

BBA responds to CEBS consultation paper on the second part of its technical advice on large exposures (CP16) on behalf of member banks with a small capital base

1. Introduction

- 1.1 The BBA is the leading UK banking and financial services trade association and acts on behalf of its members on domestic and international issues. Our 235 banking members are from 60 different countries and collectively provide the full range of banking and financial services. They operate some 130million accounts, contribute £50bn to the economy and together make up the world's largest international banking centre.
- 1.2 Due to the diverse nature of the BBA membership this is one of three responses to which the BBA is contributing, along with a collaboration with other UK trade associations that represent larger banks with parents, branches or subsidiaries based in the UK and a collaboration with the European Banking Federation. **This response focuses on the practical implications of some of the proposals contained in CP16 that have a direct and disproportionate impact on BBA membership with small capital bases and typically adopt the standardised approach to credit risk.** All references to "members" in this paper refer to BBA membership that have a small capital base and not to the entire membership, unless stated otherwise.
- 1.3 My members would like to express their thanks for this opportunity to comment on CP16 and both recognise and appreciate the role of CEBS in undertaking dialogue with the industry in reaching conclusions to its technical advice to the Commission. To that end, my members welcome any future opportunities to speak with members of CEBS and the Commission where clarity is required and to support this paper. Moreover, my members would like to make it clear that they have met with the UK Tripartite Authorities in escalating the concerns raised in this paper. This paper should be considered in light of these discussions.
- 1.4 Additionally, those members that are able to designate resource will be addressing their own responses to complement the BBA response. These responses will present high level quantitative analysis of the costs of the proposals being made to better inform the debate and to make policy makers aware of the practical implications at a micro level. Due to the varying nature of members' business models there is no macro-level analysis that can be undertaken without losing the practical implications at a micro level. For this reason, this paper does not seek to undertake a macro analysis of CBA but instead directs the Authorities to individual member responses to inform that debate.

2. Executive Summary

- 2.1 My members have identified proposals in the following areas as being of most concern and detriment to their business.
 - Interbank Exposures (IBE)
 - Intra Group Exposures (IGE)
 - Definition of interconnectedness
- 2.2 As such this paper will focus on the questions asked in respect of these issues only. It's not to say there are not concerns in other aspects of the paper, however, the most detrimental affects

of the proposals manifest themselves in these three areas and so my members have elected to focus on these proposals.

- 2.3 Moreover, my members are concerned at the amount of time policy makers are giving to consider the implications of their proposals. Whilst there has been a consultation process, it is clear that the analysis is inappropriate. Much more work needs to be undertaken and Authorities should reconsider the review period. The implications of the proposals are far reaching and much more work is needed in analysing these implications than has already been allocated. My members suggest that the timeline is delayed to allow a more appropriate and considered regulatory response and to ensure a more robust and meaningful consultation period.
- 2.4 Proposals indicating withdrawal of the exemption for IBE of maturities less than 12 months demonstrates lack of understanding of how the interbank markets operate by the policy makers. Moreover, the simplistic and macro-level CBA along with its host of assumptions and caveats renders the conclusions in this area redundant. The implications at the micro level have not been fully considered and, given the short timescale, cannot be accurately considered. Therefore there should be no changes in this area.
- 2.5 Taken together, proposals with regards to IGE limits and IBE limits have consequences that are greater than the sum of their individual parts. There is a multiplicative effect on the implications for my members that would have disastrous implications on the ability of my members to manage their liquidity, especially in times of stress. The ultimate outcome is that banks could be forced to approach their central banks in times of stress. This is costly and, as has been demonstrated over the summer, the reputational costs are disproportionately high. Whilst my members are sure that the Regulators and Authorities are seeking to consider implications during all parts of the credit cycle, my members are concerned the practical implications of the proposals have not been tested during times of stress and so ask that proposals are seriously re-considered in the light of the information provided in this response and from individual responses.
- 2.6 A definition of interconnectedness based on one-way recognition is, in practice, virtually impossible to implement with any degree of accuracy. Moreover, for smaller banks which are industry sector specific or restricted geographically by virtue of their business the implications are that their business models would fall foul of the regulations overnight. The implications on the industry sector customers and local businesses should not be underestimated. These counterparties rely on the specialisms of these smaller banks that have expertise in their chosen fields or geographical location. What cost the loss of these specialist and local relationships? Indeed, it is these banks with this local and/or specialist sector knowledge that can be better equipped to fund innovation when larger banks which may not have the same specialisms may not.
- 2.7 Sectoral and geographical risk is better considered on a case by case basis which means that it should be, as it already is, considered as part of Pillar 2 discussions. This provides regulators with a much better understanding of the bank's risk management and business model than a one-size fits all approach which does not recognise these specialisms.
- 2.8 The systems, administrative and associated costs of the proposals within the CP16 are disproportionately high for my members.
- 2.9 Whilst the Part 1 Consultation, CP14, has stated that creditworthiness is not a consideration for the LE regime, my members wish to point out that, in practice, creditworthiness is a fundamental criterion of LE management. The proposals put forward in this paper will force my members to engage with counterparties below their agreed creditworthiness criteria. As such, the benefits of increased diversification proposed are more than undone by the increase in credit risk, market risk and operational risk that my members would be forced to take on. Quite simply, my members are unable to reconcile the perceived benefits in diversification with the increased credit, market and operational risk. Furthermore, it is not felt that CP16 adequately considers these effects and so the analysis is fundamentally flawed.
- 2.10 If the Commission pushes ahead with changes based on inaccurate information then it will show the consultation process to be ineffective. It will also contradict the Commission's own objective

