

## Consultation paper

Draft regulatory technical standards on the method for the identification of the geographical location of the relevant credit exposures under Article 140(7) of the Capital Requirements Directive (CRD)



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# Consultation paper on draft regulatory technical standards on the method for the identification of the geographical location of the relevant credit exposures under Article 140(7) of the Capital Requirements Directive (CRD)

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## 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 posed;
- 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.

### Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 1 November 2013. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

### Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. 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 can be reviewed by the EBA's Board of Appeal and the European Ombudsman.

### Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EC) No 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the EBA in its implementing rules adopted by its Management Board. Further information on data protection can be found under the [Legal notice section](#) of the EBA website.

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## 2. Executive summary

The CRD IV package has introduced a countercyclical buffer (CCB) to protect the banking system against potential losses when excess credit growth is associated with an increase in system wide risk.

National authorities will be required to monitor credit growth in relation to GDP and other relevant measures and assess whether credit growth is excessive and is leading to the build-up of system-wide risk. Based on this assessment, national authorities will set a country-specific CCB rate. This rate can be set between zero and 2.5 % or even higher when justified, thus resulting in an additional common equity tier 1 (CET1) capital requirement for financial institutions.

For banks operating in more than one jurisdiction, the buffer rate will be a weighted average of the rates in the different countries, where the weights to be applied are the own funds requirements for the credit risk of the bank's various local portfolios. As outlined in Article 136(4) CRD, this institution-specific rate is then to be multiplied by the total risk exposure amount to determine the buffer amount required.

As a first step, cross-border banks must assess the proportion of their exposures in each jurisdiction and therefore they need to identify the geographical location of their relevant credit exposures in order to establish their exact institution-specific buffer rate. The relevant credit exposures under Article 140 CRD include credit risk exposures in all exposure classes (other than exposures to governments and credit institutions) that are subject to own funds requirements for credit risk, for specific risk or incremental default and migration risk (incremental risk charge – IRC), or for securitisation positions. These draft regulatory technical standards (RTS) set out how to identify the geographical location of all relevant exposures.

The geographical location of credit risk exposures should reflect the ultimate risk of an institution's loan portfolios. This consultation paper identifies the ultimate risk location as the residence of the obligor rather than the location of the entity that has generated (booked) these exposures. One notable exception is proposed, namely specialised lending such as project finance. For this category, the geographical location of the ultimate risk should be determined on the basis of the location of the source of income. Turning to trading book exposures, the ultimate risk location should be the country where the debtor of the underlying credit, security or derivatives contract resides. Finally, for securitisation exposures, the location should be where the majority of the obligors of the underlying exposures reside.

Working out the geographical distribution of trading book exposures is particularly challenging. Given their volatility, their limited weight within the total risk-weighted assets and smaller impact on excess credit growth in the private sector, it may be of limited value for firms with small trading books to include these exposures in the calculation of the institution-specific buffer, bearing in mind the resultant operational burden. For the purposes of proportionality, a materiality threshold of 2% relative to the overall credit risk exposure is proposed, so that institutions with capital requirements for specific risk and IRC below this threshold can use a simpler approach to identify the various geographical locations of their trading book exposures.

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If an institution has only minor cross-border activities, the size of these foreign exposures should arguably have a limited impact on the institution-specific buffer rate calculation. Therefore, as a simplifying assumption, for the purpose of identifying their geographical location, foreign exposures below a pre-specified threshold, also proposed at 2% of the overall credit risk exposure, could be allocated to the country in which the institution is registered.

### 3. Background and rationale

#### 3.1 Rationale for the countercyclical buffer (CCB) and the geographical location of exposures

Article 140 CRD sets out how the countercyclical buffer (CCB) should be calculated. The CCB is a capital buffer that is increased or reduced in a countercyclical manner according to changes in the systemic component of credit risk over time. The purpose is to protect the banking system against potential losses when excessive credit growth is associated with an increase in system-wide risk.

The CCB is expected to have a direct effect on the resilience of the banking system; when risks appear, the additional capital will help the system to absorb losses while continuing to provide credit to the real economy. In so doing, the CCB should counter the pro-cyclical amplification of shocks via the banking system to the real economy which has been one of the most destabilising elements of the financial crisis. As a possible positive side effect, the CCB may help to counter the expansionary phase of the credit cycle by reducing the supply of credit and/or increasing its cost.

Under the capital requirement rules in the European Union, each Member State will designate a public authority or body that will be responsible for the quarterly setting of the CCB rate for exposures located in that Member State. Designated authorities will be required to monitor both credit growth in relation to GDP and other relevant variables, and assess whether growth is excessive and is leading to the build-up of system-wide risks. National designated authorities will set a CCB rate for their respective jurisdictions based on this assessment.

The buffers to be held by individual institutions will be calculated according to the countries in their whole cross-border credit portfolio by using a combination of the rates in each country. Banks operating in more than one jurisdiction will have to assess the proportion of their exposures in each jurisdiction. The institution-specific CCB rate for banks with cross-border activities will depend on the geographical location of their credit portfolios, and not on the location of the institutions that hold these exposures. The geographical location of exposures should be based on an 'ultimate risk' principle and not on the location where the exposure was booked.

