EBA/CP/2018/03

17/04/2018

Consultation Paper

Draft Guidelines

on specification of types of exposures to be associated with high risk under Article 128(3) of Regulation (EU) No 575/2013

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 17 July 2018. 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 (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

The Standardised Approach (SA) for determining the minimum capital requirements for credit risk assigns risk weights to be applied to the exposure amount based on the exposure class of a considered exposure. The exposure classes relevant for the SA are laid down in Article 112 of Regulation (EU) No 575/2013 (CRR). Among these exposure classes are “exposures associated with particularly high risk”.

This exposure class represents the implementation of the discretion that national supervisors are granted in paragraph 80 of the current Basel II standard stating that national supervisors may decide to apply a 150% (or higher) risk weight reflecting “the higher risks associated with some other assets, such as venture capital and private equity investments”.

The CRR sets out in Article 128 the requirements for classifying an exposure as item associated with particular high risk, which result in an assignment of a 150% risk weight for the considered exposure. Paragraph (2) of Article 128 provides a list of exposures which are assigned to this exposure class:

(a) investments in venture capital firms;

(b) investments in AIFs as defined in Article 4(1)(a) of Directive 2011/61/EU except where the mandate of the fund does not allow a leverage higher than that required under Article 51(3) of Directive 2009/65/EC;

(c) investments in private equity;

(d) speculative immovable property financing.

Article 128 (3) of Regulation (EU) No 575/2013 (CRR) provides a mandate to EBA to draft guidelines (GLs) specifying which types of exposures other than those mentioned in Article 128 (2) CRR are to be associated with particularly high risk and under which circumstances. As a result of an exposure being identified as an “item of particularly high risk” such exposure receives a risk weight of 150%.

The draft GLs consist of two sections. The first section aims at clarifying the notion of investments in venture capital firms and private equity as referred to in Article 128 (2) CRR; the second section specifies which other types of exposures should be considered as high risk and under which circumstances by way of application of Article 128 (3) CRR.

Regarding the first section it should be noted that the outlined clarification is not within the mandate for the GLs that the CRR provides, but that the inclusion of this clarification as an own initiative contribution was considered helpful by EBA.

The second section contains the actual policy related to the mandate as laid down in Article 128 (3) of the CRR. This part has been drafted with the intention that institutions should specify those individual exposures as items of particular high risk which carry a high risk of loss due to being structurally different from common exposures of the same asset class.

The EBA recognises that the revised SA for credit risk agreed by the Basel Committee on Banking Supervision as part of its Basel III finalisation in December 2017 no longer includes provisions on "higher risk exposures" as the Basel II standard currently does. However, it nevertheless considers it as beneficial to issue these GLs in order to ensure detection of high risk within banks before transposition of Basel 3 in the EU legislative framework and a harmonised and consistent application of Article 128 (2) and (3) of the CRR until any revision of these provisions has to be applied by institutions, noting that the Basel Committee only requires the framework to apply from 2022.

3. Background and rationale

Article 128 (3) of Regulation (EU) No 575/2013 (CRR) gives a mandate to the EBA for drafting GLs specifying which types of exposures other than those mentioned in Article 128 (2) CRR are associated with particularly high risk and under which circumstances, which would result in these exposures receiving a risk weight of 150%. The mandate represents the implementation of the discretion that national supervisors are granted in paragraph 80 of the Basel II agreement stating that national supervisors may decide to apply a 150% (or higher) risk weight reflecting *"the higher risks associated with some other assets, such as venture capital and private equity investments"*.

It should be noted that the Basel agreement considers all credit exposures carrying a risk weight of 150% or higher to be high risk assets. The CRR however sets out in Article 128 the notion of "items associated with particular high risk", which serves as possibility to assign a 150% risk weight where this is not provided by the respective original asset class of a considered exposure. As a result, an exposure which falls under Article 128 CRR is excluded from its original exposure class and considered instead under "items associated with particular high risk" of Article 128. A high risk exposure (according to the notion provided by the Basel standard) which already receives a 150% risk weight in its original exposure class (e.g. Credit Quality Step 5 or 6 for exposures to corporates) is therefore not affected by Article 128 CRR.

