EBA/CP/2013/22
25.06.2013

Consultation Paper

Draft Implementing Technical Standards

On appropriately diversified indices under Article 344(1) of the draft Capital Requirements Regulation (CRR)

Consultation Paper on Draft Implementing Technical Standards on appropriately diversified indices under Article 344(1) of the draft Capital Requirements Regulation (CRR)

Table of contents

1. Responding to this Consultation

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

Comments are most helpful if they:

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

Submission of responses

To submit your comments, click on the “send your comments” button on the consultation page. Please note that the deadline for the submission of comments is 08.09.2013.

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 is reviewable 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) N° 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.

2. Executive Summary

This Consultation Paper proposes these draft Implementing Technical Standards (ITS) in accordance with Article 344(1) of the draft Capital Requirements Regulation (CRR) relating to the identification of relevant appropriately diversified indices for the purposes of calculating the capital requirements for equity risk according to the standardised rules. This is necessary as 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 hence not represent more than a certain percentage of the total index value; finally, the index must comprise of equities diversified both (iii) from a geographical and (iv) an economical perspective.

The EBA is expected to submit the final draft technical standards to the European Commission by 1 January 2014.

3. Background and rationale

The EBA has developed these draft ITS on the basis of the final legislative texts of the Capital Requirements Regulation (CRR) produced after the Trialogue agreement and adopted by the Council on 20 June 2013.

Article 344(1) 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.

3.1 Criteria for determining whether an index is appropriately diversified

The EBA has determined the list of exchange traded and 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 (rounding up to the superior natural number) shall represent less than 60% of the total index.

Diversification

1. By Geography: it 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 4 industries amongst the following ones[1]:
    - Oil & Gas
    - Basic Materials
    - Industrials
    - Consumer Goods
    - Health care

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

- Consumer Services
- Telecommunications
- Utilities
- Financials
- Technology

3.2 Update

The EBA expects that the list of appropriately diversified indices will be updated yearly, assessing any additional indices identified as relevant by 30 September of each year.

4. Draft implementing TS on eligible stock indices under Article 344(1) of the draft Capital Requirements Regulation (CRR).

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

Contents

EUROPEAN COMMISSION

Brussels, XXX
[…](2012) XXX draft

COMMISSION IMPLEMENTING REGULATION (EU) No …/..

of XXX

[…]

COMMISSION IMPLEMENTING REGULATION (EU) No …/... laying down implementing technical standards with regard to closely correlated currencies according to Regulation (..) No xx/xxxx[CRR] of 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 (..) No xx/xxxx [CRR] of dd mmmm yyyy of the European Parliament and of the Council on ….[2] and in particular Article 344(1) third subparagraph thereof,

Whereas:

(1) Article 344(4) of Regulation xx/xxx [CRR] states 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.

Explanatory text for consultation purposes

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?

Q2. Do you believe that the levels and numbers of the proposed criteria are appropriate?

Q3. Are there any relevant indices not listed in Annex I that meet the criteria? Please provide evidence that such indices meet the criteria defined in this draft ITS.

(2) Given that Article 344(4) of Regulation xx/xxx [CRR] 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.

---

2 OJ L […], [xx.xx.XXXX, p…].

(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 xx/xxx [CRR] and Article 15 of Regulation 1093/2010.

(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 xx/xxx [CRR]

The list of stock indices which are eligible for the purposes of Article 344 of Regulation xx/xxx [CRR] 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 xx/xxx [CRR]

	Index	Country
1.	S&P All Ords	Australia
2.	ATX	Austria
3.	BEL20	Belgium
4.	SaoPaulo - Bovespa	Brazil
5.	TSE35	Canada
6.	CROBEX	Croatia
7.	OMX Copenhagen 20	Denmark
8.	DJ Euro STOXX 50	EU
9.	Euronext 100	EU
10.	OMX Helsinki General	Finland
11.	CAC40	France
12.	SBF 120	France
13.	DAX	Germany
14.	GEX	Germany
15.	HDAX	Germany
16.	MDAX	Germany
17.	SDAX	Germany
18.	Hang Seng	Hong Kong
19.	FTSE MIB	Italy
20.	Nikkei225	Japan
21.	IPC Index	Mexico
22.	AEX	Netherlands
23.	AMX	Netherland
24.	WIG20	Poland
25.	PSI 20	Portugal
26.	Straits Times Index	Singapore
27.	IBEX35	Spain
28.	OMX Stockholm 30	Sweden

29.	SMI	Switzerland
30.	FTSE 100	UK
31.	FTSE mid-250	UK
32.	S&P 500	USA
33.	Dow Jones Ind. Av.	USA
34 .	NASDAQ	USA

5. Accompanying documents

5.1 Draft 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 draft CRR defines Specific and General risks as components of 'position' risk:

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

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 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 Art. 344.

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)"[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 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)

Apart from the above mentioned, 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 via 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 under 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 economical 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 superior natural number) shall represent less than 60% of the total index.

3. Diversification by Geography: it 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 4 industries amongst the following ones:

    - Oil & Gas
    - Basic Materials
    - Industrials

[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".

- Consumer Goods
- 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 quite automated. As a result, the updating process is not expected to produce material cost on the regulatory authorities' side.

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

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

5.2 Overview of questions for Consultation

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?

Q2. Do you believe that the levels and numbers of the proposed criteria are appropriate?

Q3. Are there any relevant indices not listed in Annex I that meet the criteria? Please provide evidence that such indices meet the criteria defined in this draft ITS.