

DECISION
ON METHODOLOGIES AND CRITERIA FOR DETERMINING THE
AMOUNT OF LIABILITIES ARISING FROM DERIVATIVES
(OGM 116/20 of 04 December 2020, 010/26 of 03 February 2026)

Subject matter

Article 1

This Decision establishes the methodology for determining the value of classes of derivatives, including transactions subject to netting arrangements, the methodology for comparing the destruction of value of derivatives resulting from the close out and bail-in with the amount of losses that would be borne by counterparties in the derivatives contract that are included in the bail-in, and the criteria for establishing the relevant point in time at which the value of a derivative should be established, which are applied in case of declaring the maturity of the derivative contract due to the implementation of resolution proceedings of the credit institution.

Definitions

Article 2

Terms used in this Decision shall have the following meanings:

- 1) central counterparty means a legal person that interposes itself between the counterparties to the contracts traded on one or more financial markets, becoming the buyer to every seller and the seller to every buyer, if it has a head office in Montenegro and the EU Member State and an appropriate licence for operation, and a central counterparty with head office in a third country recognised by the European Securities and Markets Authority;
- 2) clearing member is an undertaking which participates in a central counterparty and which is responsible for discharging the financial obligations arising from that participation;
- 3) replacement trade means a transaction entered into on or after the closeout 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;
- 4) 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.

Methodology for comparing the destruction of the value of derivatives

Article 3

- (1) When comparing the destruction in the value of derivatives, the Central Bank shall compare:
 - 1) the amount of losses that would be borne by the derivative contracts in a bail-in, obtained by multiplying:
 - the share, within all equally ranked liabilities, of liabilities arising from the derivatives contracts determined as part of the valuation and not falling within the exclusions from bail-in; by
 - the total losses expected to be borne by all liabilities ranking equally to derivatives, including the derivative liabilities stemming from the close-out (hereinafter: close-out); with

- 2) the destruction in value of derivatives 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 derivatives contracts, and obtained by summing up the following elements:
- the risk of an increased counterparty close-out claim arising from re-hedging costs expected to be incurred by the central counterparty, by taking into account the spreads between bid and offer price, medium and bid price or medium and offer price in accordance with Article 7 paragraph (2) item 2) of this Decision;
 - the cost expected to be incurred by the credit 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, and this could be achieved by taking into consideration initial margin requirements and prevailing bid-offer spreads;
 - 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 to funding costs or income levels; and
 - any precautionary buffer against possible adverse implications from close-out (such as errors and disputes on transactions or in respect of collateral exchange).
- (2) The comparison under paragraph (1) of this Article shall be made before a decision to close-out is taken, as part of the valuation, to inform decisions about resolution actions.

Notification of the decision to close-out

Article 4

- (1) Prior to exercising the write-down and conversion powers in relation to derivative liabilities, the Central Bank shall notify the counterparties in the derivative contracts being closed-out of its decision to close-out the derivative contracts.
- (2) The decision to close-out shall take effect immediately or at a later close-out date as specified in the notification referred to in paragraph (1) of this Article.
- (3) In the decision to close-out, the Central Bank shall specify a date and time, taking into account the requirements of Article 9 paragraph (1) item 3) of this Decision, by which counterparties may provide evidence of commercially reasonable replacement trades to the Central Bank for the purpose of establishing the close-out amount, along with a summary of any commercially reasonable replacement trades.
- (4) The Central Bank may change the date and time by which the counterparties may submit evidence of commercially reasonable replacement trades, provided that that change is in line with Article 9 paragraph (1) item 3) of this Decision.
- (5) In the case referred to in paragraph (4) of this Article, the Central Bank shall notify the counterparty about the change of date and time by which the counterparties may submit evidence of commercially reasonable replacement trades.
- (6) In the decision to close-out, the Central Bank may determine the criteria that it intends to apply when assessing whether the replacement trade is commercially reasonable.
- (7) Provisions of paragraphs (1) to (6) of this Article shall not apply to the close-out and valuation of centrally cleared derivative contracts entered into between the credit institution under resolution, acting as a clearing member, and a central counterparty.