Banks will need to look at the geographical location of their relevant private sector credit exposures and calculate their CCB as a weighted average of the rates applied in jurisdictions where they have credit exposures. A bank loan to a private sector entity located in any given jurisdiction will attract the same buffer requirement for that jurisdiction, irrespective of the location of the bank providing the loan.

After identifying the geographical location of an institution's credit risk exposures, the institution's specific buffer rate can be set. As an example, if the CCB rates in countries A, B and C are 2%, 1%

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and 1.5% of risk-weighted assets respectively, all loans to counterparties in country (A) will attract the same buffer requirement (2%), irrespective of the location of the bank granting the loan. A bank with 60% of its own funds requirement with country A counterparties, 25% of its own funds requirement with country B counterparties and 15% of its own funds requirement with country C counterparties would be subject to an overall CCB rate equal to the weighted average of the rates applied in A, B and C ( $2\% \times 0.6 + 1\% \times 0.25 + 1.5\% \times 0.15 = 1.68\%$ ). This institution-specific rate is then to be multiplied by total risk exposure amount, as outlined in Article 136(4) CRD, which will give the buffer amount required.

### 3.2 Rationale for the location of different credit risk exposures

Article 140(4) CRD lays down that the exposures to be included in a geographical location 'shall include all those exposure classes, other than those referred to in points (a) to (f) of Article 112 of Regulation (EU) No 575/2013' (CRR). This therefore includes all credit risk exposures, except those to governments and financial institutions, which are subject to own funds requirements for credit risk under Part Three, Title II CRR; or, where the exposure is held in the trading book, are subject to own funds requirements under Part Three, Title IV, Chapter 2 CRR for specific risk or incremental default and migration risk; or, where the exposure is a securitisation, are subject to own funds requirements under Part Three, Title II, Chapter 5 CRR.

#### Credit risk exposures

For the credit risk exposures under Article 140(4)(a) CRD, the geographical locations should depend on the geographical location of the institution's portfolios, and not on the geographical location of the institution that generates these exposures.

For the purposes of these RTS, the EBA considers that the ultimate risk basis may be applied in different ways: first, as the residence of the obligor as opposed to the booking of the exposure (the obligor principle); second, as the residence of the obligor, or if collateral or guarantee exist, the country where the collateral or guarantor resides (the guarantor principle); finally, as a mix of the two depending on the structure of the credit transaction, such as basing it on the source of income.

The general objective of the CCB is to protect the banking system against potential losses when excess credit growth is associated with an increase in system-wide risk. By anchoring the CCB to credit variables, such as the deviation of the ratio of credit-to-GDP from its long-term trend (henceforth the 'credit-to-GDP gap'), the CCB focuses on protecting the banks from the build-up of system-wide vulnerabilities. The CCB builds resilience into the banking system by actively encouraging the setting of buffers in boom times (when risks are taken on but, arguably, are not fully reflected in prices) and by releasing them in bad times.

With the objective of the CCB in mind, it appears appropriate to use the obligor principle; this will help to build capital in the country of residence of the obligor (regardless of where the collateral of these exposures is located), as the residence of the obligor will, in most but not all cases, be closely linked to the relevant economy.

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The EBA is therefore currently considering using the residence of the obligor as a first proposal and is launching this consultation about the practical implications of this criterion, compared with other possible alternatives. The EBA is very aware that the guarantor principle also has its merits and will also consider international developments in order to ensure consistency.

For a particular type of projects, namely specialised lending exposures, which typically include project financing, the geographical location will be based on where the income is generated, i.e. the source of income. The EBA believes that the source of income would be more appropriate for specialised lending exposures and has consequently chosen to deviate from the obligor principle in this case.

If an institution has minor cross-border activities, the effort required to monitor CCB rates within the EU is limited while the effort needed to track cross-border exposures to calculate the proportion of the relevant credit exposure to be assigned to each jurisdiction could be considered unduly burdensome. To achieve a proportionate approach towards banks with very limited cross-border activities, institutions with a total share of non-domestic activities below a pre-specified threshold of 2% of their risk-weighted exposures will not be obliged to identify the geographical distribution of these exposures. As a simplifying methodology, all credit risk exposures in these cases can be assigned to the domestic jurisdiction of the institution; the maximum error in the calculation of the capital requirement ought to be only 0.05%<sup>1</sup>. It should be clear that the use of this threshold does not exempt institutions from actually applying their institution-specific CCB rate to their total risk-weighted exposures, including those generated by those foreign exposures falling below the 2% threshold.

### Trading book exposures

As for relevant credit exposures, the geographical location of trading positions will generally be defined as the country where the debtor of the underlying credit, security or derivatives contract resides. However, given that the own funds requirements for trading book exposures under the advanced specific risk method are calculated on a portfolio basis, the weighting of national buffer rates by the own funds requirement of the relevant exposures would be a significant burden for institutions under that regulatory approach. Therefore, alternative methods that allow the establishment of own funds requirements at the debtor level should be considered.

