EBA/CP/2013/15

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Consultation Paper

Draft Regulatory Technical Standards

On the definition of market under Article 330(3) of the Draft Capital Requirements Regulation (CRR)

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Table of contents

1. Responding to this Consultation

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in section 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Please send your comments to the EBA by email to EBA-CP-2013-15@eba.europa.eu by 31.08.2013, indicating the reference 'EBA/CP/2013/15' on the subject field. Please note that comments submitted after the deadline, or sent to another e-mail address will not be processed.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please indicate clearly and prominently in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an e-mail message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.eba.europa.eu under the heading 'Legal Notice'.

2. Executive Summary

The draft Capital Requirements Regulation (CRR) and draft revised Capital Requirements Directive (CRD IV) set out requirements concerning the definition of a market under Article 330(3) CRR. The definition of market is used for the calculation of the overall net position, which is used for the computation of capital requirements for equity general market risk according to the CRR.

The EBA is currently considering two definitions of a market, based on respectively a nationality and currency criterion. The second alterative would only be applied for the Euro-zone, while the rest of markets would be defined using the nationality criterion.

The nationality criterion would perfectly align the definition of market with the one applied in the Basel Framework which, in practice, is the prevalent definition used today by institutions, thus minimising the impact on current practices. In addition it is the most conservative approach, since capital requirements would be higher under the nationality criterion relative to the currency criteria.

The currency criterion would recognise that the introduction of a single currency has eliminated some important elements of segmentation between equity markets, such as (i) the elimination of foreign exchange currency risk, (ii) the presence of a unique currency in which company results are reported or (iii) the existence of an integrated market with common rules.

3. Background and rationale

The EBA has developed these draft regulatory technical standards (RTS) on the basis of the versions of the legislative texts for the CRR produced after the Trialogues agreement among the EU institutions. Article 330 of the draft CRR establishes rules on calculating the overall gross and overall net positions in equity instruments. It provides that

- The overall gross position shall be the result of summing up the absolute value of the net long positions and net short positions in a given equity. The overall gross position shall be used to calculate the standardised specific equity risk charge.
- To obtain the overall net position in equities a bank shall calculate, **separately for each market**, the difference between the sum of the net long and the net short positions. The sum of the absolute values of those differences shall be its overall net position, which banks shall use to calculate the standardised general equity risk charge.

Paragraph 3 of article 330 states that the EBA shall develop draft regulatory technical standards defining the term ‘market’ for the use referred above. Furthermore it specifies, that the EBA shall submit those draft regulatory technical standards to the Commission by 31 January 2014.

On the basis of the above, it becomes evident that the term market has to be defined for the purpose of calculating the ‘general’ component of market risk for equities under the standardised rules. Article 351 of the draft CRR defines Specific and General risks as components of position risk:

Position risk on a traded debt instrument or equity instrument or derivative thereof may be divided into two components for purposes of this chapter. The first shall be its specific risk component and shall encompass the risk of a price change in the instrument concerned due to factors related to its issuer or, in the case of a derivative, the issuer of the underlying instrument. The general risk component shall encompass the risk of a price change in the instrument due in the case of a traded debt instrument or debt derivative to a change in the level of interest rates or in the case of an equity or equity derivative to a broad equity-market movement unrelated to any specific attributes of individual securities.

The general market risk calculation implicitly assumes that two equities in the same ‘market’ are subject to the same general risk.

The EBA is currently contemplating two possible definitions for the term ‘market’:

- Market is identified on the base of a nationality criterion;
- The Euro-zone is identified as a market. Other markets would be defined using the nationality criterion.

According to the rationale behind the first possibility, at jurisdiction level, equity markets would face the same general risk, stemming for instance from local economic conditions. The nationality criterion is hence based on an assumption, that the general risk is driven by country-specific drivers.

The rationale behind the alternative view (Euro-zone) would be that the nationality criterion does not recognise the fact that the introduction of a single currency in an already substantially integrated EU Single Market has eliminated some important elements of segmentation between equity markets, such as:

- The elimination of foreign exchange currency risk
- The presence of a unique currency in which company results are reported.
- The existence of an integrated market with common rules.

The integration of financial markets was one of the main reasons for the adoption of a single currency. An accession country that plans to join the Union must align many aspects of its society (social, economic and political) with those of EU Member States. Much of this alignment is aimed at ensuring that an accession country can operate successfully within the Union's single market for goods, services, capital and labour (i.e. accession is a process of integration).

Adopting the euro and joining the euro area takes integration a step further; it is a process of much closer economic integration with the other euro-area Member States. Adopting the euro also demands extensive preparations; in particular it requires economic and legal convergence. The economic 'convergence criteria' are designed to ensure that a Member State's economy is sufficiently prepared for adoption of the single currency and can integrate smoothly into the monetary regime of the euro area. Legal convergence requires that national legislation, in particular the national central bank and monetary issues, is compatible with the Treaty.