Treatment of derivative contracts subject to netting arrangements

Article 5

For derivative contracts subject to a netting arrangement, an independent valuer shall determine, in accordance with Articles 3, 6, 7 and 8 of this Decision, a single amount which the credit institution under

resolution has the right to receive or the obligation to pay as a result of the close-out of all derivative contracts in the netting set, as defined in the netting arrangement.

Principles of valuation of liabilities from derivatives in case of close-out

Article 6

- (1) The independent valuer shall determine the value of liabilities arising from derivative contracts as an early termination amount calculated as the sum of:
 - 1) unpaid amounts, collateral or other amounts due from the credit institution under resolution to the counterparty, less unpaid amounts, collateral and other amounts due from the counterparty to the credit institution under resolution as at the close-out date; and
 - 2) 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 on material terms of the contracts and the option rights of the parties in respect of the terminated contracts.
- (2) Within the meaning of paragraph (1) of this Article, unpaid amounts in respect of closed-out derivative contracts represent the sum of the following:
 - 1) amounts that became payable on or prior to the close-out date and which remain unpaid as at that date;
 - 2) amount equal to 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, and
 - 3) amount in respect of interest or compensation accrued during the period from the date on which the relevant payment or delivery obligations fell due through to the close-out date.

Determination of the close-out amount

Article 7

- (1) Where a counterparty has provided evidence of commercially reasonable replacement trades within the deadline set out by the Central Bank, the independent 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 by the Central Bank, where the independent valuer concludes that the communicated replacement trades were not concluded on commercially reasonable terms, or where another methodology is applied in accordance with Article 8 paragraph (8) or Article 9 paragraph (2) of this Decision, the independent valuer shall determine the close-out amount on the basis of the following:
 - 1) the mid-market and end-of-day prices in line with the business-as-usual processes within the credit institution under resolution at the date determined pursuant to Article 9 of this Decision;
 - 2) the mid-to-bid spread or mid-to-offer spread, depending on the direction of the netted risk position;
 - 3) adjustments to the prices and spreads specified in items 1) and 2) of this paragraph 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 independent valuer may establish the value at midmarket and end-of-day prices as referred to in paragraph (2) item 1) of this Article, notwithstanding items 2) and 3) of that paragraph, 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) of this Article, the independent valuer shall consider a full range of available and reliable data sources, and may rely on observable market data or theoretical prices generated by valuation models aimed at estimating values, including the following sources of data:

- 1) 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 central counterparties;
 - 2) for standardised products, valuations generated by the valuer 's own systems;
 - 3) data available within the credit institution under resolution, such as internal models and valuations including independent price verifications performed pursuant to Article 126 paragraphs (10), (11) and (12) of the Decision on Capital Adequacy of Credit Institutions;
 - 4) data provided by counterparties other than evidence of replacement trades communicated pursuant to Article 4 paragraph (3) of this Decision, including data on current or previous valuation disputes with regard to similar or related transactions and quotes;
 - 5) any other relevant data.
- (5) For the purposes of paragraph (2) item 2) of this Article, the Central Bank may instruct the credit institution under resolution to perform an updated independent price verification as at the reference point in time determined pursuant to Article 9 of this Decision, using end-of day information available on the close-out date.
- (6) Provisions of paragraphs (1) to (5) of this Article shall not apply to the determination of a close-out amount for cleared derivative contracts entered into between a credit institution under resolution and a central counterparty, except in the exceptional circumstances set out in Article 8 paragraph (8) of this Decision.

