

Banking Stakeholder Group comments on the EBA Draft Regulatory Technical Standards on the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets under Article 379 of the proposed Capital Requirements Regulation(EBA/CP/2013/07)

The EBA Banking Stakeholder Group (BSG) welcomes the opportunity to provide comments to the EBA consultation paper published on May 17th, 2013 on Draft Regulatory Technical Standards on the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets under Article 379 of the proposed Capital Requirements Regulation¹(EBA/CP/2013/07). The comments consist of two parts, the general remarks are included in the first part, while the answers to the specific questions are in the second one.

General Comments

The EBA consultation paper on draft RTS is mandated by Art. 379(8) CRR to "define the conditions and methodologies used to determine the overall exposure [...] and also the conditions under which the structure of the transaction does not constitute an additional exposure."²The EBA proposal aims to significantly reduce single name risk concentrations arising from large exposures through indirect transactions such as collective investment undertakings (CIUs) or structured finance vehicles.

To reach this goal, the EBA proposes substantial changes to the currently applicable methodology of the guidelines on the implementation of the revised large exposures regime issued by CEBS ("CEBS Guidelines"), for two main reasons: for the application of the worst case scenario, and the consideration of the experience of supervisors. The changes include inter alia:

- A mandatory complete / partial identification of all obligors of underlying exposures and - in case of failure to comply with these requirements - the attribution of all exposures with unclear obligors to the "unknown client". No granularity threshold exists for this requirement and no structured approach is permitted.
- Revised treatment for securitization positions, treating all tranches equally, as if they were a first loss tranche.

While sharing EBA's intention to limit the risks arising from indirect transactions, and considering that supervisors have accumulated some experience on these issues since the publication of the CEBS Guideline, we take a more ambivalent point of view concerning some aspects of the draft, which relate to the following:

- no recognition of credit enhancements for direct exposure on underlying assets
- lack of distinction between the banking book and trading book treatment;
- no possibility to use maximum potential exposure (internal limits) instead of direct exposure;
- more stringent conditions to the partial look through approach
- abandonment of the granularity criterion and the structure-based approach for CIUs
- no recognition of credit risk mitigation effects stemming from the junior tranches in structured transactions.

¹Article 390 in the final text of the CRR

²Consultation Paper: Draft Regulatory Technical Standards On the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets under Article 379 of the proposed Capital Requirements Regulation.

Credit enhancements

We are concerned about the fact that credit enhancements are not recognised for the measurement of the direct exposure on underlying assets.

The EBA argues that defaults can happen simultaneously and thus credit enhancement could disappear in a very short timeframe. This assumes that the purpose of the Large Exposures regime would be to limit losses that could arise from the “joint default of several counterparties or groups of connected clients”. This contradicts with the initial intent of the Large Exposure regime which was “to ensure that a bank can absorb losses resulting from the sudden failure of a single counterparty or group of connected counterparties without itself failing”.

The EBA also argues that institutions are not able to reassess the level of credit enhancement as defaults in the underlying pool arise. This is in contradiction with the due diligence requirement developed in article 395 of CRR requiring institutions to monitor and record, amongst others, “the level of credit enhancement when they can materially impact the performance of the institution’s securitisation position”, which is the case when an institution invests in a securitisation tranche for which the credit enhancement was to disappear after one or two defaults.

When institutions are sponsor or originator of securitisation structures, they have a clear and timely knowledge of the level of the defaults on the underlying pool and thus of the resulting credit enhancement. For instance, on pools of purchased receivables held on ABCP conduits, the credit enhancement is monitored on a regular basis and is dynamically adjusted according to the realised losses. The credit enhancement is structured to avoid any losses due to the first default, whatever its rating.

The suggestion from the BSG is that credit enhancements should be recognised for the measurement of the direct exposure on underlying assets.

Trading book and banking book

The CRR and consequently the text, make no distinction between the trading book and the banking book positions. It would be useful to underline that in the case of a trading book position, the exposures to the underlying positions should be based on the net positions and not the gross position.