Accordingly, the elimination of the foreign exchange (FX) risk would not be the only justification behind the currency criterion, since the adoption of the euro has many legal and economic conditions attached to it. Thus, under this criterion shares listed in markets located in jurisdictions with a 'pegged' currency to the euro would not be considered as part of the 'euro' market. In addition, due to the legal and economical conditions attached to the euro accession process, the currency criterion would only be applicable to the Euro-zone area.

The EBA is also taking into consideration the fact that the 'nationality criterion' perfectly aligns the definition of market with the one applied in Basel. The Basel Framework defines general market risk on equity instruments as 'the risk of holding a long and a short position in the market as a whole'. Furthermore it specifies that each 'market' has to be defined on the basis of a 'national' criterion.

In practice, most jurisdictions (and banks) have already implemented the nationality approach which, additionally, is more conservative since capital requirements would be higher with respect to the currency criteria. From a prudential perspective it may therefore be fully justified to adopt the nationality criterion, even if Euro Zone markets can be considered integrated.

4. Draft regulatory TS on the definition of market under Article 330(3) of the draft Capital Requirements Regulation (CRR)

In between the text of the draft RTS that follows, further explanations on specific aspects of the proposed text are occasionally provided, which either offer examples or provide the rationale behind a provision, or set out specific questions for the consultation process. Where this is the case, this explanatory text appears in a framed text box.

Contents

EUROPEAN COMMISSION

Brussels, XXX
[…](2012) XXX draft

COMMISSION DELEGATED REGULATION (EU) No …/..

of XXX

[…]

supplementing Regulation (..) No xx/XXXX] of the European Parliament and of the Council with regard to regulatory technical standards for the definition of market under Article 330(3)

COMMISSION DELEGATED REGULATION (EU) No …/..

of XXX

[…]

COMMISSION DELEGATED REGULATION (EU) No …/... supplementing Regulation (..) No xx/xxxx[CRR] of the European Parliament and of the Council with regard to regulatory technical standards for the definition of market according to Article 330(3)

THE EUROPEAN COMMISSION,

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

Having regard to Regulation (..) No xx/xxxx [CRR] of the European Parliament and of the Council of dd mmmm yyyy on ….[1] and in particular Article 330(3) third subparagraph thereof,

Whereas:

(1) Given the definition of general market risk at Article 351 of Regulation xx/xxx [CRR] as the risk of a price change in the instrument due to either a change in the level of interest rates (for traded debt instruments or debt derivatives), or to a broad equity-market movement unrelated to any specific attributes of individual securities (for equities or equity derivatives), the general market risk calculation stated in article 330 of Regulation xx/xxx [CRR] should assume that two equities are in the same 'market' where they are subject to the same general risk.

[OPTION 1]

(2) As a consequence, since equity markets located in the same country face the same general risk, stemming from local economic conditions, general risk should be calculated at the national jurisdiction level, which should therefore be taken to constitute a 'market' for the purposes of article 330 Regulation xx/xxx [CRR].

[OPTION 2]

(2) As a consequence, since the introduction of a single currency in an already substantially integrated EU Single Market has eliminated most elements of segmentation between equity markets, and since the adoption of the euro requires extensive economic and legal convergence, general risk should be calculated in relation to all equity markets within the euro area, while for non euro equity markets it should be calculated at the national jurisdiction level.

[1] OJ L […], [xx.xx.XXXX, p…].

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

(4) The European Supervisory Authority (European Banking Authority) has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, 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 1093x/2010.

HAS ADOPTED THIS REGULATION:

Article 1 –Definition of 'market' for the purpose of calculating the overall net position in equity instruments under Article 330(2) of Regulation xx/xxx [CRR]

[OPTION 1]
For the purpose of calculating the overall net position in equity instruments, according to Article 330(2) of Regulation xx/xxx [CRR], the term 'market' shall encompass all equities listed in stock markets located within the same national jurisdiction.

[OPTION 2]
For the purpose of calculating the overall net position in equity instruments, according to Article 330(2) of Regulation xx/xxx [CRR], the term 'market' shall mean:

(a) for the European Union area, all equities listed in stock markets located in jurisdictions that have adopted the euro as their currency;
(b) for the rest of the world, all equities listed in stock markets located in the same national jurisdiction.

Explanatory text for consultation purposes

Q1. Do you consider that the degree of integration in the European Union is sufficient to support a currency based definition of equity market? If possible please provide quantitative evidence to support your answer.

Q2. Are there implementation costs that should be taken into consideration when defining the criterion?