One possible option is to require all institutions, including those using advanced approaches, to use the methodology prescribed for the own funds requirement under the standardised approach – as set out in Article 336 CRR – to identify the location of trading book exposures. This means that the geographical distribution of the IRC own funds requirements will be determined by the relative weights calculated using the standardised approach specific risk capital charge.

Such an approach appears to be the most comparable method for determining the geographical location of trading exposures in standardised and advanced models. That said, other approaches may be explored, such as distributing the total specific risk and IRC risk-weighted amount in the same proportions as the positions, or as per the board approved limits, to assign the risk-weighted exposures to the country of the holder of the positions, or using the same geographical locations as

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<sup>1</sup> For CCB country rates up to 2.5%.

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identified for credit risk exposures. These options are indeed less burdensome for institutions, but do not offer equally comparable results.

Given the more volatile nature of trading book positions, the impact of the trading book on limiting excess credit growth may be limited and, for many institutions, these positions are likely to comprise a relatively small part of relevant credit exposures for the purposes of the CCB. A proportionate approach to identifying the geographical location of the trading book could therefore be considered.

It may be appropriate to establish a materiality threshold for the purposes of identifying the geographical location of these exposures. Institutions which fall under this threshold would not need to take account of the geographical location of their trading book positions to calculate the weighted average CCB rate. This threshold would be set in terms of the own funds requirement for the trading book positions relative to the own funds requirements identified under Article 140(4)(a) to (c) CRD. This would ensure that only institutions with material trading book positions would be required to identify the geographical locations of these positions.

The EBA is therefore considering whether institutions with positions below a threshold of 2% of the own funds requirement for specific risk as set out in Article 140(4)(b) CRD relative to the relevant credit exposures identified under Article 140(4)(a) to (c) CRD would be exempted from having to identify the geographical location of exposures in the trading book. Such an approach would appear to strike an appropriate balance between the operational burden of identifying the geographical location and the prudence of the measure.

Two additional aspects however warrant particular attention when introducing the threshold. First, it should be clear that the use of a threshold does not exempt institutions from applying their institution-specific CCB rate to their total risk-weighted assets, which include positions in the trading book. The exemption only relates to identifying the geographical distribution. Second, a further calibration of the threshold may be necessary. The EBA is currently considering whether the 2% level chosen strikes the appropriate balance and is therefore requesting input on the issue in this consultation paper.

### **Securitisation exposures**

The approach for securitisation exposures will be a look-through approach. For securitisation exposures under Article 140(4)(c) CRD the location would be that of the obligors of the underlying exposures. If these obligors are located in multiple jurisdictions, the location of a securitisation exposure would be the jurisdiction of those obligors with the largest proportion of the underlying exposures.

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### 3.3 The nature of RTS under EU law

These draft RTS are produced in accordance with Article 10 of the EBA Regulation<sup>2</sup>. Pursuant to Article 10(4) of the EBA Regulation, these RTS shall be adopted by means of a regulation or decision. Under EU law, EU Regulations are binding in their entirety and directly applicable in all Member States. This means that, on the date of their entry into force, they become part of the national law of the Member States and that enactment in national law is not only unnecessary but also prohibited by EU law, except insofar as this is expressly required by the Member States.

Shaping these rules in the form of a regulation would ensure a level playing field by preventing diverging national requirements and easing the cross-border provision of services. Currently, an institution that wishes to begin working in another Member State has to apply different sets of rules.

The EBA has developed these draft RTS on the basis of the Directive 2013/36/EU of the European Parliament and of the Council (CRD). The EBA must submit these draft technical standards to the Commission by 1 January 2014.

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<sup>2</sup>Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC.

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#### 4. Draft regulatory technical standards on the method for the identification of the geographical location of the relevant credit exposures under Article 140(7) of the Capital Requirements Directive (CRD)

In the text of the draft RTS/ITS/Guidelines/Advice that follows, there are occasionally further explanations on specific aspects of the draft, either offering examples or providing the rationale behind a provision, or setting out specific questions for the consultation process. Where this is the case, this explanatory text appears in a framed text box.

#### Contents

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**COMMISSION DELEGATED REGULATION (EU) No .../..**

**of XXX**

[...]

**supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards on the identification of the geographical location of the relevant credit exposures for the purposes of the countercyclical capital buffer under Article 140(7).**

**THE EUROPEAN COMMISSION,**

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

Having regard to Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, and in particular to Article 140(7) thereof,

Whereas:

- (1) The calculation of the institution-specific countercyclical capital buffer rates requires that the location of the own funds requirements for all credit exposures of a specific institution, including exposures held in the trading book and all securitisation exposures, are identified geographically.
- (2) The geographical location shall follow from the risk of the exposures. This will ensure that the build-up of additional reserves from implementing the countercyclical buffer is allocated to the jurisdiction with excess credit growth.
- (3) The place of residence of the obligor or of the debtor will be generally used for determining the geographical location of all credit exposures as this is considered to best reflect the location which is of importance to the financial system. However, the geographical location of credit exposures identified as specialised lending exposures under in Article 147(8) of Regulation (EU) No 575/2013 should be based on the location of the assets generating the income that is the primary source of repayment of the obligation.
- (4) Exposures of an institution to a legal person should be allocated to the place of the actual centre of administration of this person, if this is different from its registered office and the institution is, in any way, aware of this situation.
- (5) Proportionality and materiality considerations are taken into account for institutions with limited foreign overall exposure. This is intended to alleviate the burden for smaller institutions which tend to have limited foreign and trading activity.
- (6) This Regulation is based on the draft regulatory technical standards submitted by the European Banking Authority to the Commission.
- (7) The European Banking Authority has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, it has analysed the

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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*

*Definitions*

1. ‘credit exposure’ means the exposure referred to in Article 140(4)(a) of Directive 2013/36/EU;
2. ‘trading book exposure’ means the exposure referred to in Article 140 (4)(b) of Directive 2013/36/EU;
3. ‘securitisation exposure’ means the exposure referred to in Article 140(4)(c) of Directive 2013/36/EU;
4. ‘place of the obligor’ means the country where the natural or legal person, who is the institution’s counterparty to a credit exposure or the issuer of the financial instrument not included in the trading book or the counterparty to a non-trading book exposure, is ordinarily resident (in the case of a natural person), or has its registered office, or its actual centre of administration if that is in a different country from its registered office (in the case of a legal person);
5. ‘place of the debtor’ means the country where the natural or legal person who is the issuer of the financial instrument in the trading book, or the counterparty to a trading book exposure, is ordinarily resident (in the case of a natural person), or has its registered office, or its actual centre of administration if that is in a different country from its registered office (in the case of a legal person);
6. ‘place of the institution’ means the Member State in which the institution has been granted authorisation;
7. ‘place of the income’ means the country of the location of the assets, which generate the income that is the primary source of repayment of the obligation in relation to a specialised lending exposure;
8. ‘foreign exposure’ means a credit exposure which is not a domestic exposure;
9. ‘domestic exposure’ means a credit exposure whose place of obligor or place of debtor coincides with the place of the institution;
10. ‘specialised lending exposure’ means credit exposures possessing the characteristics referred to in Article 147(8) of Regulation(EU) 575/2013.

*Article 2*

*Credit Exposures*

1. For the purpose of calculating the institution-specific countercyclical capital buffer rates, institutions shall identify the geographical location of their credit exposures in accordance with this Article.
2. Credit exposures shall be deemed to be located in the place of the obligor.
3. Notwithstanding paragraph 2 of this Article, credit exposures referred to in Article 147(8) of Regulation (EU) No 575/2013 shall be deemed to be located in the place of the income.
4. Notwithstanding paragraphs 2 and 3 of this Article, if the aggregate amount of an institution's foreign credit exposures does not exceed 2% of their aggregate of credit, trading book and securitization risk weighted exposures, these credit exposures shall be deemed to be located at the place of the institution.

#### **Explanatory text for consultation purposes**

The ultimate risk basis can be specified in different ways: a) the residence of the obligor; or b) if collateral or guarantee exist, the country where the collateral or guarantor resides.

The use of the obligor principle reflects where the primary risk comes from. By using the obligor principle, the CCB would help to build capital in the country of the residence of the obligor (regardless where the collateral of these exposures are located).

The guarantor principle may better reflect the location of the ultimate risk, if a loan is granted based on the quality of the collateral/guarantor, as the risk may stem from the guarantees or collateral rather than from the initial obligor. This option is consistent with the way capital requirements are calculated. However, it could be inconsistent with the setting of the CCB rate by designated national authorities where the credit-to-GDP-gap features prominently amongst the variables national authorities should take into account, pursuant to Article 136 CRD. As credit volumes are tracked country by country on obligor basis<sup>3</sup>, using different criteria to track the credit volumes could lead to unintended inconsistencies in the practical calculation of institution-specific CCBs. For example, if institutions in UK increase their loans to UK citizens to buy a house in Spain, the CCB may be activated at 2.5% for UK. However, if the location of the collateral is taken into account for the application of the individual CCB rate, then most of the activity of banks in UK in this case is being done using collateral located in Spain. Using the collateral/guarantor principle would lead to lower institution-specific CCB rates in the UK.

The options set out above only become relevant when the guarantor or collateral reside in a different jurisdiction from the obligor. In most cases, when the residence of the obligor and the collateral/guarantor belong to the same jurisdiction, or in the absence of collateral or guarantee, using either obligor or guarantor principle would result in the same location being applied.

The principle chosen should be the option that better serves the purpose of the CCB, which is to protect the banking system against potential future losses associated with excess credit growth. Given that the excess credit growth would be geographically located in the UK economy in the above example (for the credit-to-GDP-gap), following the obligor principle would appear most consistent with the purpose of the CCB. However, also the guarantor principle is still under consideration, as this may

<sup>3</sup> <http://www.bis.org/statistics/credtopriv.htm>

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lead to better international alignment and input on the proposal to use the obligor principle is sought in this consultation paper.

