

27 April 2006

Final Report

Supervisory Stock Take on Large Exposures

Introduction

Purpose of the Survey

1. In its 'Call for Advice (No. 5) to CEBS on the review of the Large Exposures rules¹, the European Commission requested that CEBS undertake a range of work to inform the Commission's work.
2. As part of this, CEBS was asked to carry out a stock take of current supervisory practices.
3. Accordingly, CEBS has carried out a survey of member states' competent authorities' ('competent authorities') implementation of the large exposures (LE) rules in the Codified Banking Directive (2000/12/EC) and the Capital Adequacy Directive (93/6/EEC), which have been recast in the Capital Requirements Directive (CRD).
4. In brief, this report provides a review of the different regulatory approaches utilised by the member states. The report also provides insights into the proposed manner of implementation of the new and old options in the CRD and serves to point out where there are 'synergies and conflicts' of practice between national supervisory authorities.

Methodology

5. A questionnaire was circulated to competent authorities on 17 January 2006. This consisted of 47 questions designed to cover all aspects of competent authorities' implementation of the relevant provisions. In the case of the provisions which were introduced in the CRD when recasting the two Directives 2000/12/EC and 93/06/EEC, Member States have indicated their intentions about implementation. These indications should be considered to be provisional and not necessarily final decisions.

¹ 1 December 2005

6. A copy of the questionnaire is attached as Annex IV to this document. The competent authorities of the 25 Member States, 3 EEA members (Norway, Liechtenstein and Iceland) and Romania have sent their responses to the questionnaire.
7. This report is submitted to the European Commission and is posted on the CEBS website at <http://www.c-ebs.org/>.

Executive Summary

8. The European legislation sets out rules in respect of large exposures including setting limits on the extent to which an institution may be exposed to a single client or group of connected clients. These rules date back to Directive 92/121/EEC and were carried over to Directives 2000/12/EC and 93/6/EEC.
9. Member States have adopted the requirements contained in the Directives as their starting point. However, the nature of the framework is such that variations in national regimes arise from the flexibility granted, to reflect either the characteristics of local markets or different prudential approaches.
10. In general, CEBS found that:
 - there is a good degree of commonality around the core issues;
 - divergence emerges where Member States elaborate (e.g on definitions) to provide clarity; and
 - divergence emerges from Member States' exercise of national discretions.
11. The main findings noted in the report at Issue 1 – Issue 5 are as follows:
 - a. In broad terms, the Member States' definitions of exposure, large exposures, exposure values and connected clients appear to share a lot of core commonalities. All include, where applicable, in their definitions, on and off-balance sheet items in the banking and trading books.
 - b. All apply the LE rules to all institutions (credit and where applicable, investment firms) in their jurisdictions. Differences only result from the discretions with respect to waivers for subsidiaries and/or financial holding companies, which are, in effect, applicable to the whole CRD.
 - c. With regard to the administrative and accounting systems to achieve adequate internal control mechanisms for the purposes of identifying, recording and monitoring all large exposures, there is some variation in the methodology used which seems to reflect the broad range of supervisory practices across Europe.
 - d. All Member States have adopted the 25% and 800% exposure limits noted in the CRD. Differences are noted in terms of certain types of

exposure being deducted from the calculation of the limits (see below) and how intra-group exposures are handled. Also, several member states apply more stringent limits, particularly in the case of insider transactions.

- e. The CRD allows Member States to fully or partially exempt certain exposures from the calculation of the limits. The CRD permits 20 partial or full exemptions. All Member States have exercised at least one of the exemptions. Claims on central governments or central banks receiving a 0% risk weighting are granted an exemption from the exposure limits by all Member states. Otherwise, there does not appear to be a unifying theme in the selection of the exemptions made by Member States owing to the wide choice of exemptions.
 - f. Most member states recognize that institutions may, in exceptional circumstances, exceed the limits. All require immediate reporting of any breaches of limits as well as requiring their institutions to take immediate steps to comply with the regulatory limits.
 - g. The CRD provides an option of reporting either annually, with required interim reporting of all new or increased exposures of 20% or more, or quarterly. No member state has chosen the annual reporting option. Some countries require different reporting frequencies for consolidated versus solo reporting. The majority require quarterly reporting with a few receiving monthly or semi-annual reports. Some also have different LE limits with respect to reporting; eight countries exempt certain exposures from reporting requirements depending on whether the exposure is one to other governments and central banks or other cases where the CRD permits such exemptions.
 - h. With regard to Claims on and Exposures to Credit institutions, the two approaches offered by the CRD have been applied in various ways with a majority applying the maturity-driven approach rather than the standardized uniform risk-weight of 20%.
12. The Country Summaries in Annex I together with the tables contained in Annex II and Annex III set out how Member States implement the large exposure rules and their selection of national discretions. These Annexes represent a core component of the report and its findings.

