



Significant RWA Savings for Banks Using the Fair Value Option under the Prudential Boundary Approach

New CRR III Standardized Approach for Operational Risks

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Boundary Approach**, March 2025
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This short specialist article presents findings from consulting practice on determining the financial component in the new OpRisk standardized approach in accordance with CRR 3. It shows that banks using the fair value option have potential to optimize their RWA figures.

The capital requirements for operational risk are determined in accordance with the CRR Articles 311-315. The requirements are specified in the Draft RTS and ITS from the consultation paper EBA/CP/2024/05. The final RTS and ITS are expected to be published in the second quarter of 2025.

In accordance with CRR Article 314(6), the financial component is defined as the sum of a trading book component (TC) and a banking book component (BC), i.e.

$$FC = TC + BC$$

The TC and BC figures are calculated as a 3-year average of absolute values based on FINREP items.

The distinction between the trading book and banking book components is either based on the accounting standard used for FINREP reporting or the regulatory distinction of the trading book in accordance with Part 3, Title I, Chapter 3 of CRR 3. The use of the accounting-based approach, the so-called accounting approach (AA), is defined as the standard to be applied in this context, see RTS Article 9(1). Under certain conditions, institutions may deviate from this and use the prudential boundary approach (PBA) based on the derogation in RTS Article 9(2).

The main prerequisite for using the PBA is the existence of an *unwarranted increase (UI)*, i.e. an unjustified increase in the FC.

The fair value option (FVO) is widely used by banks and is particularly applied when the financial instrument under consideration does not qualify for hedge accounting. It is easy to show that in the typical use case of the FVO, where the associated economic hedging transactions are derivatives, there is generally an unwarranted increase. The PBA is therefore open to all institutions that use the FVO with this hedging model.

The following case study is based on an implementation of the PBA at a European banking group that was accompanied by us but is fictitious. The parent company is a trading book institution with a material trading book. The fair value option is used by several institutions in the group, whereby the underlying transactions are economically hedged by derivatives. The Group has decided to apply the PBA for Group reporting.

The starting point is the finding that in the accounting approach the valuation results of the fair value option and the associated hedging derivatives are reported in different components of the FC. Therefore, an unwarranted increase results.

	2021	2022	2023
P&L fair value option	0,6	2,0	-1,3
P&L related interest rate hedging derivatives	-0,5	-2,7	1,2
Contribution of fair value option + hedges to FC component in AA	1,1	4,7	2,4
Contribution of fair value option + hedges to FC component in PBA	0,1	0,6	0,1
Amount of the unwarranted increase by the FVO	1,0	4,1	2,4

Table 1: Amount of the unwarranted increase due to the fair value option (in bn EUR)

The business portfolio in the fair value option hardly changed over the three financial years under review. The differences in the individual years are due to market movements, with the particularly high UI in 2022 corresponding to the sharp rise in interest rates in this period.

The UI quantifies the RWA reduction potential resulting from a reduction in FC in the Business Indicator (BI). How much of this potential is actually realized depends on several factors, including the initial size of the TC and BC in the accounting approach and the differences between the regulatory definition of the trading book and the trading portfolio according to the accounting standard used (in this case the held-for-trading portfolio according to IFRS 9). Ideally, the UI is fully realized as a reduction of the FC. Figure 1 compares the RWA reduction potential through the FVO with the RWA reduction realized in the case study.

RWA reduction potential

OpRisk RWA in bn EUR

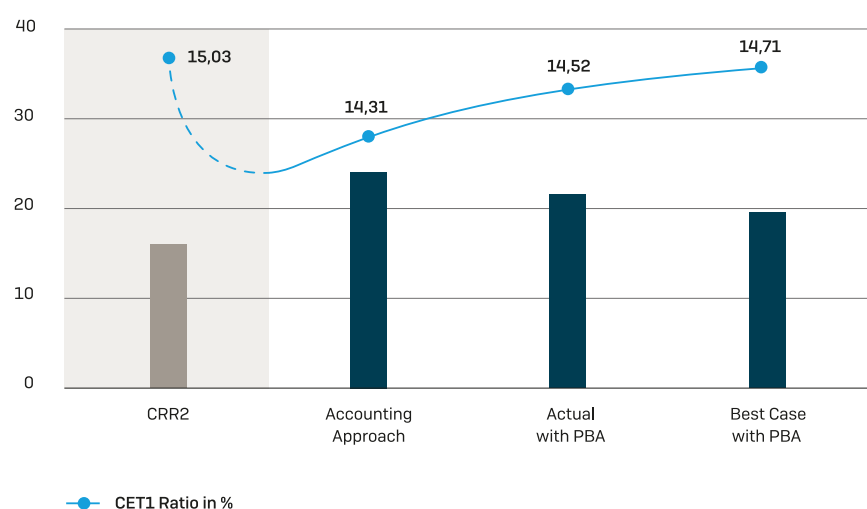


Figure 1: Comparison of CET1 ratios and RWAs between CRR 2 and CRR 3 in the AA and PBA in the case study