When adding the calculated exposures stemming from the underlying, to other exposures to the group of connected clients, monitoring frequency determines how long the underlying exposure is assumed to be constant. Since in the trading book the holding period is generally short, those positions, for which according to the trading strategy of the institution the holding period is less than the monitoring frequency, should be exempted from the monitoring requirement, provided that the position is not qualified as illiquid.

Actual exposures versus maximum potential exposures (internal limits)

For risk management purposes, specifically on a consolidated level, credit exposures to connected clients are managed by limits and there are institutions which do not consolidate positions with a monthly frequency, but only quarterly. Therefore depending on the monitoring frequency, we suggest to permit the use of the maximum potential exposures permitted by internal limits, provided that there are no limit breaches, instead of actual exposures.

The monitoring requirement should take this into account and at least on a consolidated level the frequency should be quarterly.

Partial look-through approach

The partial look-through approach in the EBA proposal keeps the approach of the CEBS Guidelines in a modified form. Unlike the CEBS Guidelines, Article 6 (3) requires the identification of all exposures at first, and does not permit to treat all the exposures to non-identified obligors aggregated together. In

practice, the identification of all exposures is already very near to the full look-through approach and would increase the compliance costs for the institutions.

We would like to note, that the partial look through approach based on the investment mandate of the CIU could be even more flexible by permitting the use of the maximum potential exposure of the institution, permitted by internal exposure limits, and adjusting it when there is an overstep of the limit, rather than the concrete amount of the exposure. This choice could be merged with a conservative approach, assuming that the CIU investment at each potential identifiable obligor under the investment mandate is the maximum exposure possible.

Treatment of CIUs

In comparison with the CEBS Guidelines³ the CP on the draft RTS establishes more stringent limits primarily for those institutions which use the less complex methods, and does not take into account that the volume of their investment is not so high as to compensate for the costs of the full look-through approach. The CP does not give any indication as to whether there has been supervisory evidence that the less sophisticated methods used by small institution has proved to be riskier in the past years than the more sophisticated methods.

The CP on the draft RTS has created more stringent conditions to the partial look-through approach and has modified the granularity threshold.

Structure-based approach

The Basel consultative document 'Supervisory framework for measuring and controlling large exposures' does not mention a treatment similar to the structure-based approach described in the CEBS Guidelines. Nevertheless, it would be important to keep the structure-based approach as a choice for institutions. It is a prudent method for those institutions where the client base consists of private persons and SMEs, exposures to which are rarely represented as underlying exposures in CIUs. Therefore in practice a potential overlap between the obligors of the underlying exposures and the client base of the institution is none or negligible.

The proposal of the EBA, the "granularity limit" which is compared to the eligible capital of the institution represents an immaterial position to the institution. According to the structure-based approach, the underlying positions are added neither to the investment exposures to a single client, nor to the aggregated exposures of the 'unknown client', but are treated as exposure to a separate unknown client. This approach is based on the condition that the institution's maximum position without the underlying is small, and if the indirect exposure from the underlying would be added, the resulting position would not alter the exposures to a single client, or in any case would not create such a change that the large exposure limit would not be complied with.

It is true, that, in specific cases, the structure based approach could create opportunities for regulatory arbitrage, but that could be eliminated provided that the treatment as separate unknown clients would be made possible only if the institution could demonstrate that, on the basis of the investment

³For the treatment of the underlying exposures in the CIUs the CEBS Guidelines introduced 4 approaches, namely:

- a) *Full look-through: the institution identifies and monitors over time all exposures in a scheme and assigns them to the corresponding client(s) or group(s) of connected clients.*
- b) *Partial look-through approach: The institution look-through to the x known exposures in a scheme and assign them to the corresponding client(s) or group(s) of connected clients. The remaining exposures are treated as exposures to the 'unknown client'.*
- c) *Unknown exposures: All unknown exposures of not sufficiently granular schemes are regarded as a single risk and is aggregated as exposures to an unknown client. A scheme is sufficiently granular if its largest exposure is smaller than 5% of the total scheme.*
- d) *Structure-based approach: If the institution can ensure (e.g. by means of a CIU's mandate) that the underlying assets of the scheme are not connected with any other direct or indirect exposure in the institution's portfolio (including other schemes) that is higher than 2% of the institutions own funds, it may treat these schemes as separate unconnected clients.*

mandates, there is no or little possibility of overlap between the underlying portfolios of the different schemes treated with the structure-based approach.