The CRR specifies in Article 128 (2) already four types of exposures which shall be considered as items associated with particular high risk, namely:

a) investments in venture capital firms;

b) investments in AIFs as defined in Article 4(1)(a) of Directive 2011/61/EU except where the mandate of the fund does not allow a leverage higher than that required under Article 51(3) of Directive 2009/65/EC;

c) investments in private equity;

d) speculative immovable property financing.

The draft GLs consist of two sections. The first section aims at clarifying the notion of investments in venture capital firms and private equity; the second section specifies which other types of exposures should be considered as high risk and under which circumstances.

Investments in venture capital firms or private equity

This part contains clarification regarding the types of exposures that should be considered as investments in private equity and venture capital firms. It specifies that investments in private equity or venture capital firms should comprise at least non-debt exposures constituting subordinated, residual claims on the assets or income of an enterprise not listed on an exchange, or debt exposures of a comparable character.

Investments in private equity are characterised by the intention to hold the exposure with the objective of generating a profit through e.g. a leveraged buyout, an IPO or any other way of selling the equity. Explicitly excluded are such types of investments where the institution has the intention to develop a strategic business relationship with the enterprise it has invested in. The latter may still be assigned to the high risk asset class for other reasons but should not be considered investments in private equity. The same holds true for investments in listed equity, which could as well be assigned to the high risk asset class but should not be considered investments in private equity

Regarding the notion of investments in venture capital firms it is clarified that this includes exposures to firms providing funding to newly established enterprises, e.g. for the development of a new product and related research for the enterprise in order to bring this product to the market, for the build-up of the production capacity of the enterprise or for the expansion of the business of the enterprise.

Other types of exposures to be considered high risk exposures

This part of the draft GLs leverages on the criteria already set out in Article 128 (3) CRR where it is required that *"institutions shall take into account the following risk characteristics, when assessing whether an exposure should be considered of particularly high risk*:

a. there is a high risk of loss as a result of a default of the obligor;[1]

b. it is impossible to assess adequately whether the exposure falls under point (a)."

The logic behind this part of the draft GLs is that institutions should identify as items associated with particular high risk those individual exposures which carry a high risk of loss due to being structurally different from other obligors or transactions of the same exposure class.

The rationale for this is that the flat[2] risk weights of the SA provided by the current Basel standard and its CRR implementation (e.g. 100% for unrated corporates, 75% for retail exposures, 100% for equity exposures) are calibrated for covering more and less risky items. The flat risk weights can be understood as representing a certain quantile of an underlying loss distribution, which includes exposures carrying a loss risk equivalent to a 150% risk weight (or even higher) as well as exposures carrying a loss risk which is lower than that expressed by the flat risk weights, thereby ensuring on average an appropriate capitalisation for a specific exposure class. Thus in principle the flat risk weights provided for each asset class in the CRR are set prior to Article 128(3) CRR. Therefore institutions should consider such exposures as of particular high risk when they show structural differences that are not reflected in the existing flat risk weights.

Paragraph 4 of the GLs instantiate this principle. The scope of exposures that institutions should assess for the purpose of identifying items associated with particularly high risk covers all exposure

[1] In this regard a high risk of loss should be understood as rather referring to the loss given default, which in the universe of the IRB would be defined at the level of a transaction.

[2] Flat risk weights should be considered risk weights that are not determined by an external credit assessment by ECAIs.

classes as no limitation is specified in Article 128 (3) of the CRR. Therefore the types of exposures listed in paragraph 5 (a) and (b) of these GLs should be identified in an institutions portfolio, for the purpose of assessing items of particularly high risk, regardless of the original exposure class of an individual exposure. The types of exposures listed in paragraph 5 (a) and (b) of these GLs facilitate the assessment regarding what constitutes structurally different exposures as referred to in paragraph 4 of the GLs, which provides that an institution should consider those exposures as of particularly high risk which exhibit levels and ranges of risk drivers that are not common to other obligors or transactions in a specific exposure class and which point to a high risk of loss.

