EBA/CP/2021/14

07 April 2021

Consultation Paper

Draft Regulatory Technical Standards on emerging markets and advanced economies under Article 325ap(3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation 2 – CRR2)

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 by 02.07.2021. 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 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 (EU) 1725/2018 of the European Parliament and of the Council of 23 October 2018. Further information on data protection can be found under the Legal notice section of the EBA website.

2. Executive Summary

Regulation (EU) No 575/2013 (the Capital Requirements Regulation – CRR) as amended by Regulation (EU) 2019/876 implements in EU legislation, inter alia, the revised framework to compute own funds requirements for market risk i.e. the Basel Fundamental Review of the Trading Book (FRTB). One component of these requirements is the Sensitivities-based method under the alternative standardised approach for market risk (FRTB-SA).

In order for institutions to be able to calculate own funds requirements under the sensitivities-based method, Article 325ap(3) of the CRR requests the EBA to specify the economies that should attract lower risk weights for equity risk under the FRTB-SA (so called 'advanced economies'). Other economies are subject to higher risk weights.

The FRTB provides a list of countries that are considered to be 'advanced' for the purpose of the FRTB-SA. The FRTB list was published without the underlying criteria used to get such list being provided. In addition, this list has not been reviewed since the first version of the list published on 14 January 2016. The EBA considers that the list would benefit from a review before the FRTB comes into effect. In particular, the EBA would expect additional EU/EEA countries to qualify as advanced economies for the purpose of the computation of equity risk own funds requirements under the FRTB-SA.

Bearing this in mind, the present consultation paper (CP) replicates the FRTB list, which should be able to ensure a harmonised computation of equity risk own funds requirements by institutions for the immediate purpose of the FRTB-SA reporting requirement. At the same time, the CP seeks stakeholders' views on sources of data and criteria that could be designed to identify advanced economies and emerging markets for the purpose of FRTB-SA equity risk own funds requirements, while maintaining a consistent treatment with how those own funds requirements would be calculated under the FRTB-IMA.

3. Background and rationale

1. Regulation (EU) No 575/2013 (the Capital Requirements Regulation – CRR) as amended by Regulation (EU) 2019/876 implements in EU legislation, inter alia, the revised framework to compute own funds requirements for market risk i.e. the Basel Fundamental Review of the Trading Book (FRTB). One component of these requirements is the sensitivities-based method under the alternative standardised approach for market risk (FRTB-SA).

2. To calculate own funds requirements under the sensitivities-based method, institutions need to multiply net sensitivities to each risk factor within a bucket by the corresponding risk weights. The risk weights to be applied for sensitivities to equity and equity repo rate risk factors are specified in Table 8 of Article 325ap of the CRR, pursuant to the Commission delegated act[1] referred to in Article 461a of Regulation (EU) No 575/2013.

3. Article 325ap(3) of the CRR requests the EBA to specify the economies that should attract a lower risk weight for equity risk under the FRTB-SA (so called 'advanced economies'). Other economies are subject to a higher risk weight. The distinction is not used anywhere else in the prudential framework. More specifically, the EBA is mandated to develop draft RTS to specify what constitutes an emerging market and what constitutes an advanced economy for the purpose of determining the risk weights for equity risk that should be applied.

4. Buckets for sensitivities to equity risk in Table 8 of Article 325ap are defined based on criteria of liquidity (large vs. small market capitalisation) and volatility (taking into account the sector and the economy relevant for the equity).

5. The distinction between small and large market capitalisation is common to the FRTB-SA[2] and the alternative internal model approach (FRTB-IMA) and was specified in the final draft RTS on Liquidity Horizons for the IMA published on 27 March 2020[3]. As for the criteria of volatility, the FRTB-SA applies[4] the risk weight corresponding to the relevant sector, with risk weights for a given sector being lower for advanced economies than for emerging markets. Unlike the distinction between small and large market capitalisation, this approach is specific to the FRTB-SA. Indeed, institutions using the IMA will directly capture the real historical volatility based on historical data, without the need for any distinction between advanced economies and emerging markets.

6. On 20 December 2013, the EBA published its final draft RTS on the definition of market, which relate to the definition of the term 'market' to be applied for the calculation of the overall net position in equity instruments under the market risk standardised rules. These RTS, which were published on

[1] https://ec.europa.eu/finance/docs/level-2-measures/crr-delegated-act-2019-9068_en.pdf

[2] Article 325ap(2) refers to the RTS on LH referred to in Article 325bd(7).

[3] https://www.eba.europa.eu/regulation-and-policy/market-risk/draft-technical-standards-on-the-ima-under-the-frtb

[4] See Delegated Act Article 1(11) p.20-21.