Granularity criterion

The Basel consultative document 'Supervisory framework for measuring and controlling large exposures' suggests the exemption from the identification of the underlying if it is ensured that none of the underlying exposures is higher than 1% of the scheme. In that case the underlying exposures must not be added either to the specific large exposures or to the exposures to the 'unknown client'.

In the CEBS Guidelines granularity limit was defined at 5% of the scheme. The EBA suggest to reconsider this limit and to define it in 0.25% of eligible capital, as from a large exposure point of view it is not the granularity, but the immaterial position that is relevant. Under the assumption that the institution's investment in the scheme is at the large exposure limit of 25% of the eligible capital, the granularity threshold suggested by the EBA is similar to that of the BCBS.

It has to be taken into account that from the point of view of the investment policy of the institutions the granularity criterion and the structure based approach have different consequences. The granularity of the underlying portfolio ensures that the marked-to-market value of the portfolio of the CIU is not influenced significantly by the default of a single obligor. Therefore, if the institution invests in well diversified and sufficiently granular CIUs, the default of an obligor will not cause a material loss to the institution. Therefore there is no need to look through to the exposures of the underlying portfolios.

The BSG strongly objects to the proposed abandonment of the granularity threshold and suggests to maintain the granularity criterion for the time being at the level defined in the CEBS Guidelines and to consider a possible change in it only after the finalisation of the BCBS large exposure regime.

Conceptually, it is possible to attach the granularity limit with the immateriality threshold, as suggested by the EBA, but in our opinion the limit should be based on the granularity threshold of the CEBS Guidelines and attached with a full exemption to consider the underlying exposures for large exposure calculation. Instead of the 0.25 per cent limit compared to the eligible capital, a limit in 1.25 per cent of the eligible capital is suggested.

Regarding the treatment of CIU's - which may be an important issue for small and medium sized banks - we would like to emphasise that we should also be aware of the potentially increasing complexity of the treatment of CIUs and securitisations regarding Article 390 in CRR in conjunction with the consultation paper on large exposures. According to our experience, the institutions' look through processes - based on the CEBS guidelines - are mostly driven by numerous manual steps. Therefore it turned out to be useful and efficient that investment firms (asset managers) in their regular reporting to investors/banks confirm that the relevant funds are fulfilling the granularity criterion (i.e. 5% of the scheme). Proposing a granularity/ immateriality threshold in per cent of the institutions' eligible capital means that the institutions will have to determine their threshold by themselves on a regular basis, probably leading to further manual steps and hence increasing costs - taking also into account the volatility of the CET 1 under CRR. Consequently, a granularity threshold in per cent of the scheme might be the more appropriate criterion from a process-related perspective.

Structured products

Based on their experience, supervisors are unwilling to recognise the protection provided by junior tranches to senior tranches, and the EBA suggests making no distinction between the treatment of the tranches by virtue of seniority. Nevertheless, the non-recognition of the credit risk mitigation effect of the first loss position and other junior tranches, and the similar treatment of the underlying exposures for all tranches, might create a wrong incentive for banks. From the point of view of large exposures stemming from the underlying assets, the EBA proposal implicitly means that it is better to invest in junior tranches with higher return, than in senior tranches.

The reasoning described for disregarding the credit risk mitigation effect from junior tranches could be appropriate in the case of concentrated structures. Therefore it is suggested to consider applying the EBA approach only to concentrated structures, where the number of obligors is below a certain threshold (e.g. 10). When the obligors in the underlying portfolio of the structure is higher than the threshold, institutions would be entitled to recognise a certain percentage of credit risk mitigation effect at investments in the super-senior tranche, and a decreasing percentage in junior tranches except the first loss position.