Future work

13. This report sets out an analysis of the mode of implementation of the large exposures regime in different jurisdictions. It represents the first step in a review of the large exposures framework. Consideration of the commonalities and divergences identified will form an important aspect of the next stage of the work. A further key step, which is currently in progress, is a thorough consideration of industry practices in relation to the

measurement and management of large exposure and concentration risk². The outputs from that investigation will make a significant contribution to the review of the large exposures framework. It will facilitate the assessment of the gap between the regulatory framework and industry practices and provide a firm basis for considering the better regulation of large exposure risk.

14. The Capital Requirements Directive is the implementing document of Basel II in Europe. The large exposures rules need to be reviewed to take into consideration new market practices in the risk management of large exposures and also the interrelationship between the measurement of these exposures in Pillar I and the Pillar II rules on concentration of risk. In this respect, CEBS is conducting a public consultation on Pillar 2 guidance with regard to concentration risk. Concentration risk is also an issue currently being addressed at an international level, for instance at the Basel Committee.

² The questionnaire on industry practices can be accessed at www.c-eps.org/Advice/LE_questionnaire.pdf

Conclusions by Issues

Issue 1: Definitions

Definition of Exposure

1. Banking Book: Article 106 defines 'exposures' as any asset or off balance sheet item referred to in the definition of 'exposure value' for the standardised approach, without application of the risk weighting or degrees of risk there provided for. All but two of the countries' definitions mirrored that of Article 106. Those two will be adopting the language of the CRD in the near future. All countries but one³ excluded exposures that were entirely covered by own funds from their LE regimes. Other typical exclusions were those outlined in Article 106.
2. On and off Balance Sheet items: All Member states indicated that the LE regime applies to both on and off-balance sheet items with references also to Annexes III and IV.
3. Trading Book: Article 28 of Directive 93/6/EEC sets out that the LE regime of institutions subject to the recast directive is the same as that set out in Articles 106 to 118 of Directive 2000/12/EC. As a derogation, institutions which calculate the capital requirements for their trading book in accordance with Annexes I, II and V, shall monitor and control their LE in accordance with Directive 2000/12/EC subject to the amendments laid down in Articles 29 to 32 of Directive 93/6/EEC. All countries indicated that "exposure" takes into account both the banking and trading books.

Please refer to Annex I, the Country Summaries for individual definitions.

4. Article 117 contains a national discretion which provides two possibilities for the treatment of an exposure to a client which is guaranteed by a third party. A breakdown of current and future intentions as to how to treat third party guarantees and collateral is contained in Annex II-D.
5. Exposure to collateral issuers: Article 110(3) of the CRD includes a national discretion which permits Member States to require their credit institutions to analyse their exposures to collateral issuers for possible concentrations. Twelve countries either intend to transpose this in some way or already obtain the information; seven do not, and the others are undecided. Please refer to Annex II-D.

Definition of Exposure Value

6. Banking Book: There is a common core approach to the determination of an exposure value in that the book value of an on-balance sheet asset is used. Some countries require the deduction of applicable provisions from the book value, but others do not. Please see individual country summaries for details.

³ Norway has indicated that it intends to change its regime in the future

7. Off-balance sheet: Where applicable, all Member States indicated that:
 - g. Those off-balance-sheet items listed in the current Annex II of Directive 2000/12/EC, are valued at nominal value;
 - h. For traded off-balance-sheet items, the value is determined from the application of one of the methods mentioned in the current Annex III of Directive 2000/12/EC
8. Trading Book: All Member States indicated that “exposures” take into account both banking and trading books and that trading book values are calculated according to Article 29 of Directive 93/6/ EEC
9. Under the Discretions granted by Article 114 (Calculation of exposure value for those institutions employing IRB financial collateral methodology), the CRD allows those institutions permitted to use own estimates of LGDs and those utilizing Financial Collateral Comprehensive Method alternative methods to calculate exposure values. Ten countries indicated they intend to apply this derogation; seven do not intend to apply it and the remaining ones have not yet decided.