Despite the decision to use the obligor principle as a general principle, there may be notable exceptions, where the obligor principle may not be adequate. For example, the systemic component of the credit risk related to specialised lending as defined in Article 147(8) CRR, such as project finance, seems to be largely linked to the source of income, which is generated in the location of the project/asset. Hence an exception should be made for specialised lending. The EBA is interested in finding out if there are any other exemptions which should be considered.

Article 2 also introduces a proportionality threshold of 2%, where all institutions with less than 2% of their risk-weighted assets in foreign exposures are to allocate these foreign exposures to their domestic exposures. This is intended to alleviate the operational burden for institutions with very limited aggregate cross-border activity.

When choosing the method of allocation, it should also be noted that the information for the geographical breakdown of exposures should be easily available, and should not add any complexity to the broad CCB measure.

Finally, this information should be comparable across institutions. It is essential that the method for identifying geographical location is fully consistent across different jurisdictions, so that banks located in different countries, but with the same mix of geographical exposures, will attract the same capital CCB rate.

**Q1. Do you agree with using the obligor principle for the practical implementation of the CCB? If not, could you provide specific examples where this principle would not work in practice and explain why an alternative option, for instance the guarantor principle, would work better?**

**Q2. Do you agree with using the place of income for specialised lending?**

**Q3. Should other exposures, such as residential or commercial mortgages, also use the guarantor principle? If yes, please justify the answer.**

**Q4. Do you agree with the inclusion of a threshold for credit risk exposures? Would this threshold lead to any substantial reduction in the burden for institutions? Should guidance be provided on the re-calculation frequency?**

### *Article 3*

#### *Trading book exposures*

1. For the purpose of calculating the institution-specific countercyclical capital buffer rates, institutions shall identify the geographical location of their trading book exposures in accordance with this Article.

2. Subject to paragraphs 3 and 4, trading book exposures shall be deemed to be located in the place of the debtor.
3. Institutions calculating the own funds requirements of their trading book exposures for incremental default and migration risk under Part Three, Title IV, Chapter 5 of Regulation (EU) No 575/2013, shall determine the geographical location of their exposures by multiplying their total risk-weighted exposures corresponding to their own funds mentioned in Article 140(4)(b) of Directive 2013/36/EU by the ratio of (a) to (b) below:
  - (a) the own funds requirements for specific risk of the trading book exposures located in each country under Part Three, Title IV, Chapter 2 of the Regulation;
  - (b) the own funds requirements in Part Three, Title IV, Chapter 2 of the Regulation for specific risk for all their trading book exposures.
4. Notwithstanding paragraphs 2 and 3 of this Article, institutions whose total trading book risk-weighted exposures does not exceed 2% of their total credit, trading book and securitisation risk-weighted exposures, shall not include the trading book exposures for the purposes of identifying the geographical location of their exposures.

#### **Explanatory text for consultation purposes**

Several methods for identifying the geographical location of trading book exposures have been considered. The approach chosen requires institutions to determine the geographical distribution of trading book exposures by applying the standardised approach for specific risk and determining the geographical location based on the obligor principle. Institutions applying advanced internal model approaches should also use the methodology set out in the standardised approach to market risk in order to identify the geographical distribution of their trading book exposures for the CCB.

As the institution-specific CCB should be based on the own funds requirement, the risk-weighted asset amount for a private sector trading book exposure will be the total capital charge for specific risk and IRC multiplied by 12.5. This risk-weighted amount needs to be geographically allocated according to a method, which is difficult as the own funds requirement calculated by internal models for IRC is on a portfolio basis. The most consistent method across jurisdictions would be to use the same proportion of the geographical allocation corresponding to the capital requirements calculated under the standardised measurement method for specific risk. Further methods may, however, be explored for banks adopting internal models as follows:

- As a proportion of the geographical distribution of the exposures. Total positions include long and short positions. It should be decided whether or not to include short positions in this calculation.
- Given the rotation of the trading book, the allocation of the exposures at a certain date may not be as meaningful as a more stable measure. A second option would be to distribute the capital charge according to limits approved by the bank. To reduce the flexibility of this option, it could be restricted only to those limits which are being used to some extent.
- A third possibility would be assign the exposures to the legal entity which holds the positions. This is only very approximate. The rationale for this simplification is that capital charges for market risk are, in general, much lower than capital charges for credit risk and, therefore, the impact of this simplification on the calculation of the institution buffer, which is a weighted average of risk-

weighted amounts, would be acceptable.

- Finally, a possibility would be assigning these exposures using the same geographical distribution as the credit risk exposures. Again this is only very approximate, the rationale being not to alter the distribution resulting from the credit risk exposures.