Q3. What would be the impact on market risk capital requirements of the implementation of option 2, measured both in relative and absolute terms?

Article 2- Final Provision

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

[For the Commission
On behalf of the President

[Position]

5. Accompanying documents

5.1 Draft Cost- Benefit Analysis / Impact Assessment

Identification of the problem: Article 351 of Regulation xx/xxx [CRR] defines general market risk as the risk of a price change in the instrument due to either a change to a change in the level of interest rates (for traded debt instruments or debt derivatives), or to a broad equity-market movement unrelated to any specific attributes of individual securities (for equities or equity derivatives).

Accordingly, the general market risk calculation stated in article 330 of Regulation xx/xxx [CRR] (i.e. 8% of the difference between long and short positions held in the 'same market') implicitly assumes that two equities are in the same 'market' are subject to the same general risk.

The Basel Framework defines general market risk on equity instruments as "the risk of holding a long and a short position in the market as a whole". Furthermore it specifies that each "market" has to be defined on the basis of a "national" criterion. The CRR (Art 330) does not refer to this criterion of nationality but delegates the definition of the meaning of "equity market" to the RTS developed by EBA.

It is assumed that all NSAs already apply the nationality criterion defined in the Basel Framework. This is quite straightforward to implement and is generally conservative. However the introduction of this nationality criterion was done prior to the existence of the euro and thus does not recognise the fact that the introduction of a single currency in an already substantially integrated EU Single Market has eliminated some important elements of segmentation between equity markets, such as:

- The elimination of foreign exchange currency risk;
- The presence of a unique currency in which company results are reported.
- The existence of an integrated market with common rules.

Regulatory / operational policy objective: The impact assessment has been carried out having in mind that the general objective of "ensuring the international competitiveness of EU banking sector (G-3)"[2] is met. Based on the "Commission Staff Working Paper – Impact Assessment", the relevant driver of the identified problem is the "Lack of detail within certain CRD provisions that allow for supervisory judgement and / or choice to be made". The operational objective is to develop a harmonised set of provisions in the area of market risk capital requirements, which includes the following "Specific objectives":

- Prevent regulatory arbitrage opportunities (S-3);

[2] For more information refer to the "Commission Staff Working Paper – Impact Assessment" accompanying the document "Regulation of the European Parliament and the Council Regulation on prudential requirements for the credit institutions and investment firms" (http://ec.europa.eu/internal_market/bank/docs/regcapital/CRD4_reform/IA_regulation_en.pdf)

- Reduce compliance burden (S-5);
- Enhance level playing field (S-6);
- Enhance supervisory cooperation and convergence (S-7)

Apart from the need to ensure a level playing field necessary for market integrity the objective is to apply the definition of market for capital calculation which is more meaningful from a risk measurement perspective.

Criteria applied and rationale: The EBA does not have a definitive view on which one of the two possibilities is more appropriate, considering both risk and capital. In addition, the EBA is also mindful of the eventual implementation costs that an alternative definition of market might have. As a consequence, the EBA is consulting on two possibilities, based on the following rationale:

- Since equity markets located in the same country face the same general risk, stemming from local economic conditions, general risk should be calculated at the national jurisdiction level, which should therefore be taken to constitute a 'market' for the purposes of article 330 Regulation xx/xxx [CRR].
- Since the introduction of a single currency in an already substantially integrated EU Single Market has eliminated most elements of segmentation between equity markets, and since the adoption of the euro requires extensive economic and legal convergence, general risk should be calculated in relation to all equity markets within the euro area, while for non euro equity markets it should be calculated at the national jurisdiction level.

Implementation and on-going costs: If the country criterion is finally adopted there would be neither capital impact nor additional burden on banks and NSAs.

If the currency criterion is finally adopted, the cost of implementing this technical standard is estimated to be limited for banks, since the procedure for calculating the net position by market would remain the same and only the definition of market would have to be modified. Under this alternative, a small reduction in capital requirements (for banks applying standardised rules for market risk) would be expected.

To assess more accurately the hypothetical impact, the EBA is asking for feedback from the industry regarding the implementation impact of both definitions, considering the internal IT and management costs, as well as an estimation of capital reduction in case the currency criterion is adopted for the Euro-zone.

Benefits: Harmonisation of the rules across EU, ensuring a level playing field necessary for market integrity and ensuring the implementation of a meaningful definition of market.

5.2 Overview of questions for Consultation

Q1. Do you consider that the degree of integration in the European Union is sufficient to support a currency based definition of equity market? If possible please provide quantitative evidence to support your answer.

Q2. Are there implementation costs that should be taken into consideration when defining the criterion?

Q3. What would be the impact on market risk capital requirements impact of the implementation of option 2, measured both in relative and absolute terms?