Definition of Large Exposure

10. Banking and Trading Books All of the countries use the definition contained in Article 108 of the CRD – in that a credit institution’s exposure to a client or a group of connected clients shall be considered a large exposure where its value is equal to or exceeds 10% of its own funds.
11. Austria also includes in their definition the de minimis level of at least 500,000 euro. Austria indicated that this level is particularly relevant for small locally-based institutions.

Definition of Connected Client

12. In general, all Member States incorporated the definition of connected client as detailed in Article 4(45) of the CRD.

Issue 2: Scope of LE Regime

13. Most of the respondents stated that they would not be applying the waivers contained in Article 69(1) and 69(2a) which, provided certain conditions are met, allow for waivers from the scope of the Capital Requirements Directive and therefore the Large exposures regime. Only three countries intend to apply both articles, five intend to apply one of the articles, thirteen do not intend to apply either and the others are still deciding. Please refer to Annex II-D for a detailed listing of each country and their decision whether or not to implement the provisions.
14. Article 3(2) allows credit institutions permanently affiliated to a central body which supervises them, and is established in the same member state, to be exempted from the LE regime provided certain conditions are met.

Please refer to Annex II-D for those countries choosing to exercise this exemption.

15. All member states indicated that the LE Requirements apply to all institutions (credit institutions, and where applicable, investment firms) in their jurisdiction.

Issue 3: Administrative and Accounting Procedures and Internal Controls

16. Banking and Trading Books: Article 109 of the CRD requires that every credit institution has sound administrative and accounting procedures and adequate internal control mechanisms for the purposes of identifying and recording all large exposures, and monitoring them, in light of the institution's own exposure policies. Most countries read this requirement in the broader context of credit risk management and for most, this requirement was implemented via general clauses such as:

- adequate and reliable information systems;
- accurate and timely reporting of any breach of limits to the supervisory authorities;
- regular review of the internal procedures by an internal audit function/ department; or
- adequate internal procedures that set limits and monitor positions according to parameters such as the sector of the economy, the geographic area and country, or currency.

The respondents indicated that they verify the presence and adequacy of these procedures through a combination of various tools.

Please refer to individual country summaries in Annex I for more information.

17. With regard to the Trading Book, Article 32(1) requires member states to establish procedures to prevent institutions from deliberately avoiding additional capital requirements. Member States were asked what procedures they had established and required institutions to put in place.

18. Member States (Belgium, Cyprus, Czech Republic, Estonia, France, Greece, Germany, Lithuania, Netherlands, Portugal and the United Kingdom) all confirmed that either they were putting in place, or already had in place, a varied range of procedures to ensure compliance by institutions with Article 32(1). These measures ranged from ensuring institutions had robust systems and controls to monitor all exposures and the relevant capital charges, to rules preventing firms from undertaking certain risk transfers or artificial transactions which were aimed at avoiding capital charges.

19. Iceland, Ireland, Luxembourg, Norway, Spain and Sweden all confirmed that they were adhering to the provision. However, they would not be

putting any additional measures in place to ensure the institutions didn't attempt to avoid additional capital charges.

Issue 4: Exposure Limits

20. In all Member States, institutions may not incur an exposure to a client or group of connected clients that exceeds 25% of its own funds or large exposures which in total exceed 800% of its own funds.
21. Please refer to Annex II-A.
22. With regard to the limits on exposures of an institution to its parent or subsidiary and/or one or more subsidiaries of that parent undertaking, a large majority of member states have set a 20% limit. However, this limit is usually waived if the exposures in question are included in the scope of their supervision on a consolidated basis. (Please refer to Annex II-B.) Indeed, for these intra-group exposures, a majority of the member states allow them to be fully exempt from all of the limits laid down in Article 111 of the CRD if they are covered by their supervision on a consolidated basis. France, which does not allow such exemptions, uses a lower reporting threshold (5%) for exposures to the parent institution or related entities.
23. The main difference is the way that the exemptions referred to in Article 113(2) are granted. In some countries, they are granted with prior approval from the supervisory authority, in others, this is not required.
24. The exemptions to the limits contained in Article 113(3) allow Member States to fully or partially exempt certain exposures. Annex III details these 20 permitted partial or full exemptions and Member States' utilization of these discretions. All Member States have exercised at least one exemption. Claims on central governments or central banks receiving a 0% risk weighting are granted an exemption from the exposure limits across all Member states. Otherwise, the application of these exemptions differs substantially among the Member States.
25. The treatment of Claims on and Exposures to Credit institutions, as permitted in the CRD, varies widely. There are three possible treatments outlined in the CRD for exempting claims on and exposures to credit institutions from the limits laid down in Article 111. Article 115 allows Member States to apply a 20% risk weighting to claims with a maturity less than one year and 50% risk weighting if the maturity is greater than one year, but less than three. Article 116 allows Member States, to apply a weighting of 20% regardless of maturity. Please refer to Annex II-E for the wide range of variability in the terms of application of these provisions.
26. Annex III contains a spreadsheet of Exemptions used under Article 113(3) by Member States and Annex II A to C and E provides tables indicating Country exposure limits and reporting.
27. Breaches of Limits: Article 111(4) of the CRD states that a credit institution shall at all times comply with the limits laid down in paragraphs

