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Commission Delegated Regulation (EU) 2016/1401 of 23 May 2016 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)

COMMISSION DELEGATED REGULATION (EU) 2016/1401

of 23 May 2016

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[(1)], 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.

(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

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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 (EU) 2016/860[(2)] adopted under Article 44(11) of that Directive. 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 Delegated Regulation (EU) 2016/860.

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(11) Since there is a need for consistent interpretation of paragraphs (3) and (4) of Article 49 of Directive 2014/59/EU, methodologies and principles for the valuation of derivatives carried out by independent valuers and resolution authorities should be specified.

(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. It is nevertheless appropriate to set out principles on the types of data that have to 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

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contracts by providing for mandatory clearing through central counterparties ('CCP') for standardised over-the-counter ('OTC') derivatives, valuation and margining requirements for CCP-cleared derivatives and for a wide range of OTC derivatives and mandatory reporting to trade depositories for all OTC derivatives.

(17) 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 of the European Parliament and of the Council[(3)], 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.

(18) 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.

(19) 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 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 should be without prejudice to the default management procedures run by CCPs in accordance with Regulation (EU) No 648/2012.

(20) 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.

(21) The point in time for the valuation of derivative contracts should reflect the valuation principle 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,

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the valuation 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.

(22) 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 in accordance 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 that Directive.

(23) This Regulation is based on the draft regulatory technical standards submitted by the European Banking Authority to the Commission.

(24) 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[(4)],

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 Four of Commission Delegated Regulation (EU) 2016/1075[(5)] or the resolution authority when conducting the valuation pursuant to paragraphs (2) and (9) of Article 36 of Directive 2014/59/EU;

(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;

(b) established in a third country and recognised in accordance with the procedure set out in Article 25 of Regulation (EU) No 648/2012;