In detail and in line with the principle outlined above paragraph 5 provides that banks should consider any financing of speculative investments (other than immovable property as these are already high risk items according to Article 128 (2)CRR) as high risk exposures where there are indications that there is a risk of a high loss e.g. due to insufficient market liquidity and/or high price volatility for the financed object that is not yet sufficiently mitigated for example by pre-sales contracts, and there is insufficient other income and assets of the obligor for mitigating the loss risk for the financing institution. As an example an institution could decide to finance speculative investments in mobile property (e.g. ships, containers or cars), in agricultural products or even in intangible assets, such as licenses or patents.

The next paragraph 5 (b) provides that, in their assessment of high risk items, institutions consider specialised lending exposures[3] as being potentially high risk exposures. In particular, where such exposures relate to a single project in its pre-operational phase and where the cash flows serve as security and as source of repayment at the same time, institutions should assess whether these exposures exhibit a high risk of loss. However, it should be noted that such exposures are not high risk by definition, but that paragraph 5 (b) requires as well that the institution considers such project of no high quality in order for it to be characterized as a high risk item. Paragraph 5 (b) point 2 lists some potential indications for the existence of high risk exposures (for all types of specialised lending exposures) which are based on the criteria which would be used by an IRB institution when applying the slotting approach for specialised lending exposures. However, as these GLs are dedicated to SA institutions it is not expected that SA banks apply the RTS on slotting but that they take the overall principles as listed in paragraph 5 (b) point 2 into account for the purpose of assessing whether a specialised lending exposure should be considered high risk. It should be noted that the GLs do not generally hinder a potential preferential treatment of infrastructure projects.

As pointed out above Article 128 (3) CRR is not limited to certain exposure classes and therefore the types of exposures specified in paragraphs 5 (a) and 5 (b) should as well be assessed for exposures to central governments or central banks, exposures to regional governments and local authorities and exposures to public sector entities. It is however expected that in practice it is very improbable that any exposure of these exposure classes will fall under the types mentioned in 5 (a) or (b).

[3] For clarification of the term specialised lending exposures (project finance, object finance and commodities finance) institutions may refer to paragraphs 44 and 45 of the Basel III standard: https://www.bis.org/bcbs/publ/d424.pdf

The same holds true for "exposures to multilateral development banks" listed in paragraph 2 of Article 117 CRR. Although for these exposures, the assessment for high risk purpose may be perceived contradictory to the intrinsic nature of the multilateral development banks that are created for economic and social development projects they are not excluded in Article 128 of the CRR and can therefore not be excluded from the scope of that Article. However, also for these exposures it is expected that in practice it is very improbable that an individual exposure will be identified as being high risk as a result of the application of paragraph 5.

It is also noted that in practice exposures towards SMEs will generally not constitute financing of speculative investments or specialised lending and that is therefore improbable that exposures to these borrowers are considered high risk as a result of paragraph 5 (a) and (b). Therefore it is considered that the assessment of SME exposures for high risk purposes under paragraph 5 will not negatively affect the financing of SMEs that play a fundamental role in creating economic growth and providing employment in Union market (see recital 44 of CRR). However, as pointed out earlier, Article 128 (3) of the CRR also applies to SMEs and the GL cannot reduce the general scope of that Article. Not providing the guidance laid down in paragraph 5 of these draft GLs for this type of exposure would expose institutions to a higher degree of uncertainty.

