EBA/CP/2013/33
30 July 2013

Consultation Paper

Draft Regulatory Technical Standards

On the definition of materiality thresholds for specific risk in the trading book under Article 77 of Directive 2013/36/EU (Capital Requirements Directive - CRD IV)

Consultation paper on draft regulatory technical standards on the definition of materiality thresholds for specific risk in the trading book under Article 77 of Directive 2013/36/EU (Capital Requirements Directive - CRD IV)

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 section 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 15.10.2013. 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 whether 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) 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 in the Legal notice section of the EBA website.

2. Executive summary

This Consultation Paper (CP) proposes draft regulatory technical standards (RTS) in accordance with Article 77(4) of Directive 2013/36/EU (Capital Requirements Directive - CRD IV). These RTS set out requirements concerning the implementation of internal approaches for calculating own funds requirements for the specific risk relating to debt instruments in the trading book (TB).

The RTS establish criteria for assessing when the specific risk of debt instruments in the trading book (considered both at a solo and a consolidated level) is sufficiently material to trigger an evaluation by the competent authority. After this evaluation, competent authorities should determine whether it is worth encouraging banks to develop internal assessment capacity and to increase the use of internal models for capital calculations.

The RTS define ‘exposures to specific risk which are material in absolute terms’ as those where the sum of all net long and net short positions is greater than EUR 1 000 000 000, and establish two additional thresholds for what is a ‘large number’, and what are ‘material counterparties and positions in debt instruments of different issuers’, namely that the portfolio should include more than 100 positions, each greater than EUR 2 500 000 in absolute terms.

The scope of the RTS as defined by CRD IV relates exclusively to specific risk of debt instruments in the TB, excluding equity instruments in the TB. Banking book credit risk positions are not included in the scope.

CRD IV provides that the thresholds established in these RTS are relevant solely for institutions that apply the standardised approach for specific risk (as the remaining institutions already apply internal approaches). Accordingly, the materiality assessment reflects how the specific risk of debt instruments is measured under the standardised approach for market risk.

3. Background and rationale

Article 77 of Directive 2013/36 (CRD IV) establishes the conditions under which competent authorities are to encourage the use of internal models for credit risk in the banking book (BB) as well as for specific risk of debt instruments in the trading book (TB):

1. Competent authorities shall encourage institutions that are significant in terms of their size, internal organisation and the nature, scale and complexity of their activities to develop internal credit risk assessment capacity and to increase use of the internal ratings based approach for calculating own funds requirements for credit risk where their exposures are material in absolute terms and where they have at the same time a large number of material counterparties. This Article shall be without prejudice to the fulfilment of criteria laid down in Part Three, Title I, Chapter 3, Section 1 of Regulation (EU) No 575/2013.

2. Competent authorities shall, taking into account the nature, scale and complexity of institutions' activities, monitor that they do not solely or mechanistically rely on external credit ratings for assessing the creditworthiness of an entity or financial instrument.

3. Competent authorities shall, taking into account institutions' size, internal organisation and the nature, scale and complexity of their activities, encourage them to develop internal specific risk assessment capacity and to increase use of internal models for calculating own funds requirements for specific risk of debt instruments in the trading book, together with internal models to calculate own funds requirements for default and migration risk where their exposures to specific risk are material in absolute terms and where they have a large number of material positions in debt instruments of different issuers.

Paragraph 4 of this article requires the EBA to develop draft RTS to further define the notion *'exposures to specific risk which are material in absolute terms'* referred to in paragraph 3 and the '*thresholds for large numbers of material counterparties and positions in debt instruments of different issuers'*. The EBA is required to submit these draft RTS to the Commission by 1 January 2014.

Since the EBA mandate refers to the first subparagraph of Article 77(3) CRD IV, it appears that the scope of application of these draft RTS is limited to trading book (TB) positions. In this regard, defining solely a threshold for large numbers of material counterparties has no added value and could lead to confusion, as it would relate only to banking book (BB) positions and would make sense only if a minimum size for the BB portfolio was also defined. Therefore, the present technical standards focus solely on the definition of 'large number of material positions in debt instruments of different issuers'.