Grandfathering/transitional period

The CEBS guidelines from 2009 introduced a grandfathering for all schemes acquired before 31 January 2010 until 31 December 2015 to avoid administrative burdens for the supervised institutions. This grandfathering was already necessary under the - less stringent - guidelines defined by CEBS and is widely used for a large number of schemes today. Hence, it would be at least appropriate to issue a grandfathering rule for existing transactions concluded prior to the effective date of the RTS shall and must remain eligible for treatment under the rules on the look-through approach issued in the various jurisdictions on the basis of the CEBS Guidelines.

The introduction of a transitional or, moreover, grandfathering clause is furthermore entirely compatible with the provisions under the CRR and with the EBA's mandate. Art. 390 (8) CRR gave the EBA its mandate, of specifying in greater detail the criteria and methods for establishing the total exposure. This mandate's language contains an element of plurality. Hence, under the mandate the EBA is entitled to employ a differentiated set of criteria and methods depending on the transaction type or the timing of the transaction's closing.

Q1: Is the treatment provided in Article 5 sufficiently clear and do the examples provided appropriately reflect this treatment?

It is the BSG opinion that the description of the treatment is not easy to understand without attached examples, which cannot be in the final text of the RTS. Therefore, institutions might not apply the calculation method in the same way. Moreover, the examples could be further developed to present entirely the calculation method and published e.g. at least in the framework of the Q&A at the EBA website.

If we understand the described method correctly, the presentation of the limit regulated in Article 5(1) is missing. By changing the parameters in Example 4, and assuming that the institution is the only investor in the senior tranche and in the first loss position, it turns out that calculating with a pro rata share of 1 (no other investors), the institutions exposures to the underlying assets are the following

- to underlying A,B it would equal to 45 (25+20),
- to underlying C to F it would equal 20 (10+10)
- to underlying G to H it would result in 10 (5+5)

Apparently, this is not correct, because an underlying may not create more exposure to the institution than its exposure value in the transaction. In our understanding, the exposure value from the underlying would be limited by Article 5(1)a), but the role of the limit is not shown in the examples of the CP.

Q2: Is there an appropriate alternative way of calculating the exposure values in the case of securitisations, which would be compatible with the large exposures risk mitigation framework as set out by the draft CRR?

The large exposures risk mitigation framework set out by the CRR allows banks to reduce their exposures by adjusting the exposure value in case of financial collateral using the Financial Collateral Simple Method or the Financial Collateral Comprehensive Method. To be consistent with those principles, the credit enhancement should be taken into account. As a consequence, when the credit

enhancement is funded, we propose to assimilate it to cash collateral and thus reduce the exposure of the underlying names up to the amount of collateral received.

As mentioned in the introduction, the BSG urge the EBA to reconsider its position not to take into account the Credit enhancement as a credit risk mitigant. The reasons developed by the EBA, that multiple defaults can happen and thus credit enhancement could disappear in a very short time frame, is not appropriate with the large exposure initial intent “which is to ensure that a bank can absorb losses resulting from the sudden failure of a single counterparty or group of connected counterparties without itself failing”.

On securitisation structures of purchased receivables held on ABCP conduits for instance, the credit enhancement is assimilated to a credit risk mitigation mechanism in term of risk management since it prevents the institution from a sudden default of a single obligor. In addition, the sponsor or originator of the structure performs a regular monitoring of the credit enhancement following market practices and of the losses occurred to the underlying pool. The level of credit enhancement is an important parameter of the credit decision and is regularly monitored.

As indicated in the general remarks, it is suggested to recognise some credit risk mitigation effect at the non-concentrated structures. A possible simple formula for assessing the credit risk mitigation effect of the junior tranches could be the following

$$CRM = (1 - r) * (1 - 1/n) * (1 - ((tn-1)/(n-1))^2$$

where

r is the share of the largest underlying exposure in the structure or tranche

n is the number of tranches

tn is the seniority grade of the tranche with value of 1 for the super senior tranche and a value of 0 for the first loss position

In other words, the credit risk mitigation effect in the suggested treatment depends on the share of the largest exposure in the underlying portfolio, the number of tranches and the seniority grade of the tranche.