Paragraph 6 provides guidance on the assessment for the purpose of identifying exposures associated with particularly high risk which are not covered by paragraph 5. This first sub-paragraph 6 (a) clarifies that under the scope of the GLs institutions should identify additional types of exposures as constituting exposures of particularly high risk in line with the principles set out in paragraph 4 (i.e. exposures which exhibit levels and ranges of risk drivers that are not common to other obligors or transactions of the same exposure class) only for exposures to corporates, equity exposures and other items. The rationale for this limitation is to ensure more harmonisation in the application of Article 128 (3) CRR under these GLs. Institutions may for example analyse the EAD, LTV and internal rating distributions of exposures in these exposure classes if available and if these are relevant risk drivers for the considered exposures in order to identify exposures of particularly high risk due to structural differences in line with the principles set out in paragraph 4. Another example for this could be the financing of exotic types of property where a high risk of loss could be assumed.

As pointed out several times before Article 128 (3) CRR is neither limited to specific exposure classes nor to the principle set out in paragraph 4 of the draft GLs. Therefore institutions should and could identify exposures carrying particularly high risk as a result of Article 128 (3) CRR which are not covered by these GLs. In this sense the GLs do not provide an exhaustive list of types of exposures to be classified as exposures of particularly high risk. It is however expected that only in exceptional cases an exposure would need to be assigned to the high risk exposures class without being in the scope of this GLs or Article 128 (2) of the CRR. Therefore a notification mechanism is proposed in paragraph 6 (b) where it is required that banks notify EBA of any type of exposure they identified as carrying particularly high risk by application of Article 128 (3) CRR but which is not covered by these draft GLs. The rational for this notification mechanism is twofold, first it allows the regulator to monitor which exposures, apart from those already covered by these GLs or Article 128 (2) CRR, should receive a 150% risk weight as a result of the application of Article 128 (3) and second to ensure a harmonised application of Article 128 (3) CRR where it comes to exposure not covered by these GLs. In this regard it should be pointed out that via the regulatory reporting scheme (COREP) regulators can monitor the amount of exposure in the high risk exposure class, but not the nature of these exposures.

Paragraph 7 sets out another criterion for equity exposures to be considered as potentially constituting exposures with a high risk of loss. It states that equity exposures should be considered whether to be classified as high risk:

- if the institution holds any other debt exposure to the same issuer and this other exposure is risk weighted 150%, or

- where any debt of such issuer would receive a 150% risk weight if these debt obligations were exposures of the institution.

Article 128 (3) CRR mentions explicitly two characteristics which institutions shall take into account within this assessment, namely that:

(a) there is a high risk of loss as a result of a default of the obligor;

(b) it is impossible to assess adequately whether the exposure falls under point a).

Institutions should ensure within their relevant governance structures that all types of exposure outlined in the draft GLs are assigned to the high risk exposure class as applicable, regardless of the state of the considered exposure within its credit-life-cycle. However such governance aspects are not part of the GLs.

To summarize, it should be noted that institutions are generally not expected to have a large high risk portfolio as a result of application of Article 128 (3) CRR considering that: (i) some exposure classes generally are not expected to carry items of particularly high risk; (ii) exposures which already receive a 150% risk weight in their original exposure class are not affected by the considerations under Article 128 (3) CRR; (iii) the assessment under Article 128 (3) CRR should be conducted especially with reference to those exposures which are assigned a flat risk weight which is lower than 150% and/or (iv) which are structurally different from other obligors or transactions of the same exposure class.

4. Draft EBA Guidelines on specification of types of exposures to be associated with high risk

Criteria for identification of the relevant types of exposures

1. For the purpose of identifying exposures associated with particularly high risk an institution should take into account in its policy on high risk items all types of exposures referred to in Article 128 of the CRR and sections 4.1 and 4.2 of the present Guidelines.

