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EBA FINAL draft Implementing Technical Standards

On appropriately diversified indices under Article 344(1) of Regulation (EU) No 575/2013 (Capital Requirements Regulation -CRR)

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Table of contents

1. Executive Summary

These draft Implementing Technical Standards (ITS) specify, in accordance with Article 344(1) of the draft Capital Requirements Regulation (CRR), relevant appropriately diversified indices for the purposes of calculating the capital requirements for equity risk according to the standardised rules. This is necessary because the CRR text considers that stock-index futures, which are both exchange traded and 'appropriately diversified', only pose general risk for an institution. Consequently, these ITS list the exchange-traded and appropriately diversified indices, for which specific risk can be ignored.

To ensure that the specific risk incorporated in a stock index can be dismissed, the minimum level of diversification required in these draft ITS takes into account a number of considerations: in particular, (i) the index must comprise a minimum number of equities; (ii) none of the equities (or concentration of equities) must significantly influence the volatility of the index and thus not represent more than a certain percentage of the total index value; and, finally, the index must comprise equities diversified both from (iii) a geographical and (iv) an economic perspective.

2. Background and rationale

Article 344(1) of Regulation (EU) No 575/2013 (CRR) requires the EBA to identify indices which might be eligible for the treatments stated in paragraph 4. Article 344(4) establishes the treatment that banks must apply where the stock indices are not broken down into their constituent equities. In this case the stock indices shall be treated as if they were individual equities. In addition, the paragraph states that the specific risk on this individual equity can be ignored if the stock-index future in question is exchange traded and represents a relevant appropriately diversified index.

Accordingly, the ITS mandate refers to the identification of 'relevant appropriately diversified' indices that do not incorporate specific risk for capital calculation purposes.

2.1 Criteria for determining if an index is appropriately diversified

The EBA has determined the list of exchange-traded appropriately diversified indices for the purposes of Article 344 of the draft CRR, based on the following criteria:

Number

- A diversified index shall contain at least 20 equities.

Concentration

- By equity: No single equity shall represent more than 25% of the total index.
- By group of equities: 10% of the largest equities (rounded up to the next whole number) shall represent less than 60% of the total index.

Diversification

1. By Geography: the index shall encompass equities from at least one national market; no regional indices shall be recognised as appropriately diversified.
2. By Industry: the index shall comprise equities from at least four of the following industries[1]:

    - Oil and Gas
    - Basic Materials
    - Industrials
    - Consumer Goods
    - Health care
    - Consumer Services
    - Telecommunications

[1] See Industry Classification Benchmark (ICB) http://www.icbenchmark.com/ICBDocs/ICB_%20Product_Spec_Nov2011.pdf

- Utilities
- Financials
- Technology

2.2 Update

The list of appropriately diversified indices may be updated yearly, assessing any additional indices identified as relevant by 30 September of each year.

3. EBA FINAL draft implementing Technical Standards on appropriately diversified indices under Article 344(1) of Regulation (EU) No 575/2013 (Capital Requirements Regulation - CRR).

EUROPEAN COMMISSION

Brussels, XXX
[…](2012) XXX draft

COMMISSION IMPLEMENTING REGULATION (EU) No …/..

of XXX

[…]

COMMISSION IMPLEMENTING REGULATION (EU) No …/... laying down implementing technical standards with regard to appropriately diversified indices according to Regulation (EU) No 575/2013of the European Parliament and of the Council

of XXX

THE EUROPEAN COMMISSION,

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

Having regard to Regulation (EU) No 575/2013 of 26 June 2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012[2] and in particular Article 344(1) third subparagraph thereof,

Whereas:

(1) Article 344(4) of Regulation (EU) No 575/2013states that the specific risk can be ignored for stock-index futures which are exchange traded and represent a relevant appropriately diversified index. Therefore, the exchange traded indices listed in this Regulation should be considered as appropriately diversified where it can be assumed that they represent no specific risk. This, in turn, should be the case where the indices meet all of the following criteria: they contain at least 20 equities; in terms of concentration, no single entity contained within them represents more than 25% of the total index, while 10% of the largest equities (rounding up the number of equities to the superior natural number) represent less than 60% of the total index; in terms of diversification they encompass equities from at least a national market, and they comprise equities from at least four industries amongst oil and gas, basic materials, industrials, consumer goods, health care, consumer services, telecommunications, utilities, financials and technology.