Consequently, in order to calculate the sum to be added to the institution's large exposure from the underlying exposure in the securitisation position, the appropriate metric is the pro rata share of the institution in the tranche, multiplied by the amount of the tranche and multiplied by (1-CRM).

Q3: Would the application of requirements provided by Article 6 (3) and (4) imply unjustified costs to the institutions? Would the introduction of a materiality threshold be justified on a basis of a cost-benefit analysis? Please provide any evidence to support your response.

The CEBS Guideline considers it to be a low risk for banks if an underlying exposure contributes to up to 5% of the total investments value of a scheme, consequently dropping the need to look through to the indirect exposure stemming from the transaction.⁴

It is the BSG view that supplemental information for EBA's reasons to deviate from the 5 % threshold would be useful for the discussion. With the CEBS Guidelines (in effect since December 2009) and national implementation in force for an even shorter period of time, we would like to raise the question, if there is sufficient evidence of regulatory arbitrage taking place. The standardized reporting formats for large exposures contain no information for observing that.

On the one hand, the abolition of the granularity threshold overall reduces risk resulting from exposures to single clients. Under the current CEBS Guidelines and their application in national laws,

⁴ CEBS Guideline on the implementation of the revised large exposures regime, p. 20 – 22.

institutions could be vulnerable to exposures to single name clients that are under the granularity threshold of multiple indirect transactions, but add up to a large exposure in total and are thus not reported. CEBS tries to weaken doubts in this issue, stating that institutions should be able to demonstrate to competent authorities that no regulatory arbitrage of this kind is intended.

With the proposed RTS, supervisors would like to eliminate opportunities for this kind of regulatory arbitrage, making sure that all obligors would be identified or treated as one unknown client. Article 6 (2) of the draft RTS addresses this issue by stating that "For each credit risk exposure for which the obligor is identified, an institution shall include the exposure value of the institution's exposure to the relevant underlying asset when calculating the overall exposure to this obligor as an individual client or to the group of connected clients to which this obligor belongs." This approach, combined with the requirement to identify every obligor underlying a transaction and with the need to assign underlying exposures that cannot be attributed to a known obligor to the "unknown client", seems to be an effective way of ensuring that all relevant credit risk could be assigned.

On the other hand, transparency benefits and therefore enhanced risk awareness on behalf of banks would come at a price. The CEBS Guidelines took this into account, recognizing that "in a fund with a very granular and dynamic portfolio, the marginal contribution of this scheme to the "unexpected idiosyncratic credit risk" of the institution may be low, while the cost of a full look-through of this portfolio may be high."⁵ Under the EBA's draft RTS, banks, and especially those relying heavily on asset management, would likely be confronted with vastly increased regulatory costs. Following the devastating impact of the financial crisis, it is clear that supervisors have become considerably less concerned about compliance costs imposed on banks in the context of the potential systemic costs of bank failures.

Notwithstanding the abolishment of CEBS' granularity threshold of 5 % which could be justified by lessons learned out of regulatory arbitrage, we think that the abolishment of a granularity threshold at all should be discussed and reconsidered.

Q4: Keeping in mind that such materiality threshold would need to be sufficiently low in order to justify that all unknown underlying assets of a single transaction would be assigned to this transaction as a separate client, what would be the right calibration? Would the reference value (the institution's eligible capital) be appropriate for this purpose? Please provide any evidence to support your response.

The EBA discusses an alternative threshold on the basis of eligible capital instead of the value of the transaction. As pointed out above, this would be more consistent with the measurement of large exposures. However, the proposed threshold for this option of 0.25 % of the institution's eligible capital for a single exposure, under which no assignment to the unknown client would be recommended, would in our opinion force institutions to carry out an almost complete look-through of the transaction.

Under the assumption that an institution invests 25% of the eligible capital in a CIU, the 0.25% limit is similar to the BCBS proposal. In a recently closed consultation, the BCBS regarded transactions "for which no single underlying asset is more than 1% of the total value of the transaction" to be sufficiently granular to refrain from identifying its obligors.⁶ In transactions where a single underlying asset is above this threshold, a look-through approach for all assets in the transaction would be recommended.⁷

⁵CEBS Guideline on the implementation of the revised large exposures regime, p. 21.