4.1. Investments in venture capital firms and/or private equity

2. Institutions should consider that investments in venture capital firms referred to in point (a) of Article 128 of Regulation (EU) No. 575/2013 cover at least any investment meeting both of the following conditions:

   (a) it belongs to either of the following types of investment:

      (i) non-debt exposures not listed on an exchange conveying a subordinated, residual claim on the assets or income of an enterprise not listed on an exchange;

      (ii) debt exposures and other securities, partnerships, derivatives, or other vehicles the economic substance of which is similar to the exposures specified in point (a) and not listed on an exchange;

   (b) it is held with the objective of providing funding to newly established enterprises (e.g. for the development of a new product and related research for the enterprise in order to bring this product to the market, for the build-up of the production capacity of the enterprise or for the expansion of the business of the enterprise, etc.).

3. Institutions should consider that investments in private equity referred to in point (c) of Article 128 of Regulation (EU) No. 575/2013 cover at least any investment meeting both of the following conditions:

   (a) it belongs to either of the following types of investment:

      (i) all non-debt exposures not listed on an exchange conveying a subordinated, residual claim on the assets or income of an enterprise;

(ii) debt exposures and other securities, partnerships, derivatives, or other vehicles, the economic substance of which is similar to the exposures specified in point (a) and not listed on an exchange;

(b) it is held with the intention of generating a profit through a leveraged buyout, an initial public offering, sale of the equity stake by other means or any transaction with a similar economic substance.

Any investments where the institution has the intention to develop a strategic business relationship with the enterprise it has invested in shall not be considered as private equity for the purposes of these Guidelines. However, such investments may still constitute high risk exposures according to section 4.2 of these Guidelines.

Explanatory box for consultation purposes

The proposed clarification regarding investments in private equity should provide guidance and ensure harmonisation regarding the type of exposures considered investments in private equity. It should be noted that although investments which are held by the institution on a long term basis with the intention to develop a strategic business relationship are not covered here, these types of exposures may still be high risk due to any of the criteria mentioned in section 4.2.

The proposals made here, however, do not take into account whether an institution has more information at hand on the entity in which it plans to invest and which might exclude or indicate a high risk of loss, for example a credit assessment from an ECAI or a credit assessment which the institution has done itself for the purpose of granting a loan.

Therefore an alternative approach for what constitutes private equity would be to suggest that:

All non-listed equity is private equity unless:

a) a credit assessment for the equity issuer by a nominated ECAI (issuer rating) would result in a risk weight lower than 150% for comparable debt exposures to the same issuer; or

b) the institution has sufficient additional information to confirm there is no particularly high risk of loss for the considered investment.

However, this definition was not taken on board, because it was deemed inconsistent to the philosophy of SA where a risk weight is generally determined by the exposure class, the external rating of the counterparty, or by the structure of the transaction, but no internal assessment has in principle an impact on the risk weight of a transaction. It has therefore been considered that the definition of private equity should not depend on the bank's level of information.

Question 1: Do you agree with the proposed clarifications in paragraphs 2 and 3? Would you like to bring forward arguments which potentially mitigate the caveats of the alternative approach for defining what constitutes an investment in private equity?

4.2. Other types of exposures to be considered high risk exposures

4. For the purposes of identifying items associated with particularly high risk and which are not already covered by Article 128 (2) of Regulation (EU) No. 575/2013, institutions should consider as items associated with particular high risk at least those exposures which exhibit levels and ranges of risk drivers that are not common to other obligors or transactions of the same exposure class.

5. For the purposes of paragraph 4 institutions should consider at least all of the following exposures as exhibiting levels and ranges of risk drivers that are not common to other obligors or transactions of the same exposure class:

   (a) any financing of speculative investments in both financial and non-financial assets other than immovable property, where the obligor has the intention to resell the assets for profit, where both of the following conditions are met:

      (i) there is a particularly high risk of loss in case of the default of the obligor (in particular in case of insufficient market liquidity and/or high price volatility for the financed object, where not yet sufficiently mitigated e.g. by irrevocable pre-sales contracts);

      (ii) there are insufficient other income and assets of the obligor for mitigating the loss risk for the financing institution (in particular in case of high loss risk compared to the financial resources of the obligor);

   (b) any exposure for which an issue specific external rating is not available and which can be considered as specialised lending exposure where any of the following conditions is met:

      (i) the institution has identified in its analysis a high risk of loss resulting from any of the following:

         - significant deficiencies in the financial strength of the according SPV;
         - significant uncertainty related to the political and legal environment of the location of the project, if relevant;
         - transaction and/or asset characteristics;
         - diminished strength of the sponsor and developer.