1, 2 and 3 with respect to exposures. If, in an exceptional case, exposures exceed those limits, that fact must be reported without delay to the competent authorities which may, where the circumstances warrant it, allow the credit institution a limited period of time in which to comply with the limits. All competent authorities reported that they require institutions to report any breach of the limits without delay and to provide an explanation of the cause of the breach.

28. As the Directive indicates, Member States reported that for breaches, their institutions are required immediately to take the necessary measures to comply with the regulatory limits and to set out an action plan with a precise timetable for complying with the regulatory limits. Competent authorities may fix the period of time in which the institution shall restore its situation. Usually, the Member States report that such period is adjusted on a case-by-case basis according to the circumstances. In many countries, it is sufficiently rare that there is no specified time limit to cure a breach. Belgium is the only country with a predefined 6 month maximum statutory limit.
29. Hungary and Spain indicated that any excess over the limits shall be automatically deducted from regulatory own funds until the problem is solved. In Germany, the excess over the limits shall be backed by liable capital without delay. Other countries indicated that each breach is analysed on a case-by-case basis for appropriate supervisory treatment.
30. All respondents reported that should institutions fail to restore lawful compliance with the regulatory regime, the supervisors are legally empowered to sanction them in accordance with their national laws, these include administrative fines, penalties, and withdrawal of authorisation.
31. Trading Book - Article 31 of the recast Directive 93/6/EEC permits Member states to allow the limits laid down in Articles 111 to 117 of the CRD to be exceeded temporarily in the trading book if certain conditions are met. All but five Member States stated that they allow institutions to exceed the LE limits in Article 111 to 117 provided an additional capital requirement is held by the institution. In some cases respondents also stated that in addition to the additional capital, institutions are required to pre-notify the competent authority before exceeding the limits.
32. Some, but not all, of the respondents who stated that they use Article 31 to allow institutions in their jurisdiction to exceed the LE limits indicated that breaches in their jurisdiction happen infrequently. Finland confirmed that a breach had not happened in their jurisdiction despite adopting Article 31.

Issue 5: Reporting of Limits

33. Member States have implemented in a rather consistent way the reporting requirements laid down in the CRD, i.e. reporting on a standardised frequency in the context of Article 110(1) (b). In a large majority of Member States, the LEs are reported on a quarterly basis.
34. In some Member States, the reporting frequency depends on the scope of application of the LE rules. It is the case for instance in some new Member States that LEs are reported monthly on a solo basis and quarterly on a consolidated basis.
35. There is also a sense in some countries that the LE limits may not reflect the risk profile of the institution as well as they could. A few Member States have used the possibility of imposing more stringent limits, or of designating certain exposures as requiring tighter limits (for example those to insiders). Most of the Member States have tried to capture the riskiness of exposures through various requests for additional, and more detailed/targeted, reporting.
36. A few Member States have set up a specific approach to controlling the most significant exposures of institutions, or in some cases for the exposures of the larger institutions, whereby the institutions' most significant exposures are reported in accordance with specific thresholds. For instance, in France, reporting is required of any exposure over 300 million euros regardless of the percentage of own funds.
37. A few countries such as France, Portugal and Belgium require their institutions to report any exposure exceeding 10% of own funds before eligible deductions.
38. Finally, some countries require specific reporting to capture exposures to clients in a 'close relationship' with the institution, even though they may not be subject to specific limits.

Please refer to Annex II-C for details.