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EBA FINAL draft Regulatory Technical Standards

On the definition of market under Article 341(3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation - CRR)

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Table of contents

1. Executive Summary

The Capital Requirements Regulation (CRR) sets out requirements concerning the definition of the term ‘market’ under its Article 341(3). The definition of market is used for the calculation of the overall net position in equity instruments, which is used to calculate the own funds requirements for equity general market risk according to Article 343 the CRR.

The EBA has agreed to define market based on a currency criterion, but solely for jurisdictions included the Euro-zone. For the rest of jurisdictions, market will be defined using a nationality criterion.

The currency criterion applied for the Euro-zone recognises that the introduction of a single currency has addressed 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.

2. Background and rationale

Article 341 of Regulation (EU) 575/2013 (CRR) establishes rules for 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. According to Article 342 the overall gross position shall be used to calculate the standardised own funds requirement against specific equity risk.
- 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, according to Article 343, banks shall use to calculate the standardised own funds requirement against general equity risk.

Paragraph 3 of article 341 states that the EBA shall develop draft regulatory technical standards defining the term 'market' 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 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.

The general market risk calculation implicitly assumes that two equities in the same 'market' are subject to the same general risk. In this regard, the EBA considers that the introduction of a single currency in an already substantially integrated EU Single Market has addressed 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-zone, takes integration a step further; it is a process of much closer economic integration with the other Euro-zone 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-zone. Legal convergence requires that national legislation, in particular the national central bank and monetary issues, is compatible with the Treaty.

Accordingly, since the adoption of the euro has many legal and economic conditions attached to it, the elimination of the foreign exchange (FX) risk is not the only condition behind the adoption of a currency criterion to define 'market'. Accordingly, those shares listed in markets located in jurisdictions with a 'pegged' currency to the euro should not be considered as part of the Euro-zone market.

In addition, due to the legal and economic conditions attached to the euro accession process, the currency criterion is only applicable to the Euro-zone area. For the rest of markets outside the Euro-zone a nationality criterion will be followed.

3. EBA FINAL draft regulatory Technical Standards on the definition of market under Article 341(3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation -CRR)

EUROPEAN COMMISSION

Brussels, XXX
[…](2012) XXX draft

COMMISSION DELEGATED REGULATION (EU) No …/..

of XXX

[…]

supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for the definition of market under Article 341(3)

COMMISSION DELEGATED REGULATION (EU) No …/..

of XXX

[…]

COMMISSION DELEGATED REGULATION (EU) No …/... supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for the definition of market according to Article 341(3)

THE EUROPEAN COMMISSION,

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

Having regard to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [1] and in particular Article 341(3) third subparagraph thereof,

Whereas:

(1) Given the definition of general market risk at Article 362 of Regulation (EU) No 575/2013 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 343 of Regulation (EU) No 575/2013 should assume that two equities are in the same 'market' where they are subject to the same general risk.

(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.

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

(3) 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 1093/2010.

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

HAS ADOPTED THIS REGULATION:

Article 1 –Definition of 'market' for the purpose of calculating the overall net position in equity instruments under Article 341(2) of Regulation (EU) No 575/2013

For the purpose of calculating the overall net position in equity instruments, according to Article 341(2) of Regulation (EU) No 575/2013, 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.

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]

4. Accompanying documents

4.1 Cost- Benefit Analysis / Impact Assessment

Identification of the problem: Article 362 of Regulation (EU) No 575/2013 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 341 of Regulation (EU) No 575/2013 (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.

It is assumed that NSAs generally apply a nationality criterion =. This is quite straightforward to implement and is generally conservative. However the introduction of this 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.

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);
- 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.

[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)

Criteria applied and rationale: Prior to consultation, the EBA did not have a definitive view on which one of the two possibilities was more appropriate, considering both risk and capital. As a consequence, the EBA consulted 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 341 Regulation (EU) No 575/2013[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.

During consultation a clear majority of respondents consider that the degree of integration in the Eurozone is sufficient to support a definition of 'market' based on a 'currency' criterion for the Eurozone.

The EBA has finally decided to follow a currency criterion for the Euro-zone, while for the rest of jurisdictions the nationality criterion will apply.

Implementation and on-going costs: According to the feedback received during the consultation, the cost of implementing this technical standard is estimated to be negligible for banks, since the procedure for calculating the net position by market remains the same and only the definition of market has to be modified. According to banks, a very small reduction in capital requirements (for banks applying standardised rules for market risk) is expected.

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

4.2 Views of the Banking Stakeholder Group (BSG)

No feedback was received from the BSG.

4.3 Feedback on the public consultation

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
General comments			
Majority support to option 2	3 respondents support EBA's Option 2, whereby the criteria proposed for determining a common market is based on a common currency as well as a common regulatory and (to certain extent) legal framework, such as in the Euro-zone. The rest of markets would be defined using the nationality criterion. This recognizes that the introduction of a Single Market with a Single Rulebook and currency has eliminated some important elements of segmentation between equity marketplaces and established clear rules for equivalence. One respondent is against a currency based definition of equity market whilst another one does not entirely oppose it, however it considers that this change should be implemented only if strong evidence is in place to demonstrate the risk profiles warrant such a change.	A majority of respondents consider that the degree of integration in the Eurozone is sufficient to support a definition of 'market' based on a 'currency' criterion for the Eurozone.	Apply option 2 for the definition of 'market': i.e. a 'currency' based definition but solely to the Euro-zone
Transparency	One firm asks EBA to publish a comprehensive summary of the quantitative and qualitative research that they have undertaken while preparing for this paper to increase transparency.	The EBA conducted some empirical analysis to assess both options included in the consultation paper. The analysis was performed both by some EBA members and by the EBA itself. However the data used in both cases was extracted from data providers under licensing agreements that do not allow public use of the information.	No change