**Q5. Do you agree with approach chosen and is the approach sufficiently clear? If not, please describe the best method for allocating the total specific and IRC capital charges and describe its rationale and practical implementation.**

**Q6. Do you agree with the inclusion of a proportionality threshold for trading book exposures?**

#### *Article 4*

##### *Securitisation exposures*

1. To calculate the institution-specific countercyclical capital buffer rates, institutions shall identify the geographical location of their securitisation exposures in accordance with this Article.
2. A securitisation exposure shall be deemed to be located at the place of the obligor of the underlying exposures.
3. If there is more than one location corresponding to the obligor of the underlying exposures of a given securitisation exposure, that exposure shall be deemed to be located at the place of the obligor of the underlying exposures with the highest proportion in the underlying securitisation exposures.

#### **Explanatory text for consultation purposes**

As the geographical location of underlying exposures is to be reported, the application of a look-through approach appears feasible. The geographical location of the jurisdiction with the highest proportion of underlying exposures has been chosen so as to limit the operational burden.

**Q7. Do you agree with the application of a look-through approach for securitisation exposures? Can the approach proposed be implemented for re-securitisation exposures? Should other exposures such as CIUs also use the look-through approach? If yes, please justify the answer.**

**Q8. Do you agree that the geographical location of exposures should be the location with the highest proportion of the underlying exposures? Would it be difficult to locate all underlying exposures geographically?**

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*Article 5*

*Final provisions*

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]*

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## 5. Accompanying documents

### 5.1 Draft cost-benefit analysis / impact assessment

1. Article 10(1) of the EBA Regulation (Regulation (EU) No 1093/2010 of the European Parliament and of the Council) provides that when any draft regulatory technical standards developed by the EBA are submitted to the Commission for adoption, they shall be accompanied by an analysis of 'the potential related costs and benefits'. This analysis should provide an overview of the findings regarding the problem to be dealt with, the solutions proposed and the potential impact of these options.
2. The analysis of the draft RTS on the method for identifying the geographical location of the relevant credit exposures is provided in this note. These draft RTS have been developed pursuant to Article 140(7) CRD.

#### Problem definition

##### *Issues addressed by the European Commission regarding pro-cyclicality*

3. In the impact assessment accompanying its proposal for the CRD<sup>4</sup>, the Commission noted that the non-responsiveness of regulatory capital requirements to the build-up of risk at the macro level had led to an accumulation of financial imbalances before the most recent financial crisis. These imbalances, once the economic cycle turned, prompted a deleveraging spiral and precipitated steep credit-related losses.
4. In line with Basel III, the Commission proposed in CRD IV a countercyclical buffer that would take account of the macro-financial environment in which institutions operate. National authorities would set the buffer for credit exposures in their jurisdiction. The buffer should not generally exceed 2.5% of the risk-weighted assets of an institution and would only be imposed when there was evidence that the excess credit growth was resulting in a build-up of system-wide risk. Institutions with exclusively domestic credit exposures would only be subject to the buffer determined by their national supervisors.

##### *Issues addressed by the RTS and objectives*

5. Institutions with exposures in other jurisdictions will have to determine the rate to apply for their countercyclical buffer by calculating the weighted average of the countercyclical buffer rates that apply in the jurisdictions where these relevant credit exposures are located. In practice, this means that cross-border credit institutions would have to look at the geographical location of their credit exposures and calculate their countercyclical capital buffer according to the buffers prevailing in those Member States where their exposures are located. To promote consistency in the method used to calculate the countercyclical buffer, the Commission mandated the EBA to define a method for identifying the geographical location of the credit exposures.

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<sup>4</sup> [Impact assessment accompanying the document Regulation of the European Parliament and the Council on prudential requirements for the credit institutions and investment firms](#) pp.12-13.

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6. These RTS will contribute to a common understanding among institutions and the EU's national competent authorities about the methodology that institutions should use to identify the geographical location of their exposures. It will also ensure a minimum level of harmonisation and consistent practice in this area and contribute to achieving the objectives in the CRD of reducing the cyclicity of provisioning and capital requirements.

#### Technical options considered

7. This section explains the rationale behind some of the choices that the EBA has made in drafting the RTS.

#### *Determining the location of the credit risk exposures*

8. Initially, the EBA considered two possible locations to which an exposure could be allocated:
- ▶ Option A1 - The country where the obligor resides;
  - ▶ Option A2 – The country where the obligor resides, or, if there is a guarantor, (i) where the guarantor resides, or, ultimately, (ii) where the collateral is held.
9. Using data from the consolidated statistics of the Bank for International Settlements (BIS) , which capture the consolidated positions of institutions' worldwide offices<sup>5</sup>, the EBA has tried to determine:
- a. the volume of foreign claims booked by EU institutions and specialised lending, in particular relatively to the total assets;
  - b. how the different methods proposed for the geographical location of a claim may affect the size of the countercyclical buffer to be held.
10. **Significance of foreign claims** – In the six countries for which data was available, foreign claims in Q4 2012 were USD 11.8tn, of which around USD 7tn (58% of total foreign claims) were granted to counterparties in the non-bank private sector (which includes non-bank financial institutions and non-financial private sector). The share of non-bank private sector foreign claims was between 51% and 72% of total foreign claims granted by domestic institutions. Total foreign claims represented between 17.2% and 32.4% of the total assets held by domestic institutions in each of the six countries. Non-bank private sector foreign claims accounted for between 8.8% and 22.5% of the total assets held by institutions.
11. Between 2005 and 2010, total foreign claims booked by banks to counterparties in foreign countries varied significantly. In most of the six countries under consideration, total foreign claims doubled between 2005 and 2008, fell by 30%-50% during the period 2008-2010, and have been