Valuation of cleared derivative contracts entered into between a credit institution under resolution and a central counterparty

Article 8

- (1) The independent valuer shall establish the value of liabilities arising from derivative contracts entered between, on the one hand, a credit institution under resolution acting as a clearing member and, on the other hand, a central counterparty, based on the valuation principle specified in Article 6 of this Decision.
- (2) The early termination amount shall be determined by the central counterparty, within the deadline specified in paragraph (6) of this Article, after deducting the collateral provided by the credit institution under resolution including initial margin, variation margin and contributions of the credit institution under resolution to the default fund of the central counterparty.
- (3) The Central Bank shall communicate to the central counterparty and the central counterparty's supervisory authority its decision to close out the derivative contracts based on the authorisation to close out and terminate derivative contracts, which shall take effect immediately, or on the date and time specified in the communication.
- (4) The Central Bank shall instruct the central counterparty to provide its valuation of the early termination amount for all the derivative contracts in the relevant netting set, in accordance with the central counterparty default procedure.
- (5) The central counterparty shall provide the Central Bank with the central counterparty default procedure documents and shall report the default management steps undertaken.
- (6) The Central Bank shall, in agreement with the central counterparty and the central counterparty's supervisory authority, set the deadline by which the central counterparty must provide the valuation of the early termination amount, and for that purpose, the Central Bank, the central counterparty and the central counterparty's supervisory authority shall take both of the following into account:
 - 1) the default procedure, as established by the central counterparty governance rules;
 - 2) the resolution timeline.
- (7) The Central Bank may change the deadline set based on paragraph (6) of this Article upon agreement with the central counterparty and the central counterparty's supervisory authority.
- (8) Notwithstanding paragraph (2) of this Article, the Central Bank may decide to apply the methodology laid down in Article 7 of this Decision, after cooperating the central counterparty's supervisory authority,

in either of the following cases:

- 1) the central counterparty fails to provide the valuation of the early termination amount within the deadline set by the Central Bank pursuant to paragraph (6) of this Article; or
- 2) the central counterparty's valuation of the early termination amount is not in line with the central counterparty default procedures.

Point in time for establishing the value of derivate liabilities

Article 9

- (1) The independent valuer shall determine the value of derivative liabilities at the following points in time:
 - 1) where the independent valuer determines the early termination amount at the prices of replacement trades pursuant to Article 7 paragraph (1) of this Decision, the day and time of the conclusion of the replacement trades;
 - 2) where the independent valuer determines the early termination amount in accordance with the central counterparty default procedures pursuant to Article 8 paragraph (1) of this Decision, the day and time when the early termination amount has been determined by the central counterparty;
 - 3) 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 independent valuer may, as part of a provisional valuation, determine the value of liabilities arising from derivatives even earlier, and such early determination shall be made on the basis of estimates, relying on the principles laid down in Article 6 and Article 7 paragraphs (2) to (5) of this Decision, and on data available at the time of the determination.
- (3) Where the independent valuer carries out an early determination pursuant to paragraph (2) of this Article, the Central Bank may at any time require 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) of this Article, and these developments or evidence, where available by the dates determined pursuant to Article 4 paragraph (2) of this Decision, shall be taken into account in the ex post definitive valuation carried out pursuant the law governing resolution of credit institutions.
- (4) Where the independent valuer carries out an early determination pursuant to paragraph (2) of this Article in relation to derivative contracts entered into between a credit institution under resolution acting as a clearing member and a central counterparty, the independent valuer shall take due account of any estimate of expected close-out costs provided by the central counterparty.
- (5) Where the central counterparty provides a valuation of the early termination amount in accordance with the central counterparty default procedures by the deadline set pursuant to Article 8 paragraphs (6) and (7) of this Decision, that valuation shall be taken into account in the ex post definitive valuation of credit institution's assets and liabilities carried out pursuant to the law governing resolution of credit institutions.

Entry into force

Article 10

This Decision shall enter into force on the eighth day following that of its publication in the Official Gazette of Montenegro.

THE COUNCIL OF THE CENTRAL BANK OF MONTENEGRO