Position of other regulators outside of the Europe	One respondent considers that, if option 2 were to be adopted, it would not just be adopted within the EU but also in all the major trading jurisdictions outside the EU.	The existence of a common currency is not the only criteria that has been considered, a common regulation and economic integration is also needed. These elements can only be granted for the Eurozone.	No change
Transition to the fundamental review	One firm believes that option 2 would make the transition to the (potentially) more complex and risk sensitive standard method that is currently being contemplated in the Fundamental Review of the Trading Book smoother and would reduce the amount of additional burden on firms that have only a limited interest in equities in the Eurozone.	The EBA intends to monitor the potential implications that the Fundamental Review (FR) process in Basel might have for Market Risk standards. However, at this stage, there is no envisaged interaction between this particular RTS and the BCBS consultation of the FR.	No change
Responses to questions in Consultation Paper EBA/CP/2013/15			
Q1. Do you consider that the degree of integration in the European Union is sufficient to support currency based definition of equity market? If possible please provide quantitative evidence to support your answer.	3 of the respondents are in favour of applying the currency criterion for the Euro-zone. In particular, one respondent considers that the introduction of a Single Market with a Single Rulebook and currency has eliminated some important elements of segmentation between equity marketplaces and established clear rules for equivalence. According to this respondent's view, the European Union has seen the introduction of euro-denominated indices (Euro STOXX 50, STOXX Europe 600 Health Care…) that are commonly used by banks and delta hedged with their components. Such strategy should be reflected in the regulation by recognizing the Euro-zone as a single market. Another respondent provided a quantitative study which supports that different equities from Euro-zone are subject to the same general risk. They studied the daily returns of the most traded national indices of the Euro-zone over a period of 3 years, and compared the daily	A majority of respondents consider that the degree of integration in the Euro-zone is sufficient to support a definition of 'market' based on a 'currency' criterion for the Euro-zone.	Apply option 2 for the definition of 'market': i.e. a 'currency' based definition but solely to the Euro-zone

	variations to the main European equity index Eurostoxx50 (SX5E) using a model of linear regression (method of least squares): Return (National index) = Return (SX5E) * Beta + u In this model, the closest the Betas is to 1, the closest the national index behaves like the European index. This respondent calculated the 2-year Betas using daily returns for 380 Betas over the last 1,5 year. The average Betas for the main national indices vary between 79.7% (Italy) and 104.9% (Ireland). The evolution of the betas over 1,5 year is stable and the different national indices are close one to another. For each national index the Betas vary within a thin range and close to 1. This respondent concludes that national indices and the European index used are closely related and show similar general risk what supports the compensation of equity positions within the euro-zone for the general risk capital requirement. Another respondent believes that the legal and political measures taken were in the direction of a greater integration and economic convergence in terms of: - Reinforcement of the pillars of the Euro Zone project; - The adoption of common economic and fiscal policies - Alignment of the prudential rules with the European target of a greater integration of the markets; - Normalization of financial markets; - Tax harmonization; This respondent notes that, although the integration/convergence process is not yet completed, the recent steps taken in the EMU, a single framework for banking supervision and regulation, monetary policy measures, enhanced fiscal and budgetary discipline are signs towards the integration in the EU.		

	As a conclusion, the supporters of the currency criterion argue that: - The great majority of the segmentation elements have been eliminated; - There is existence of a strong link between markets; - Countries share the same general risk; Thus, according to this view, the conditions that support a currency based definition for the equity market would have been reinforced during the recent crisis period. However one respondent thinks that the degree of integration in the Euro area is not sufficient to support a currency based definition of equity market. The main argument against this currency based definition of equity market would be the considerable difference in the size and liquidity of stock markets across the Euro area. According to this respondent, the impact of the Euro on the equity market's size and liquidity in each country within the Euro area varies considerably. Big differences in value of share traded ratio as percentage of GDP and turnover ratio across Euro countries would still exist. Other respondent considers that nobody has so far provided the quantitative evidence to demonstrate that the degree of integration is sufficient to categorically support this change in definition. This respondent believes that, without such evidence, the prudential risk framework would mistreat equity general market risk.		
Q2. Are there implementation costs that should be taken into consideration when defining the criterion?	The general opinion is that the costs of implementing the currency criterion for the definition of equity market would be immaterial to institutions. It relies on updating mapping table and running usual implementation tests (a few days): nothing burdensome or costly. The alternative definition would imply no implementation costs at all.	According to the responses received the cost of implementing option 2 will be negligible.	

Q3. What would be the impact on market risk capital requirements impact of the implementation of option 2 measured in both relative and absolute terms?	Option 2 will allow more opportunities for netting positions and so will result in the lowering of the capital requirement. Two respondents believe that this method would be beneficial as it reduces the amount of sub-consolidations for capital requirements against equities exposures and provides for some hedging/consolidation benefits that cannot be achieved if exposures are consolidated along the national lines. These changes would only impact institutions in the Standard Method (usually of a smaller size) that hold capital instruments in their trading portfolio, it is not foreseen that would have a relevant impact to the market as a whole. On an individual/institution basis, the impacts could vary a bit further, depending on its dimension and the exposures to equity holdings in trading portfolios. One respondent estimated that the impact of the implementation of option 2 is a reduction of 5 / 10% of the capital requirements regarding the equity market risk, and globally a reduction of 0,2 / 0,3% regarding capital requirements on standard market risk. Another firm estimated the impact on its market risk capital requirements over their actual portfolio would be less than 1%.	According to the responses received the impact in capital of implementing option 2 will be quite limited.	