Scope of application:

To fulfil the RTS mandate the EBA has to 'further define':

- what a material ***exposure*** is in absolute terms, and
- two additional thresholds for :
  - large numbers, and
  - material ***positions in debt instruments of different issuers***

Bearing in mind that Article 77(3) refers solely to 'debt' instruments, the EBA considers that the scope of the RTS relates exclusively to specific risk of debt instruments in the TB. Accordingly, equity instruments in the TB are not included in the materiality assessment.

The RTS establish criteria to assess when a bank's specific risk of debt instruments in the TB is material enough to trigger an evaluation by the competent authority. After this evaluation, competent authorities should determine whether they should encourage banks to develop internal assessment capacity and increase the use of internal models for capital calculations.

The thresholds established in these RTS are relevant solely for institutions that apply the standardised approach for specific risk. Accordingly, the materiality assessment reflects how the specific risk for debt instruments is measured under the standardised rules for market risk.

Article 327 of Regulation 575/2013 (CRR) on netting for own funds requirements for position risk in the TB does not refer to '*exposures'* but to '*net positions*' in equity, debt and convertible issues in the TB. The standardised capital risk weightings for debt instruments established in Article 336 CRR are applicable to both net long and net short positions (irrespective of their signs, i.e. whether negative or positive) in each of those different instruments.

The EBA considers that the concept of 'positions in debt instruments of different issuers' mentioned in the RTS mandate should be equivalent to 'net position' (i.e. the position in each instrument after offsetting effective credit risk hedging in accordance with the allowances established in Articles 346 and 347 of the CRR).

Material exposure in absolute terms

Both from a risk and a capital perspective all debt instrument positions (irrespective of their sign, i.e. whether negative or positive) are subject to specific risk. Thus, the sum of the net long and net short positions is the most sensible approach if 'exposures to specific risk' are to be captured broadly. In this regard, the templates for supervisory reporting of own funds requirements already include information both on the net long and net short positions and on the own funds requirements by category of instrument.

From a theoretical perspective, it could be argued that the own funds requirement should be the best indicator of 'specific risk'. However, Article 77 does not discriminate on the basis of riskiness. In any case, the EBA believes that the use of risk-weighted assets to define material positions would not be appropriate in this case, since the economic incentives behind the use of internal models should be independent from risk weighting.

Regarding the determination of a threshold based on the size of the 'exposure', the EBA considers that the most appropriate approach is the use of an absolute threshold (i.e. a fixed amount in Euros). This is consistent with a literal reading of the mandate. The EBA has gathered information from National Supervisory Authorities (NSAs) in order to calibrate this absolute threshold (see impact assessment)[1].

[1] As an alternative approach, the EBA considered linking the 'absolute' threshold to a certain percentage of the institution's own funds (i.e. a similar approach to the one applied in the 'large exposure' framework). Despite being more risk-sensitive, the EBA discarded this option, since it considers that the determination of the minimum

As a result of the above, the EBA has determined that a bank's exposure to specific risk of debt instruments should be considered material in absolute terms when the sum of net long and net short positions is greater than EUR 1 000 000 000.

Large number of material positions

The second part of the mandate includes defining what is meant by 'a large number of material positions in debt instruments of different issuers'.

This means that two materiality thresholds have to be defined, one for all net positions subject to specific risk and a second to spot 'individual' material positions. The EBA has calibrated what is a 'large number' of material (net) positions on the basis of a limited quantitative analysis, gathering information from a sample of banks that apply the standard rules to specific risk of debt instruments (see impact assessment).

The EBA has determined that a bank's TB debt instruments' specific risk portfolio has a large number of material positions in debt instruments of different issuers if the portfolio comprises more than 100 positions which are greater than EUR 2 500 000, irrespective of whether they are net long or net short.

Joint consideration of both criteria

Under Article 77(3), NSAs should encourage banks to use internal model if 'their exposures to specific risk are material in absolute terms and where they have a large number of material positions in debt instruments of different issuers'.