      (ii) the institution has identified a high risk of loss for an exposure related to project finance in the form of a single project in its pre-operational phase, where its cash flows serve both as security and as source of repayment and which the institution considers to be of no high quality;

6. In addition to what is referred in paragraph 5, institutions should:

   a) assess additional relevant types of exposures which potentially carry a particularly high risk of loss due to being structurally different, as outlined in paragraph 4, for exposures belonging to the exposures classes set out in points (g), (p) and (q) of Article 112 of the CRR;

   b) identify any other relevant types of exposures carrying a particularly high risk of loss due to Article 128 (3) CRR and which are not identified according to paragraph 5 or 6 (a). In case such a type of exposure is identified it should be notified to EBA including a brief description of its main characteristics.

Explanatory box for consultation purposes:

Article 128 of the CRR referring to 'Items associated with particular high risk', through its paragraph 3, does not suggest any limits to the types of exposures that may be classified as high risk. Therefore, for the specific types of exposures mentioned in paragraphs 5(a) and (b), institutions have to consider **all** exposure classes under the SA.

However, when considering the development of the present GLs and their scope, the EBA has taken into account the fact that, empirically, there are some exposure classes that are more likely to contain items that would be classified as high risk. In EBA's view, among these exposure classes, the most prominent ones are 'Corporates', 'Equity' and 'Other items', as specified in Article 112 points (g), (p) and (q) of the CRR. More specifically, as the criteria set out in paragraphs 5(a) and (b) are very specific, it is expected that the GLs will have limited application to all other exposure classes under the SA, among which are "exposures to central governments", "retail exposures" or "exposures secured by mortgages on immovable property". Nonetheless, it does appear possible that also for these other exposure classes high risk items may be identified according to paragraph 5 (a) and (b) and therefore the identification should also be undertaken as regards these exposure classes.

Paragraph 6 (a) sets out the scope of assessment in order to identify any other types of exposures potentially carrying a high risk of loss due to structural difference, which are not already covered by paragraph 5. The according assessment should be conducted for the three asset classes 'Corporates', 'Equity' and 'Other items' The rationale for this provision is, as said above, that in EBAs view these exposure classes are more likely to contain items that would be classified as high risk. This however should not lead to the reverse conclusion that high risk items can only occur in these exposure classes or that any assessment related to Article 128 (3) can be limited to these exposure classes.

In this regard it should be pointed out that while the GL aim at identifying a high risk of loss as a result of structural differences of specific exposures, the scope of Article 128 (3) is broader. However in order to account for the potential variability in capital requirements which might arise from the application of Article 128 (3) for types of exposures not considered in these GLs a notification mechanism is proposed in paragraph 6 (b).

Such non-public notification mechanism would require institutions to report any type of exposure that has been assigned to this exposure class on the grounds of Article 128 (3) and which is not covered by paragraphs 4,5 or 6 (a) of these GLs, which would enable the EBA to monitor a potential divergent application of Article 128(3). It is however expected that there would be a small number of notifications. The expectation may be reconsidered based on the feedback from consultation and where deemed necessary in order to provide proportionality in the regulatory requirements.

Question 2: Do you agree that the identification of high risk items is particularly relevant for some of the existing exposure classes?

Question 3: Do you have any comments or concerns regarding the proposed scope of the exposures at least to be analysed according to paragraph 5? Should more guidance be provided as regards other types of exposures? If yes, please provide specifications.