(2) Given that Article 344(4) of Regulation (EU) No 575/2013 refers to ‘relevant’ eligible indices, only those stock indices which are relevant for financial institutions in the EU should be assessed against the criteria for identifying eligible stock indices.

(3) Due to changes in the composition and relative weights of the equities that comprise each index assessed, the list of appropriately diversified indices may be updated annually.

(4) The updating of the list of appropriately diversified indices constitutes a revision of this Regulation, therefore it should be carried out in accordance with the process described in Article 344(1) of Regulation (EU) No 575/2013 and Article 15 of Regulation 1093/2010.

[2] OJ L OJ L 176, 27.6.2013, p. 1.

(5) Where revised versions of this Regulation are necessary, they should be published at the end of each year, with the view to enter into force on January 1st of the following year, in order to allow for any preparations that institutions might need to make before they apply any revisions to the list.

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

(7) The European Supervisory Authority (European Banking Authority) has conducted open public consultations on the draft implementing 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 1093/2010].

HAS ADOPTED THIS REGULATION:

Article 1 –Stock indices for the purposes of Article 344 of Regulation (EU) No 575/2013

The list of stock indices which are eligible for the purposes of Article 344 of Regulation (EU) No 575/2013 are provided in Annex 1.

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

On behalf of the President

[Position]

Annex 1- Stock indices meeting the requirements of Article 344 of Regulation (EU) No 575/2013

	Index	Country
1.	S&P All Ords	Australia
2.	ATX	Austria
3.	BEL20	Belgium
4.	SaoPaulo - Bovespa	Brazil
5.	TSE35	Canada
6.	FTSE China A50 Index	China
7.	CROBEX	Croatia
8.	OMX Copenhagen 20 CAP	Denmark
9.	DJ Euro STOXX 50	Europe
10.	FTSE Eurofirst 100	Europe
11.	FTSE Eurofirst 80	Europe
12.	FTSE Eurotop 100 index	Europe
13.	MSCI Euro index	Europe
14.	STOXX Europe 50	Europe
15.	STOXX Europe 600	Europe
16.	STOXX Europe Lrg 200	Europe
17.	STOXX Europe Mid 200	Europe
18.	STOXX Europe Small 200	Europe
19.	STOXX Select Dividend 30	Europe
20.	CAC40	France
21.	SBF 120	France
22.	DAX	Germany
23.	HDAX	Germany
24.	MDAX	Germany
25.	SDAX	Germany
26.	Athens General	Greece

27.	Hang Seng	Hong Kong
28.	Hang Seng China Enterprises	Hong Kong
29.	NIFTY	India
30.	FTSE MIB	Italy
31.	FTSE Bursa Malaysia	Malaysia
32.	MSE Share Index	Malta
33.	Nikkei225	Japan
34.	Nikkei300	Japan
35.	IPC Index	Mexico
36.	AEX	Netherlands
37.	AMX	Netherland
38.	WIG20	Poland
39.	PSI 20	Portugal
40.	Straits Times Index	Singapore
41.	IBEX35	Spain
42.	OMX Stockholm 30	Sweden
43.	SMI	Switzerland
44.	FTSE nasdaq Dubai 20	UAE
45.	FTSE 100	UK
46.	FTSE mid-250	UK
47.	S&P 500	USA
48.	Dow Jones Ind. Av.	USA
49.	NASDAQ	USA

4. Accompanying documents

4.1 Cost-Benefit Analysis / Impact Assessment

Identification of the problem: According to the standardised rules for market risk, all equities are subject to a general and specific capital charge. Article 362 of the 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.

Article 344 of the draft CRR states that stock-index futures which are exchange traded and represent a relevant appropriately diversified index shall be subject only to a general market risk charge.