From a risk management perspective, it makes sense to require a minimum number of significant counterparties (i.e. some 'critical mass') before an internal model is developed. However the EBA considers that this requirement should not be overstated. The more 'stringent' the articulation of the second criterion is in the RTS (i.e. the larger the number of positions and the bigger the position threshold to be considered 'material') the more lenient the overall criteria in the RTS might end up being.

In particular, there is a risk that institutions that have large concentrated holdings will not be captured by the above definition if, despite fulfilling the absolute materiality criterion, they do not meet the large number of material positions criterion.

The EBA considers that banks holding large concentrated positions in the trading book should be encouraged to develop internal specific risk assessment capacity and to increase the use of internal models for specific risk.

portfolio size required to justify the use of an internal model is independent from a firm's own funds. In addition, this approach would not be in line with a literal reading of the mandate.

4. Draft regulatory technical standards (RTS) on the definition of materiality thresholds for specific risk in the trading book under Article 77 of Directive 2013/36/EU (Capital Requirements Directive - CRD IV)

In between the text of the draft RTS 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 DELEGATED REGULATION (EU) No …/..

of XXX

[…]

supplementing Directive 2013/36 of the European Parliament and of the Council with regard to regulatory technical standards on the definition of materiality thresholds for specific risk in the trading book under Article 77

COMMISSION DELEGATED REGULATION (EU) No …/..

of XXX

[…]

COMMISSION DELEGATED REGULATION (EU) No …/... supplementing Directive 2013/36 of the European Parliament and of the Council with regard to regulatory technical standards on the definition of materiality thresholds for specific risk in the trading book under Article 77

THE EUROPEAN COMMISSION,

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

Having regard to Directive 2013/36of the European Parliament and of the Council of 24 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC [2] and in particular Article 77(4) third subparagraph thereof,

Whereas:

(1) Given that Article 77 of Directive 2013/36 refers solely to 'debt' instruments, equity instruments in the trading book should not be included in the materiality assessment of specific risk described in this Regulation.

(2) The materiality of specific risk should be measured by applying the standardised rules for the calculation of net positions of debt instruments. The assessment should consider both long and short net positions calculated according to Article 327 of Regulation (EU) 575/2013, after recognising hedges by credit derivatives established in Articles 346 and 347 of Regulation (EU) 575/2013.

(3) *[Recital to be used in case there is no corrigendum of Article 77 and 'large counterparties' remains in it]*. Article 77 of Directive 2013/36 refers to specific risk relating to debt instruments under the first subparagraph of its paragraph 3; accordingly, the scope of application of these rules should be limited to trading book positions. As a result, defining thresholds for large numbers of material counterparties, which relates to the banking book, would result in no added value, without establishing at the same time an absolute threshold for all banking book exposures. Therefore these rules should focus on the definition of a materiality threshold for large number of material positions in debt instruments of different issuers.

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

[2] OJ L 176, 27.6.2013, p.338.

(5) 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 1093x/2010.

HAS ADOPTED THIS REGULATION:

Article 1 –Definition of 'exposures to specific risk which are material in absolute terms' according to Article 77(4) of Directive 2013/36/EU

An institution's exposure to specific risk of debt instruments shall be considered material in absolute terms where the sum of all net long and net short positions, as defined in Article 327 of Regulation (EU) 575/2013, is greater than 1.000.000.000 €.

Article 2 –Definition of 'minimum number of material positions in debt instruments of different issuers' according to Article 77(4) of Directive 2013/36/EU

An institution's specific risk portfolio shall be considered to comprise a large number of material positions in debt instruments of different issuers where the portfolio includes more than 100 positions which are greater than 2.500.000 €. Such positions may be net long or net short, as defined in Article 327 of Regulation (EU) 575/2013.

Explanatory text for consultation purposes

Q1. Do you agree with the use of an absolute materiality threshold?

Q2. Do you agree with the proposed values for (i) overall specific risk and (ii) significant number of (iii) material exposures? If you believe the values are inappropriate, please provide some rationale and alternative values.