Question 4: Do you agree to the proposed scope of exposures to be assessed in Paragraph 6 (a) in order to identify additional types of exposures which should be subject to a potential assignment to the high risk exposure class due to being structurally different?

Question 5: Should there be a notification mechanism as proposed in paragraph 6 (b)? Based on the current portfolio of exposures, would you expect that your institution (the institutions represented by you) would need to provide a notification?

7. All equity exposures should be considered whether to be classified as high risk if the risk weight for any debt exposure to the same issuer is 150% or where any debt of such issuer would receive a 150% risk weight if these debt obligations were exposures of the institution.

5. Accompanying documents

5.1 Draft Cost- Benefit Analysis / Impact Assessment

The impact Assessment (IA) provides analysis of the potential related costs and benefits of the policy provided in the draft GLs. This analysis shall provide the reader with an overview of the findings as regards the problem identification, the options identified to remove the problem and their potential impacts.

The following analysis consists of three parts. The first part provides analysis on the baseline scenario in terms of institutions current practices, supervisory rules and practices and regulatory environment. The second part contains the options considered with respect to the major policy decisions included in the consultation paper. Finally, the draft cost-benefit analysis is based on the main policy changes in comparison with the current supervisory rules and practices, institutions current practices and regulatory environment.

A. Problem identification

The issue that is addressed by the GLs is the lack of common institutions' and supervisory practices regarding the types of exposures which are associated with particularly high risk and under which circumstances. As a result of identifying an exposure carrying a particularly high risk by application of Article 128 (3) of the CRR such exposure receives a risk weight of 150%. All issues that have been considered while developing these GLs aim at harmonising the rules for the identification of exposures to be associated with particularly high risk.

B. Policy objectives

The objective of the GLs is to establish convergence of institutions' assessment of whether an exposure constitutes a particularly high risk in the sense of Article 128 (3) CRR. Divergent practices of institutions and supervisors regarding the specification of types of exposures that should be considered as particularly high risk may lead to a non-level playing field among institutions as well as to unjustified RWA variability in the SA. Member States and institutions are expected to enhance comparability of own funds requirements.

The GLs aim at specifying the types of exposures to be associated with particularly high risk, by way of:

- Providing a clarification on the notion of venture capital firms and investments in private equity as referred to in Article 128 (2) (a) and (c) of the CRR;
- Providing a general approach for identifying exposures to be associated with particularly high risk;
- Specifying specific types of exposures which should be considered as exposures to be associated with particularly high risk;
- Introducing a notification scheme for any other high risk exposure assigned a 150% risk weight by application of 128 (3) CRR not covered by any other requirement in these GLs.

C. Baseline scenario

The baseline scenario can be defined in terms of supervisory rules and practices, institutions current practices and regulatory environment.

The baseline scenario in terms of the supervisory expectations is specified on the basis of information exchanged among the competent authorities that participated in the relevant working groups. Based on this exchange it can be considered that speculative investments as well as low quality specialized lending is already considered in some EU jurisdictions for the purpose of identifying exposures of particularly high risk.

The baseline scenario in terms of institutions current practices is assumed to be comparable to the supervisory baseline scenario. However this assumption will have to be reviewed based on the feedback to this consultation paper.

The baseline scenario in terms of regulatory environment is set by the current CRR and does therefore not provide any starting point for the impact assessment as currently no specific types of exposures are set out under Article 128 (3) of the CRR.

D. Options considered

The Scope of the GLs on high risk

It was discussed to exclude several exposure classes from the scope of these GLs. In particular is was proposed to exclude exposures to central governments or central banks, exposures to regional governments and local authorities and exposures to public sector entities from the scope of the GLs with the rationale that such exposures are not expected to be exposed to a high risk of loss. In this regard it should be noted that Article 128 (3) of the CRR cannot be limited to certain exposure classes and that therefore this Article applies to the above outlined exposure classes as well. Moreover it should be noted that in practice it is very improbable that any exposure stemming from these exposure classes will fall under the types of exposures described in paragraph 4,5 or 6 of these GLs.