20 May 2014 in the Official Journal of the EU[5], define the euro area as a market and, for Member States whose currency is not the euro, the national market as a market. The present CP is consistent with the then made specification.

7. The FRTB provides a list of countries that are 'advanced' for the purpose of the FRTB-SA. According to MAR 21.75, the advanced economies are Canada, the United States, Mexico, the euro area, the non-euro area western European countries (the United Kingdom, Norway, Sweden, Denmark and Switzerland), Japan, Oceania (Australia and New Zealand), Singapore and Hong Kong SAR.

8. The FRTB list was published without the underlying criteria used to get such list being provided. In addition, this list has not been reviewed since the first version of the list published on 14 January 2016[6]. The EBA considers that the list would benefit from a review before the FRTB comes into effect. In particular, the EBA would expect additional EU/EEA countries to qualify as advanced economies for the purpose of the computation of equity risk own funds requirements under the FRTB-SA.

9. Bearing this in mind, the present CP replicates the FRTB list, which should be able to ensure a harmonised computation of equity risk own funds requirements by institutions for the immediate purpose of the FRTB-SA reporting requirement. At the same time, the CP seeks stakeholders' views on sources of data and criteria that could be designed to identify advanced economies and emerging markets for the purpose of FRTB-SA equity risk own funds requirements, while maintaining a consistent treatment with how those own funds requirements would be calculated under the FRTB-IMA.

[5] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:JOL_2014_148_R_0004

[6] https://www.bis.org/bcbs/publ/d352.htm

4. Draft regulatory technical standards on emerging markets and advanced economies under Article 325ap(3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation 2 - CRR2)

In between the text of the draft RTS that follow, 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.

EUROPEAN
COMMISSION

Brussels, XXX
[…](2021) XXX draft

COMMISSION DELEGATED REGULATION (EU) …/...

of XXX

supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards on emerging markets and advanced economies under Article 325ap(3) of Regulation (EU) No 575/2013

(Text with EEA relevance)

THE EUROPEAN COMMISSION,

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

Having regard to Regulation (EU) No 575/2013 of 26 June 2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012[7], and in particular the fourth subparagraph of Article 325ap(3) thereof,

Whereas:

(1) The market risk own funds requirements under the alternative standardised approach set out in Part Three, Title IV, Chapter 1a of Regulation (EU) No 575/2013 requires, for the calculation of the own funds requirement under the Sensitivities-based method set out in Section 2 of that Chapter, the application of the risk weights for equity risk specified in Table 8 of Article 325ap pursuant to the delegated act referred to in Article 461a. Since advanced economies and emerging markets are mutually exclusive categories, it should be clarified in this Regulation that markets not constituting advanced economies should be regarded as emerging markets for the purpose of application of Article 325ap of Regulation (EU) No 575/2013.

(2) To specify what constitutes an advanced and what an emerging market economy, this Regulation should draw upon the definition of the market set out in Article 1 of Commission Delegated Regulation (EU) No 525/2014[8]. Thus, the euro area should be referred to in this Regulation as a single economy while Member States who have not adopted the Euro as their currency and third countries should be referred to as national economies.

(3) When setting out which markets constitute an advanced and which an emerging market ecomony, applicable international standards should be taken into consideration, in order for departures and deviations increasing the cost of reporting for insitutions to be avoided.

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

(5) EBA 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[9],

[7] [7] OJ L 176, 27.6.2013, p. 1.

[8] Commission Delegated Regulation (EU) No 525/2014 of 12 March 2014 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. OJ L 148 of 20.5.2014, p. 15.

[9] 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 (OJ L 331, 15.12.2020, p. 12).

HAS ADOPTED THIS REGULATION:

Article 1

Advanced economies and emerging markets for the purpose of Article 325ap under the reporting requirement referred to in Article 325(3)(a)

1. For the purpose of applying risk weights for equity risk in accordance with Article 325ap of Regulation (EU) No 575/2013, the euro area as referred to in point (a) of Article 1 of Commission Delegated Regulation (EU) No 525/2014 and the markets of Denmark and Sweden shall constitute advanced economies.

2. For the purpose of applying risk weights for equity risk in accordance with Article 325ap of Regulation (EU) No 575/2013, the following third countries shall constitute advanced economies:

(a) Australia;

(b) Canada;

(c) Hong Kong SAR;

(d) Japan;

(e) Mexico;

(f) New Zealand;

(g) Norway;

(h) Singapore;

(i) Switzerland;

(j) The United Kingdom;

(k) The United States.

