its definitive valuation the CCP's value produced under its default management procedure. First of all, the agreement of the CCP and the CCP's competent authority on the deadline will ensure that deadlines are realistic. The EBA considers that it is necessary to allow for flexibility in the deadline agreed by stakeholders in justified cases.</p> <p>Secondly, even if the CCPs have provided the relevant information within the set deadline, resolution authorities will have an interest in avoiding litigation by waiting for the counterparty and incorporating the actual or hypothetical replacement costs provided by the counterparty in its final values in order to prevent no-creditor-worse-off compensation claims. That is why the draft RTS may acknowledge the possibility for CCPs to provide resolution authorities with any information or estimation in the context of calculating the close out value based on the statutory approach.</p> <p>Finally, in extreme circumstances, where it is</p>	

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		<p>necessary to finalise the resolution process as soon as possible, e.g. to re-establish market stability, resolution authorities may decide to determine the definitive values on the basis of all available information at or shortly after the deadline. In such extreme case, in any event the valuation performed pursuant to Art. 74 of the BRRD will verify that the CCP has not been treated worse off than in insolvency proceedings, and in this context the value provided by the CCP as a result of its internal default management procedure will provide useful input.</p>	
<p>13. Do you find the guidance provided in paragraph 2 of this Article sufficiently clear as to the terms of comparison?</p>	<p>All respondents agreed with the guidance provided in paragraph 2 of Article 8 of the RTS.</p> <p>One respondent proposed adding further guidance on the technical realisation of the calculations.</p>	<p>The EBA notes that all respondents agreed with the guidance provided within paragraph 2 of Article 8 of the draft RTS.</p> <p>In the EBA's view, the words 'share of equally ranked liabilities' are self-explanatory (e.g. amount of the concerned liabilities as ratio of liabilities of the same level in the insolvency hierarchy, e.g. senior depending on the applicable law).</p>	<p>No amendment.</p>
<p>14. Do you agree with the main drivers of the destruction in value as described in this Article?</p>	<p>All respondents agreed with the main drivers of the destruction in value assessment as described in Art. 8 of the RTS.</p> <p>Some of them also proposed adding the following drivers:</p> <ul style="list-style-type: none"> <li>• additional consequential losses, e.g. novation and other close-out costs, and resultant contagion;</li> <li>• liquidity impacts;</li> </ul>	<p>According to Art. 44(3)(d) of the BRRD, derivative contracts may be excluded from bail-in if 'the application of the bail-in tool to those liabilities would cause a destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in.'</p> <p>By definition the destruction in value assessment will be a forward projection prone to uncertainty and will also be dependent on the available information and timeframe. An attempt to exhaustively list all</p>	<p>No amendments to the draft RTS.</p>

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	<ul style="list-style-type: none"> <li>• impact on ability and timing of (re-)hedging the new one-sided un-hedged market risk;</li> <li>• capital impacts.</li> </ul>	<p>possible factors, especially in such a broad way as the drafting proposed, would risk hindering the ability of the resolution authority to perform its function in line with the circumstances of each case. Therefore the list is considered sufficiently broad, especially considering that it includes any precautionary buffer against possible adverse implications from close-out, such as errors and disputes on transactions or in respect of collateral exchange.</p>	
<p>15. Do you agree with the provision for a precautionary buffer? Do you consider the indicative elements supporting this precautionary buffer as sufficient? Do you see other considerations that should be taken into account when calculating a precautionary buffer?</p>	<p>The majority of respondents understood the benefit of having the possibility to set a precautionary buffer against possible adverse implications from close-out within the destruction in value assessment. However, some respondents expect the RTS to be more precise in the description of the factors the precautionary buffer should cover. In particular, more guidance on the concepts and situations that the buffer covers and the way to assess or measure the costs arising from adverse scenarios would be useful. Apart from that, the draft RTS should clarify the reference to collateral exchange, e.g. whether it relates to errors or disputes in the valuation of collateral. One respondent argued that there is no need for a special precautionary buffer for derivative liabilities because of the possibility to use the buffer for provisional valuations pursuant to Art. 36 of the BRRD.</p>	<p>As explained in relation to question 14 some margin of manoeuvre must be given to resolution authorities in order to identify sources of uncertainties appropriate under the circumstances of a given case.</p> <p>The purpose of the buffer that can be used in provisional valuations pursuant to Art. 36(9) of the BRRD is different from the precautionary buffer discussed here. Indeed, the buffer in Article 36(9) is actually incorporated in the provisional valuation of assets and liabilities and may serve as a basis for applying resolution actions. In contrast, in the context of Article 8 of these draft RTS, the buffer is only part of a projection performed before taking the decision to close-out and bail-in derivatives, and is justified by the fact that it is impossible to predict how the value of the derivatives will move before they are actually closed out. Once the decision is taken and the liabilities are closed out, the elements factoring in the valuation, be it provisional or</p>	<p>No amendments to the draft RTS.</p>

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		definitive, are listed in Article 6 and 7.	
<p>16. In determining destruction in value, should resolution authorities incorporate into their analysis the impairment to the firm's franchise value that would result from the termination and closing-out of a firm's derivatives contracts and the cessation of its related business operations?</p>	<p>All respondents are in favour of incorporating any expected reduction in franchise value in the destruction in value assessment. In particular, after the bail-in tool has been applied, the franchise value of the new recapitalised bank will have an impact on the market value of shares issued to bailed-in creditors and will thus directly impact losses imposed on those liability holders. One respondent argued that the quantitative analysis of the destruction of franchise value would be both difficult for the resolution authority or the valuer and possibly questioned by third parties because of its subjective and questionable nature. Therefore, a clear demonstration of cause-effect relationships between the drivers and the amount of franchise value destruction should be required.</p>	<p>According to Art. 44(3d) of the BRRD, derivative contracts may be excluded from bail-in if 'the application of the bail-in tool to those liabilities would cause a destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in.'</p> <p>The losses borne by other creditors might very likely include – amongst other factors mentioned in Art. 8 of the draft RTS – losses derived from a variation of the franchise value of the resolved firm that would result from the termination and closing-out of a firm's derivative contracts. Theoretically, closing-out and bailing-in derivative contracts might also lead to an improvement of the firm's franchise value.</p> <p>In order to cater for both possibilities, resolution authorities should analyse the (expected) franchise value variation that derived from the close-out and bail-in of derivative contracts and incorporate this estimation in their destruction in value assessment. While this analysis may be prone to uncertainty, further specification does not appear realistic as the conclusion will depend on the circumstances.</p>	<p>The draft RTS already include the requirement for resolution authorities to incorporate into their analysis the impairment to the firm's franchise value that would result from the termination and closing-out of a firm's derivative contracts and the cessation of its related business operations. Therefore, no amendments to the draft RTS.</p>