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<sup>5</sup> Granular data on foreign claims on an ultimate risk basis (URB) is only available at a country level for six EU countries: Belgium, France, Germany, Italy, Spain and United Kingdom. The data available for intermediate basis (IB) is aggregated for all BIS reporting countries and is not available at country level.

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mostly stable since 2010. For all the countries in the sample except the UK, more than 50% of the foreign claims were booked with a counterparty located in the EU28.

12. **Significance of specialised lending** – Project financing represents only a small fraction of the loans granted to non-financial institutions and is likely to be only slightly affected by these RTS. According to Dealogic<sup>6</sup>, the worldwide project finance total was USD 172.0bn in the first half 2012 and around 22.5% was done in Europe<sup>7</sup> (USD 38.6bn). Using data from the ECB<sup>8</sup>, the EBA estimated that project financing represented between 0.5% and 1.1% of the total loans granted to non-financial institutions in 2011. This includes both domestic and foreign claims so the share of project financing granted to foreign entities as a proportion of all loans granted is likely to be even smaller.
13. **Impact of the different methods of allocating foreign claims** – The EBA has examined the differences in exposures under the immediate obligor principle (i.e. when claims are allocated to the country of residence of the immediate counterparty (option A1)) and those allocated under the guarantor/collateral principle (where the ‘ultimate risk’ lies (option A2)). For foreign claims measured on an intermediary basis, the data available is aggregated across all countries reporting to the BIS<sup>9</sup>, and no data is available at a reporting country level. However, the exposure of all institutions reporting to the BIS to all counterparties in any given country is available.
14. A number of important caveats associated with the data in this report must be highlighted. First, the breakdown by sector is not available and therefore it was not possible to compare exposure for the non-banking sector only, which is the type of exposure specifically affected by this RTS. Then, the set of institutions reporting data on an immediate borrower basis is composed by domestic banks on a consolidated basis and non-domestic resident banks, whereas that reporting data on an ultimate risk basis (or guarantor basis) includes only resident banks. The difference between the two populations of reporting banks reduces the comparability between the two measures of foreign claims. With these caveats in mind, the absolute and relative difference between the foreign claims that each of countries of the EU28 had towards all the BIS reporting countries was calculated from 2005 to 2012.
15. Figures 1 and 2 present some summary statistics of the results of this calculation. During this period, taking 22 of the 28 countries, foreign claims measured using intermediary basis were 6% lower than exposures measured according ultimate risk basis for the country with the highest negative difference, and 16% higher for the country with the highest positive difference. In absolute terms, taking 22 of the 28 countries, foreign claims measured using the intermediary basis were USD 37bn lower than measured using the ultimate risk basis for the country with the highest negative difference, and USD 3bn higher for the country with the highest positive difference. For the outliers (not shown in the graph), the absolute differences reached extremes of USD 440bn and -USD 369bn before 2009, and after this date, USD 139bn and -USD 247bn. In

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<sup>6</sup> Dealogic Project Finance Review - 1H 2012.

<sup>7</sup> Europe covers here all European countries including Russia.

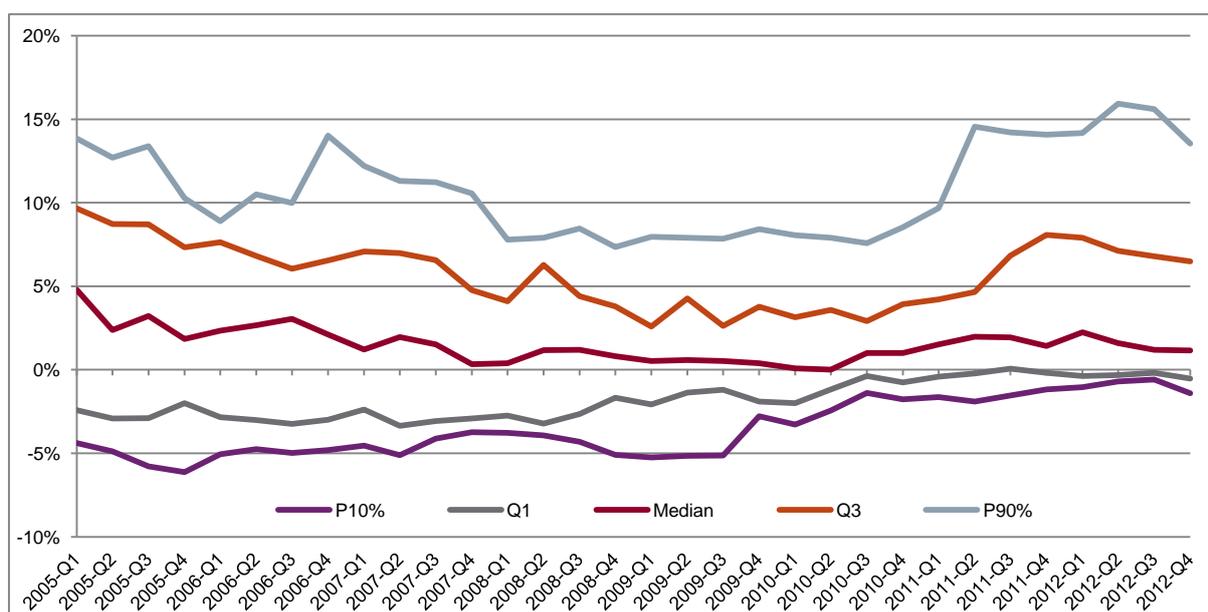
<sup>8</sup> ECB Statistical Data Warehouse - [Loans to non financial corporations](#)