3. For the purpose of applying risk weights for equity risk under Article 325ap, markets of Member States not included in paragraph 1 and of third countries not included in paragraph 2 shall constitute emerging markets.

Explanatory text for consultation purposes

The list in Article 1 of the proposed draft RTS corresponds to the list laid down in the international standards. Although such proposal ensures the EU alignment with those standards, as said earlier the EBA considers that the 2016 Basel list would benefit from a review at international level. It is, in particular, noticeable that the IMF recognises in its October 2020 IMF World Economic Outlook additional EU/EEA Member states as advanced economies, although those countries are currently not included in the Basel list. While it is expected that the criteria used in Basel should reflect prudential considerations, which are not necessarily part of the assessment conducted by other international organisations, the EBA generally considers that further EU/EEA Member states should be included as advanced economies in the Basel list.

To this end, the EBA considers beneficial to gather views around sources, metrics, and other criteria that could be used as an alternative for the purpose of identifying advanced economies.

In particular, the EBA seeks views on:

(i) The metrics (GDP per capita, volatility of local equity market..) and sources that should be used for potentially defining alternative criteria on which a list of advanced economies could be based;

(ii) Whether there are markets of other countries that are characterised by a higher liquidity and lower volatility if compared to those included in Article 1, which as such should not trigger a higher risk-weight if compared to those of the countries listed in Article 1.

(iii) Whether being part of the Single Market (EU and EEA Member states are part of the Single Market, with some exceptions for EEA states), in particular in the perspective of the Capital Market Union, is an additional criteria that should be considered, when reviewing the Basel list.

When answering the below questions, stakeholders should focus on prudential considerations, limit themselves to the purpose of the draft RTS (i.e. the appropriate capitalisation of equity risk in the trading book) and substantiate their views with appropriate technical risk analyses.

Questions for consultation:

Q1. Do you agree with the list provided in Article 1 or do you think that the EBA should propose an alternative list? In particular, do you think that there is a case for additional – or potentially all - EU/EEA countries to be added to the list? Please elaborate providing technical evidence and focusing on similarities and differences in risk across markets.

Q2. What are the metrics, sources, and other criteria that should be used for potentially defining alternative criteria on which a list of advanced economies could be based? Please elaborate considering the context in which this definition this will be applied, i.e. assigning a lower/higher risk weight for equity risk.

Q3. Do you think that there are markets of other countries that are characterised by a higher liquidity and lower volatility if compared to those included in Article 1, which as such should not trigger a higher risk-weight if compared to those of the countries listed in Article 1? Please elaborate providing evidence.

Article 2

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]

5. Accompanying documents

5.1 Draft cost-benefit analysis / impact assessment

Article 325ap(3) of the CRR requests the EBA to specify what constitutes an emerging market and an advanced economy for the purposes of risk weighting equity and equity repo rate risk factors under the sensitivities-based method.

Article 10(1) of Regulation (EU) No 1093/2010 (EBA Regulation) provides that any RTS developed by the EBA should 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 options proposed and the potential impact of these options.

This section presents the cost-benefit analysis of the main policy options included in the draft RTS described in this CP. The analysis is high level and of qualitative nature.

A. Problem identification

The alternative standardised approach for market risk (FRTB-SA) comprises of three parts: a) the sensitivities-based method (SbM) for calculating the own funds requirement for market risk; b) the residual risk add-on (RRAO); c) the own funds requirements for the default risk (DRC).

Under the sensitivities-based method, institutions need to multiply net sensitivities to each risk factor within a bucket by the corresponding risk weights to calculate own funds requirements. Buckets for sensitivities to equity and equity repo rate risk factors are defined based on criteria of liquidity (large vs. small market capitalisation) and volatility (taking into account the sector and the economy relevant for the equity).

In particular, for the criteria of volatility, the FRTB-SA distinguishes between advanced economies and emerging markets, and assigns lower risk weights to a given sector if it belongs to an advanced economy rather than an emerging market. This approach is specific to the FRTB-SA, whereas institutions using the IMA are required to directly capture the real historical volatility based on historical data, without the need for any distinction between advanced economies and emerging markets.

The FRTB provides a list of countries that are considered to be 'advanced' for the purpose of the FRTB-SA. However, CRR2 leaves this specification to the EBA. The lack of a common specification would result in an inconsistent implementation of the simplified standardised approach for market risk across banks.

B. Policy objectives

The specific objective of the RTS is to establish a common specification of what constitutes an emerging market and an advanced economy for the purpose of assigning risk weights for the sensitivities to equity and equity repo rate risk factors under the simplified standardised approach.