Several national supervisory authorities (NSAs) already publish list of appropriately diversified indices, however there is no common set of criteria used to assess the diversification, and accordingly there is not a common list of indices which should be subject to the treatment stated in Article 344.

Regulatory / operational policy objective: The impact assessment has been carried out bearing in mind that the general objective of “ensuring the international competitiveness of EU banking sector (G-3)”[3] is met. Based on the “Commission Staff Working Paper – Impact Assessment”, the relevant driver of the identified problem (of not having a common list of appropriately diversified indices) is the “lack of harmonization in application of regulatory adjustments”. The operational objective that has to be met is to develop a harmonised set of provisions in the area of capital requirements which includes the following “Specific objectives”:

- Prevent regulatory arbitrage opportunities (S-3);
- Reduce compliance burden (S-5);
- Enhance level playing field (S-6);
- Enhance supervisory cooperation and convergence (S-7).

[3] For more information see 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)

Apart from the abovementioned objective, a more targeted objective is to obtain a more risk-sensitive standardised approach for equity risk allowing diversified indices to ignore the specific risk component of position risk.

Criteria applied and rationale: From an academic (and risk management) perspective, it is generally considered that the risk which can be eliminated by diversification is the specific risk. Accordingly, the general risk is the remaining one (i.e. the one that cannot be eliminated by diversification).

Following this rationale, the CRR level 1 text considers that stock-index futures which are exchange traded might only pose general risk for an institution. Of course, the exclusion of the specific risk from any stock-index future is only acceptable provided it is 'appropriately diversified'.

The EBA considers that the minimum level of diversification must be factored from several perspectives:

1. The index must comprise a minimum number of equities. There must be an absolute threshold below which an index cannot be sufficiently diversified to ignore the specific risk completely.
2. None of the equities must significantly influence the volatility of the index and thus must not represent more than a certain percentage of the total index value.
3. The index must comprise equities diversified from a geographical perspective.
4. Finally, the index must represent equities which are diversified from an economic perspective. This implies that several "industries" must be appropriately represented in the index.

The EBA based on the academic literature and practice, proposes the following criteria to fulfil the aforementioned requirements:

1. Number: a diversified index shall contain at least 20 equities[4].
2. Concentration

- By equity: No single equity shall represent more than 25% of the total index.
- By group of equities: 10% of the largest equities (rounding up to the next whole number) shall represent less than 60% of the total index.

3. Diversification by Geography: the index shall encompass equities from at least one national market; no regional indices shall be recognised as appropriately diversified.

4. Diversification by Industry: the index shall comprise equities from at least four of the following industries:

    - Oil and Gas
    - Basic Materials
    - Industrials
    - Consumer Goods

[4] To diversify away the non-systematic risk, Meir Statman argues in a 1987 article that 30 stocks should be included in an index; however, Frank Reilly and Keith Brown in their book "*Investment Analysis and Portfolio Management*" reported that in one set of studies for randomly selected stocks "about 90% of the maximum benefit of diversification was derived from portfolios of 12 to 18 stocks".

- Health care
- Consumer Services
- Telecommunications
- Utilities
- Financials
- Technology

For this industry categorisation, the EBA has decided to apply the Industry Classification Benchmark (ICB)[5], which is a definitive system categorizing over 70,000 companies and 75,000 securities worldwide, enabling the comparison of companies across four levels of classification and national boundaries.

The ICB system includes 114 subsectors, 41 sectors, 19 supersectors and 10 industries; the EBA has decided to apply the broadest category available ('industry'). The system is supported by the ICB database, which is maintained by FTSE International Limited.

Implementation and on-going costs: the cost of implementing this technical standard (i.e. announcing and updating the lists of diversified indices) is estimated to be limited since the procedure will be more or less automated. A small reduction in capital requirements, for banks applying standardised rules for market risk, is expected.

The regular update of the list of diversified indices might create a permanent involvement of EBA resources. The EBA may update the list of indices to reflect the changing economic and financial conditions. However, this involvement would not require the engagement of additional resources as the process would take place, at a minimum, on a yearly basis and be fairly automated. As a result, the updating process is not expected to produce any material cost for the regulatory authorities' side.