Article 3- 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]

5. Accompanying documents

5.1 Draft cost-benefit analysis / impact assessment

5.1.1 Introduction

1. In accordance with Article 10(1) of the EBA regulation (Regulation (EU) No 1093/2010 of the European Parliament and of the Council), any draft implementing technical standards/regulatory technical standards/guidelines developed by the EBA – when submitted to the EU Commission for adoption - are to be accompanied by an impact assessment (IA) annex which analyses 'the potential related costs and benefits'. Such annex should provide the reader with an overview of the findings as regards the problem identification, the options identified to resolve the problem and their potential impacts.

5.1.2 Problem definition and objectives of the regulatory technical standards

Issues addressed by the European Commission on the use of internal models for computing capital requirements as opposed to the use of external credit ratings

2. Through both specific measures as part of the CRD IV/CRR package and the revision of the Credit Rating Agencies (CRA) Regulation (Regulation (EC) No 1060/2009, as last amended by Regulation (EU) No 462/2013), the European Commission has proposed new rules to encourage the use of institutions' internal models over external credit ratings for, among other purposes, the calculation of institutions' capital requirements.
3. Further development of and increased reliance on internal models is first of all expected to result in:
    a) improved quality of institutions' risk measurement methods and risk management practices;
    b) capital requirements that more closely reflect the actual idiosyncratic risk profile of the institution subject to the requirements.
4. Both objectives (a) and (b) contribute to the general regulatory objective of enhanced financial stability.
5. In addition, following the implementation of the CRA Regulation, the European Commission identified a series of issues relating to the use of external credit ratings which were not properly addressed by the regulation then in place. Among the problem drivers identified by the European Commission[3], one relates to the overreliance on external ratings giving rise to pro-cyclicality and 'cliff' effects in computed capital requirements and, more generally, in capital markets. Procyclicality and cliff effects contribute to financial markets' instability and low investor confidence. In order to tackle the problem of overreliance on external ratings the CRA Regulation was amended in 2011 with the introduction of provisions intended to discourage the mechanistic reliance, by institutions, on external credit ratings for assessing the creditworthiness of entities and financial instruments. The amended regulation provides for institutions to develop their own

[3] See the impact assessment accompanying the European Commission's Proposal for a Regulation amending Regulation (EC) No 1060/2009 on credit rating agencies .

internal credit risk assessment practices and for competent authorities to encourage institutions to do so, taking into account the principle of proportionality[4].

Issues addressed by the RTS and objectives

6. These draft RTS propose a set of thresholds intended to trigger an assessment, by the National Supervisory Authority (NSA), of whether the individual institution should adopt internal models for the assessment of specific risk of debt instruments in the trading book.
7. The proposed provisions address materiality of specific risk of debt instruments in the trading book in absolute terms, given that all considerations concerning the proportionality of the adoption of internal models, e.g. the size, nature, complexity and business model of the institution, are mainly associated with the assessment carried out by NSAs.
8. The thresholds proposed in the RTS should strike the right balance between the objective of ensuring that specific risk in the trading book is addressed through the use of internal models and that a good level of internal model coverage in the EU is achieved and the need to avoid internal models becoming an inefficient requirement for minor trading book portfolios of debt instruments for which there might be insufficient data, infrastructure and/or expertise.
9. In this regard, it is worth remembering that the purpose of these RTS is to spot those standardised banks that competent authorities should assess on an ad-hoc basis. Accordingly, since the consequences of ignoring banks with significant portfolios are more relevant than the consequences of spotting banks that may not need an internal model, the criteria proposed should work as a 'screening test'[5], designed to minimise 'type I errors'[6] though it may produce a number of 'type II errors'[7].

5.1.3 Baseline current regulatory framework and market practices

10. The use of internal models for assessing the specific risk of debt instruments held in the trading book currently depends on case-by-case decisions taken in each jurisdiction by institutions and competent authorities. No harmonised criterion for the identification of institutions that should adopt internal specific risk assessments is in place at EU level.

5.1.4 Considered approaches and expected impact of the proposals

11. In order to set quantitative thresholds relating to the mandates received, the EBA has asked NSAs to provide individual institution-level data on:

[4] See Article 5a of Regulation (EU) No 462/2013 amending Regulation (EC) No 1060/2009 on credit rating agencies.