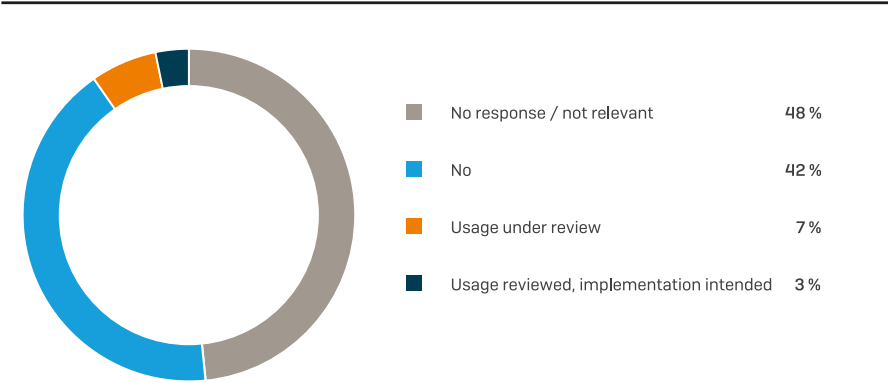


By implementing the PBA, the banking group was able to improve their CET1 ratio by more than 20 bp and reduce its OpRisk by nearly one-fifth for the reporting date of December 31st, 2023.

With a few assumptions, the RWA reduction potential for a sample of European banks with material FVO portfolios for the reporting date of December 31st, 2023 can be estimated on the basis of public information¹ (see Table 2).

Despite the high savings potential, many banks have not yet explicitly addressed the PBA. In an anonymous survey conducted at the d-fine OpRisk Round Table on November 7th, 2024 on the new standardized approach, only 3% of participants assume that implementation of the PBA is planned, while 42% refrain from implementing it.

Is use of the PBA planned?



¹ Annual financial statements and disclosure report for pillar 3

Figure 2: Results of an anonymous survey conducted during the d-fine OpRisk Round Table on 7th November 2024 among 77 participants from 49 institutions in German-speaking countries.

	Bank 1	Bank 2	Bank 3	Bank 4	Bank 5	Bank 6	Bank 7
CET1 ratio according to CRR 3 in Accounting Approach	14,17%	15,08%	14,99%	15,28%	14,43%	13,79%	13,85%
Best-case CET1 ratio in accordance with CRR 3 in Prudential Boundary Approach	15,04%	15,69%	15,18%	15,42%	14,54%	13,88%	13,87%
Potential for improvement of CET1 ratio	0,88%	0,62%	0,19%	0,14%	0,10%	0,09%	0,03%
Annual imputed equity cost savings assuming a target return on equity of 10% (in EUR million)	7,8	14,6	4,5	6,3	1,4	2,2	1,4

Table 2: Anonymized overview of the RWA reduction potential of selected European banks

With the opening clause for the Prudential Boundary Approach, the supervisory authority has provided banks with a procedure that is comparatively easy to implement to reduce their OpRisk RWAs and improve their capital ratios.

The RWA savings potential identified above is mainly driven by the fair value option P&L in the individual annual periods. For the reporting date of December 31st, 2023, the year 2022 with the significant increase in interest rates is decisive, while the years 2021 and 2023 make smaller contributions. In volatile phases that extend over several years (e.g. increase in one year and decrease in the next), the RWA savings potential can be even greater. We therefore recommend that all banks using the fair value option examine the use of the prudential boundary approach.

3M – EURIBOR over the past years

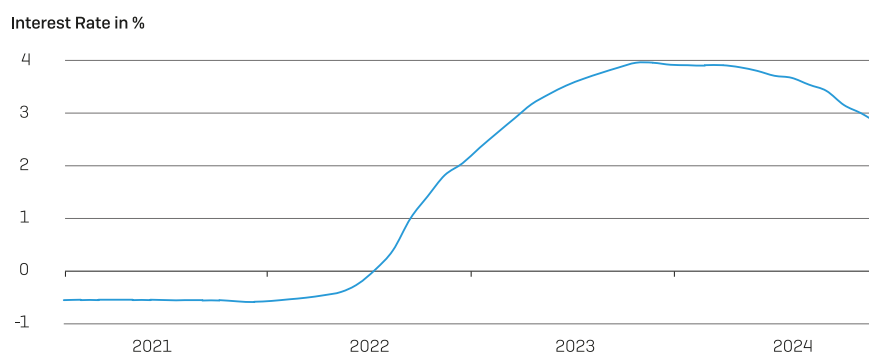


Figure 3: 3M Euribor yield curve in the period 2021-2025²

² Deutsche Bundesbank <https://www.bundesbank.de/de/statistiken/geld-und-kapitalmaerkte/zinssaetze-und-renditen/geldmarktsaetze-650668>

References

Reference	Title
CRR	Capital Requirements Regulation. Regulation (EU) No 575/2013
EBA/CP/2024/05	Consultation on Technical standards on the new Business Indicator framework for operational risk

Glossary

Term	Explanation
AA	Accounting Approach
BC	Banking Book Component
BI	Business Indicator
CET1	Common Equity Tier 1
CRR	Capital Requirements Regulation
EBA	European Banking Authority
FC	Financial Component
FINREP	Financial Reporting
FVO	Fair Value Option
P&L	Profit and Loss
ITS	Implementing Technical Standard
PBA	Prudential Boundary Approach
RTS	Regulatory Technical Standard
RWA	Risk Weighted Asset
TC	Trading Book Component
UI	Unwarranted Increase

Contact us

Using the PBA can lead to significant RWA savings. Would you like to evaluate the individual possibilities in your institution? We would be happy to support you throughout the entire process – from an initial assessment to full implementation – including for other topics related to the new standardized approach!

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