It was as well proposed to exempt “exposures to multilateral development banks” according to Article 117 (2) of the CRR from the draft GLs since they are risk weighted at zero per cent. For these exposures, the assessment for high risk purpose contradicts the intrinsic nature of the multilateral development banks that are created for economic and social development projects and have large sovereign membership. However as pointed out in the previous paragraph the GL cannot limit the general scope of Article 128 (3) CRR.

Last it was considered to exclude SMEs from the scope of the GLs. In this regard, it was deemed that their assessment for high risk purpose might negatively affect the financing of SMEs that play a fundamental role in creating economic growth and providing employment in Union market (see recital 44 of CRR). This argument has been developed in the Background and rationale Section of the Consultation Paper. However Article 128 (3) of the CRR applies to SMEs via the CRR and the GLs cannot reduce the general scope of that Article as pointed out above. However it should be noted that it is very improbable that SME exposures fall under the types of exposures captured by in paragraph 4 and 5 and therefore it has been considered preferential to keep SMEs in the scope of the assessment as otherwise their assessment for the purpose of Article 128 (3) might be sufficiently harmonised.

Governance aspects

It was considered to include governance aspects into the draft GLs which would have required institutions to lay down in internal policies e.g. their risk appetite with respect to high risk exposures, how they assess high risk exposures for newly acquired business as well as for exposures already in the stock as well as some other governance aspects. However, for the sake of sticking more closely to the mandate set out in Article 128 (3) CRR, these considerations were not pursued.

List of criteria

It was as well considered to introduce a list of more detailed and objective criteria for the assessment of whether single exposures/transactions are subject to a high risk of loss, which would have required institutions to identify additional relevant types of exposure, which are not already covered by Article 128 (2) CRR or any part of the draft GLs. Such more detailed and objective criteria would have required institutions to identify exposures which inhibit levels and ranges of risk drivers that are not common to other obligors or transactions in a considered exposure class by taking into among others:

(a) triggers based on the institution's own credit assessment indicating insufficient financial resources of an obligor to repay debt;

(b) the significance of the amount of exposure, the portion of the unsecured part or level of LTV which would lead to high risk of loss;

(c) internal or external credit rating/ quality expressing high level of risk or other aspects, which would lead to high risk of loss.

However these considerations were discarded due to the following reasons:

- If such list would be provided it was deemed necessary to define thresholds for the individual triggers as otherwise the assignment of an exposure to the high risk exposure class would be bank-specific, which would be in contradiction to the concept of the SA. The calibration of such thresholds was envisaged to be extremely difficult.

- It was considered that SA-institutions might not have the required information at hand (i.e. internal PD or LGD). Moreover the proposed triggers would have to be defined with a high level of detail which would then in practise again be difficult to assess for SA banks (e.g. LTV with respect to current or original market value, how to define market value).

5.2 Overview of questions for Consultation

Question 1: Do you agree with the proposed clarifications in paragraphs 2 and 3? Would you like to bring forward arguments which potentially mitigate the caveats of the alternative approach for defining what constitutes an investment in private equity?

Question 2: Do you agree that the identification of high risk items is particularly relevant for some of the existing exposure classes?

Question 3: Do you have any comments or concerns regarding the proposed scope of the exposures at least to be analysed according to paragraph 5? Should more guidance be provided as regards other types of exposures? If yes, please provide specifications.

Question 4: Do you agree to the proposed scope of exposures to be assessed in Paragraph 6 (a) in order to identify additional types of exposures which should be subject to a potential assignment to the high risk exposure class due to being structurally different?

Question 5: Should there be a notification mechanism as proposed in paragraph 6 (b)? Based on the current portfolio of exposures, would you expect that your institution (the institutions represented by you) would need to provide a notification?