Benefits: one of the most significant benefits is the harmonisation of the rules across the EU.

[5] (See Industry Classification Benchmark – ICB)
http://www.icbenchmark.com/ICBDocs/ICB_%20Product_Spec_Nov2011.pdf

4.2 Views of the Banking Stakeholder Group (BSG)

No feedback from the BSG has been received.

4.3 Feedback on the public consultation and on the opinion of the BSG

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
General comments			
Sector indices / Diversification by industry	One respondent considers that the industry dimension is not appropriate since sector specific indices are systematically being excluded although these indices may generally comply with undertakings for collective investment in transferable securities (UCITS) industry diversification requirements in terms of concentration, weights and geographical diversification.	UCITS regulation has a different scope of application and does not cover all the dimensions that the EBA considers are necessary to state than an equity index is exempted from market specific risk.	No change.
Regional indices / Diversification by geography	The same respondent considers that it is not clear why regional indices shall not be recognized as appropriately diversified. Furthermore it remains unclear why an appropriately diversified index shall encompass at least one national market, while a multitude of encompassed national markets may lead to comprise a specific region.	The proposed criteria do not exclude regional indices (e.g. European indices) that encompass several national markets. They exclude regional indices as part of a national market.	No change.
Minimum number of shares	It also notes that there are some sector indices that do contain fewer than 20 equities. Instead of focusing on a number of equities the respondent believes it would make more sense to focus on distribution and weightings within an index.	The number of equities is one of the dimensions considered; the distribution and weightings are also taken into consideration. In addition the academic literature seems to agree that there needs to be a minimum number of equities to consider than an index is appropriately diversified.	No change.
Request for clarification	One respondent requests confirmation that the criteria and list of indices offer 'safe harbour' for the purposes of CRR Article 76 and the netting of positions in capital instruments. Thus, an index listed in Annex 1 would be considered "an index" under Article 76. This respondent believes that this treatment is appropriate because the list would represent a sub-set of possible indices that are considered to be appropriately diversified.	There is no connection between the two articles. Under Article 344 the index may be treated as an individual equity provided that the bank does not break down the index into its components, whereas under Article 76 the index would be broken down into its components.	No change.

Responses to questions in Consultation Paper EBA/CP/2013/22			
Q1. Do you agree with the set of criteria proposed for determining whether an index is diversified? Are there any other criteria that should be considered?	Three of the respondents agree with the criteria proposed for identifying appropriately diversified indices. However one respondent does not agree with the set of criteria proposed, because there is no index methodology that may cover all the criteria cumulatively. They propose to take in consideration the existing European Securities and Markets Authority / UCITS criteria for greater consistency and harmonization within the regulation.	UCITS regulation has a different scope of application and does not cover all the dimensions that the EBA considers are necessary to state that an equity index is exempted from market specific risk.	No change.
Q2. Do you believe that the levels and numbers of the proposed criteria are appropriate?	One respondent considers that the criteria proposed are too tightly calibrated, which would have the effect of excluding indices that are generally considered to be well diversified (for example, the S&P ASX 200). It suggests broadening the criteria so that a higher percentage level than 60% issued (perhaps 65% or 70%), and/or the largest 5% of equities is used rather than the largest 10%. Another respondent suggests adopting the existing UCITS rules with concentration levels of 35% and 20%.	The EBA considers that not enough evidence justifying a relaxation in the proposed criteria has been provided. Accordingly, the EBA has finally decided that the calibration of the criteria cannot be relaxed to ensure that the degree of diversification is sufficient.	No change.
Q.3 Are there any relevant indices not listed in Annex I that meet the criteria? Please provide evidence that such indices meet the criteria.	The respondents have identified: a) Additional relevant indices that meet the proposed criteria and should therefore be included in the prescriptive list. b) Amendments to the list of indices in Annex 1 c) Other indices that are not in line with the criteria that they think should still be considered as appropriately diversified or where there are already stock index futures outstanding.	The EBA has assessed whether the suggested additional indices meet the proposed criteria. The EBA has checked and corrected the errors in the names of two indices.	Include the additional indices in the assessment and amend the names of two indices already in the list.