Generally, the RTS aim to create a level playing field, promote the convergence of institution practices and enhance comparability of own funds requirements across the EU. Overall, the RTS are expected to promote the effective and efficient functioning of the EU banking sector.

C. Baseline scenario

The baseline scenario aims to describe the regulatory environment and regulatory developments, as well institutions' practices.

In terms of regulatory environment, the baseline assumes the entry into force of CRR2, which does not provide any specification for what constitutes an emerging market and an advanced economy. In terms of institutions' practices, the baseline scenario assumes that no common approach exists regarding the distinction between emerging market and an advanced economy, given that such a specification is not present in the current CRR.

D. Options considered, Cost-Benefit Analysis, Preferred option

The FRTB provides a list of countries that are 'advanced' for the purpose of the FRTB-SA. According to MAR 21.75, the advanced economies are Canada, the United States, Mexico, the euro area, the non-euro area western European countries (the United Kingdom, Norway, Sweden, Denmark and Switzerland), Japan, Oceania (Australia and New Zealand), Singapore and Hong Kong SAR. The FRTB list was published without the underlying criteria used to get such list being provided.

The EBA has considered the following options when allocating a market or a country to the advanced economy category:

Option 1a: Use the list of advanced economies set out in the FRTB standards

Option 1b: Create a European-specific list of advanced economies, which covers the EU Member states and third countries included in the FRTB list, as well as additional EU/EEA Member states.

Option 1c: Develop a set of criteria or a methodology for distinguishing advanced economies

Option 1a ensures full alignment with international standards and enhances a level playing field across jurisdictions. In addition, it will be straightforward to update in case new markets or countries become advanced economies in the future. However, it does not explains the underlying criteria used to get such list, providing little transparency to the market on how the list was determined.

Moreover, under this option six EU Member states (Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania), and two EEA states (Liechtenstein, Iceland), would not be considered advanced economies despite being part of the EU or EEA, respectively.

Option 1b considers adding to the Basel list further EU/EEA Member states as advanced economies. EU/EEA Member states are part of the Single Market i.e. one territory without any internal borders or other regulatory obstacles to the free movement of goods and services (with some exceptions for EEA states). In addition, some EU/EEA Member states not currently included in the Basel list are explicitly recognised as advanced economies by the IMF[10]. Establishing this list requires assessing six additional EU Member states (Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania) and two additional EEA states (Liechtenstein, Iceland), which were not part of the FRTB list, but are all expected to comply with the EU-level CRR2 requirements. Similar to Option 1a, this list can be easily updated. However, this list will deviate from international standards and create an unlevel playing field between European and international institutions. In addition, the risk weights for advanced economies calibrated in the FRTB standards, and subsequently adopted in CRR2, were based on the FRTB list and may therefore not be appropriate for the extra countries.

Option 1c can potentially increase transparency towards external stakeholders regarding the methodology for the determination of advanced economies, depending on the methodology and associated disclosure. Moreover, it can avoid being reliant on a pre-defined list produced by other organisations (e.g. BCBS) or benchmarks. However, it may result in a list that is different from international standards, creating an unlevel playing field. Moreover, it can be more complex to update such list and may need to collect data on a continuous basis.

Given that the immediate purpose of this list is to allow for a harmonised computation of equity risk own funds requirements by institutions for the immediate purpose of the FRTB-SA reporting requirement, Option 1a is retained for consultation. This is very simple and allows for full harmonisation with international standards.

However, the EBA considers that the FRTB list would benefit from a review before the FRTB comes into effect, given that it has not been reviewed since the first version of the list published on 14 January 2016. In particular, the EBA would expect additional EU/EEA countries to qualify as advanced economies for the purpose of the computation of equity risk own funds requirements under the FRTB-SA.

[10] Advanced economies in the October 2020 IMF World Economic Outlook.

5.2 Overview of questions for consultation

Q1. Do you agree with the list provided in Article 1 or do you think that the EBA should propose an alternative list? In particular, do you think that there is a case for additional – or potentially all - EU/EEA countries to be added to the list? Please elaborate by providing technical evidence focusing on similarities and differences in risk across markets.

Q2. What are the metrics, sources, and other criteria that should be used for potentially defining alternative criteria on which a list of advanced economies could be based? Please elaborate considering the context in which this definition this will be applied, i.e. assigning a lower/higher risk weight for equity risk.

Q3. Do you think that there are markets of other countries that are characterised by a higher liquidity and lower volatility if compared to those included in Article 1, which as such should not trigger a higher risk-weight if compared to those of the countries listed in Article 1? Please elaborate providing evidence.