<sup>9</sup> The countries for which foreign claim data is available after 2005, both for ultimate risk and intermediary basis are the following: Australia, Austria, Belgium, Canada, Chile, Chinese, Taipei, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States.

relative terms, the largest difference during the whole period was 29% for the highest positive difference and 15% for the highest negative difference.

16. From this analysis, for most exposures to a member of the EU28, using one either geographical location option will only have a modest impact on the volume of exposures which are allocated to each foreign country and therefore on the size of the countercyclical buffer. This result should be taken with caution, as it has not been possible to identify to which extent some of the differences between the two measures of foreign claims may be explained (or compensated) by the difference of reporting population from the data used (domestic and non-domestic for immediate risk basis and only domestic for ultimate risk basis).

**Figure 1 – Relative difference between foreign claims held by banks from all BIS reporting countries towards an EU28 Member State from 2005 to 2012 (in %)**



17. In light of these results, the EBA favours option A1, the country of residence of the obligor for geographical location of exposures. The role of the CCB is to protect banks from the build-up of system-wide vulnerabilities, by creating buffers in boom times (when risks are taken on but, arguably, are not fully reflected in prices) and by releasing them in bad times (when the market price of risk shoots up as losses materialise). With that objective in mind, it seems more appropriate to link the geographical location to the residence of the obligor, which is closely linked to the economy that, in most cases, is relevant for the buffer.

18. The EBA agrees that in some cases (for instance in project financing) the guarantor plays such an important role that the economic environment (thus, geographical location) of the guarantor or collateral would be a better reference for the purposes of the CCB. Therefore, for specialised lending exposures, the EBA favours option A2, i.e. the country where the obligor resides, or, if there is collateral or a guarantor, the country where the guarantor or collateral resides.

## Impact of the proposals

### Costs

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19. There will be direct compliance costs for identifying the geographical location of the exposures according to the methodology proposed. Institutions are likely to have this information available already (especially as it is required for the COREP reporting), so geographical location identification should not require significant resources.
20. The implementation of these RTS may have additional resource implications for national supervisory authorities (NSAs), in terms of additional staff time required for supervision. However, these additional resources should not be significant, as NSAs should already be monitoring the compliance of institutions with EU capital requirements.

*Benefits*

21. By establishing harmonised practices for the geographical location of exposures, these RTS will ensure that institutions in different Member States use the same methodology when calculating their countercyclical buffer, providing legal clarity and a level playing field, as well as facilitating the CCB calculation by cross-border institutions.

**Q9: Do you agree with our analysis of the impact of the proposals in this consultation paper? If not, can you provide any evidence or data that might further assist our analysis of the possible impact of the proposals?**

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## 5.2 Overview of questions for consultation

Q1. Do you agree with using the obligor principle for the practical implementation of the CCB? If not, could you provide specific examples where this principle would not work in practice and explain why an alternative option would work better?

Q2. Do you agree with using the guarantor principle for specialised lending?

Q3. Should other exposures, such as residential or commercial mortgages, also use the guarantor principle? If yes, please justify the answer.

Q4. Do you agree with the inclusion of a threshold for credit risk exposures? Would this threshold lead to any substantial reduction in the burden for institutions?

Q5. Do you agree with approach chosen and is the approach sufficiently clear? If not, please describe the best method for allocating the total specific and IRC capital charges and describe its rationale and practical implementation.

Q6. Do you agree with the inclusion of a proportionality threshold for trading book exposures?

Q7. Do you agree with the application of a look-through approach for securitisation exposures? Can the approach proposed be implemented for re-securitisation exposures? Should other exposures such as CIUs also use the look-through approach? If yes, please justify the answer.

Q8. Do you agree that the geographical location of exposures should be the location with the highest proportion of the underlying exposures? Would it be difficult to locate all underlying exposures geographically?

Q9: Do you agree with our analysis of the impact of the proposals in this consultation paper? If not, can you provide any evidence or data that might further assist our analysis of the possible impact of the proposals?