[5] In medicine, screening is a test used in a population to identify an unrecognised disease in individuals without signs or symptoms. In statistical test theory, the notion of statistical error is an integral part of hypothesis testing. The test requires an unambiguous statement of a null hypothesis. In this case the null hypothesis would be 'the Institution should develop an internal model since the specific risk portfolio is material.

[6] A type I error, also known as an error of the first kind, occurs when the null hypothesis is true, but is rejected by the test (i.e. the bank should develop an internal model for specific risk but its portfolio is not significant according to the criteria).

[7] A type II error, also known as an error of the second kind, occurs when the null hypothesis is false, but erroneously fails to be rejected by the test (i.e. the bank should not develop an internal model despite the fact that the criteria determines that the portfolio is material).

a) the total value of the positions in traded debt instruments subject to specific risk, as reported in COREP (intersection between column 50 and row 250 of the MKR SA TDI COREP template);
b) the 200 largest net individual positions (in absolute value, i.e. irrespective of whether they are long or short) which form part of the figure reported in the intersection cells between columns 30 (Net Long Positions) and 40 (Net Short Positions) and row 250 of the MKR SA TDI COREP template.

12. The feedback received following the data request can be summarised as follows:

Table 1

Respondent National Supervisory Authority (NSA)	**Number of institutions**
Austria	2 + 1 related group
Belgium	4
Czech Republic	4
France	4
Germany	4
Denmark	5
Ireland	2
Italy	4 + 1 related group
Latvia	5
Portugal	5
Spain	3
Total	**44**

13. Three institutions within the sample reported in *Table 1* were excluded from the analysis because their COREP figure on 'positions subject to specific market risk' (item (I) above) was inconsistently smaller than the sum of the 200 largest net individual positions.
14. The remaining sample comprises 41 institutions, covering 11 EU jurisdictions. The size of exposures to specific risk of debt instruments as reported in COREP, within the institutions in the sample, varies from approximately EUR 2 million to EUR 100 billion. In particular:
    a) only one institution reports a specific risk exposure above EUR 100 billion;
    b) 17 out of 36 institutions report an exposure of between EUR 25 billion and EUR 1 Billion;
    c) The remaining institutions in the sample report an exposure lower than EUR 1 billion.
15. On the basis of the different levels of coverage of institutions in the sample, the draft RTS propose that:
    a) A bank's exposure to specific risk is to be considered material in absolute terms where the sum of all net long and net short positions is equal to or greater than EUR 1 000 000 000.
    b) A bank's specific risk portfolio is to be considered to comprise a large number material counterparties and positions in debt instruments of different issuers where the portfolio includes more than 100 net long or net short individual positions which are equal to or greater than EUR 2 500 000.

16. As shown in *Table 2* below, the proposed quantitative thresholds would give the following coverage:
    a) 17 out of 41 institutions in the sample;
    b) 94% of specific risk exposure in the sample.
17. The provisions of these draft RTS contribute to the NSAs' assessment of whether individual institutions should adopt internal models for computing own funds requirements. The benefits of these provisions, therefore, depend on the overall realisation of the regulatory objectives linked to the development of internal models (see previous sections of this annex), and cannot be quantified within the framework of this impact assessment.
18. The development and use of internal models by institutions that do not currently use internal models is expected to result in operational compliance costs for institutions, and supervisory costs for NSAs supervising the use of such models. However, these costs are not expected to be large enough to offset the benefits to financial stability and market confidence stemming from the proposed provisions.

Table 2 – Coverage of proposed thresholds

	Proposed thresholds
Material position in absolute terms (EUR)	1 000 000 000
Material individual position (EUR)	2 500 000
Number of material individual positions	100
	Resulting coverage in sample
No of institutions	17 / 41
% of sample total specific risk of debt instruments	94%

5.2 Overview of questions for consultation

Q1. Do you agree with the use of an absolute materiality threshold?

Q2. Do you agree with the proposed values for: (i) overall specific risk and (ii) significant number of (iii) material exposures? If you believe the values are inappropriate, please provide some rationale and alternative values.