⁶ Basel Committee on Banking Supervision: Consultative Document "Supervisory framework for measuring and controlling large exposures", p. 16 and 21.

⁷ Basel Committee on Banking Supervision: Consultative Document "Supervisory framework for measuring and controlling large exposures", p.21.

Although the current threshold set by CEBS may not seem to be appropriate to the EBA anymore, the BSG would like to point out that each lowering of this threshold comes with a diminishing marginal utility: the lower a threshold is set, the higher the costs of institutions climb in comparison to the single exposure that needs to be identified. A threshold that is set too low or the abandonment of a threshold would most likely discourage institutions to invest in diversified transactions and force originators to reduce retail activities or raise interests to a level where they can still retain earnings (and thereby raise costs for consumers and/or banks). It would instead constitute an incentive for banks to focus on direct business with medium to large obligors, each of them (or their group of connected clients) just below the large exposures definition threshold and thereby run short the retail market.

In our opinion, establishing a granularity threshold of 1.25 % compared to the eligible capital would be mostly in line with the 5% of granularity criterion, and at the same time, would still be immaterial from a large exposure point of view. We would suggest to apply this limit and if necessary, to modify it only after the finalization of the BCBS large exposure regime.

The discussion of a granularity threshold is even more important given that the EBA seems to have dropped the structure-based approach completely. Under this method, institutions that can currently ensure that the underlying assets of the scheme are not connected with any other direct or indirect exposure in the institution's portfolio (including other schemes) that is higher than 2% of the institutions own funds, can refrain from a complete or partial look-through. In our view, that approach is useful for many institutions and still sufficiently prudent from a large exposure perspective. We would like to point out that EBA's near final draft RTS on own funds⁸ still retains the structure-based approach for exposures to financial sector entities that are included in indices and for which a monitoring on an ongoing basis is deemed to be operationally burdensome by the competent authority.⁹ We think that approving equal approaches for both topics (i.e. own funds and large exposures) would increase efficiency in banks' processes.

For means of large exposures, a structure-based approach without the need to attribute a transactions value to the unknown client could be deemed acceptable for example in cases where banks invest in schemes that are made up of retail exposures (e.g. student or car loans) without having retail activities themselves, or where the institution has no client with such features, where the CIU can invest in. In these cases, the investments in schemes themselves are to be reported as a large exposure if the investment is above the 10% of the eligible capital.

Q5: Would the requirement to monitor the composition of a transaction at least monthly, as provided by Article 6 (5), imply unjustified costs to the institutions? Please provide any evidence to support your response.

According to Article 6 (5) of the RTS, institutions shall monitor the composition of a transaction on an ongoing basis, at least monthly. For cost-benefit concerns, it should be taken into account that for investments in well-diversified portfolios, relevance for "large exposure issues" is usually very limited. Monitoring and control instruments could also be an alternative to identify obligors' limits, for example via a comparison between relevant clients in the bank to a list of clients of the underlying portfolio.

As has been mentioned already, in the general remarks above, the text does not make a distinction between the trading book and the banking book positions. Nevertheless, trading book positions for which the holding period defined in the trading strategy is less than the monitoring frequency, should be exempted from the monitoring requirement, provided that the positions are not qualified as illiquid. Moreover, it should be emphasized that in the case of trading book items, the exposures

⁸EBA draft Regulatory Technical Standards – near final version of June 5th 2013; EBA RTS 2013/01.

⁹EBA draft Regulatory Technical Standards – near final version of June 5th 2013; EBA RTS 2013/01, p. 27.

stemming from the underlying must also be taken on a net basis, as the long and short positions to the same CIUs or same structured products are also netted in the trading book.

Q6: Are there other conditions that could be met by the structure of a transaction in order to not constitute an additional exposure according to Article 7?

No, the listed conditions seem to cover the necessary cases.