of seeking better regulation. The industry supports the Commission's Better Regulation initiative in which it commits, inter alia, to ensure that the "right regulatory style" is used and that any burdens imposed are as light as "is compatible with the policy results desired". The Commission is reminded of this commitment when delivering the outcomes of the LE Review.

3. Interbank Exposures

31 Given the market failure and CBA set out above, what treatment would you consider appropriate for interbank exposures?

- 3.1 In light of the flaws with the CBA, the current exemption applied to IBE should remain. Much of the market failure analysis is theoretical and there is no practical evidence of market failure occurring in practice due to IBE. It is my members' view that, without real evidence of a failure due to IBE, despite bank failures occurring in the past, the MFA fails.
- 3.2 Smaller members wish to suggest that, if regulators continue to have concerns in this area, then a more appropriate means of supervision would be by reporting and peer review of IBE. This would ease regulatory concerns of perceived market failures and promote dialogue between regulator and regulated. This would be complemented by robust stress and scenario testing of failures of a key counterparty, which firms already undertake. Such regulation would be more flexible to respond to specific climates and be more aligned to existing business practices. If greater regulation is considered necessary, and my smaller member firms categorically believe that there is no justification for this, then credit quality must form part of the matrix of the regulation in the area of IBE to ensure alignment to business practices and to minimise the inappropriate and disproportionate regulatory burden that any such regulation would impose.
- 3.3 With regard to stress testing, my members regularly undertake stress testing based on the failure of a single bank counterparty. Whilst the outcomes show that such an event would, no doubt, be painful, their risk management and existing diversification means that they could continue to operate. If two or more banks were to fail then my members agree that this may be unsustainable. However, as their existing counterparties are the most credit worthy banking institutions then in the event of two or more such counterparties failing then, in reality, the systemic event ensuing from this wide failure means that the problems are much further reaching than any LE regime would be able to prevent anyway. Put simply, if one major bank was to fail there is an issue, but a potentially surmountable one. If two or more major banks failed then, in all likelihood, the entire banking system is at risk and no LE regime could prevent the ensuing fall-out.

29 Do you consider that large interbank exposures of all maturities are associated with the market failures described above (see Appendix 1)

- 3.4 This is a weighted question, based on the theoretical evidence presented in the Market Failure Analysis. However, what the CEBS fails to consider is proportionality. This should be a fundamental cornerstone of policy making. It is my members' view that the probability of an unforeseen default for short maturity exposures placed with highly rated counterparties is significantly low compared to the costs of insulating the banking sector from an event of this nature. Accordingly, our major concerns lie with the CBA which, as will be demonstrated in the next response, is fundamentally flawed bringing about ill-judged, inappropriate and disproportionate conclusions.

30 What do you consider to be the implications of the caveats set out above for the conclusions of the CBA (see Appendix 1)? Do you have any other comments on the CBA?

- 3.5 Building on paragraph 3.1, the list of caveats and assumptions in undertaking the analysis for IBE are too sweeping and unrealistic making the conclusions redundant. The key assumptions in paragraph 262 of CP16 that firms would be able to collateralise, diversify or otherwise extinguish IBE above 25% does not apply to banks with a small capital base. Paragraph 286 of CP16 recognises implications for smaller banks but does not consider it in detail. This is disappointing. Perhaps if more time was available these implications would have been given

more thought. After all, the consequences for smaller banks are disproportionate whilst the consideration seems to be quite lacking.

- 3.6 Regulators must remember that banks already adequately diversify their exposures. Small banks prefer to do business in their local market as they have limited resources and so can better manage their IBE by dealing with counterparties with whom they have a good knowledge. Smaller banks are uncomfortable that they will be forced to do business outside their comfort zone and with counterparties they do not know as well as existing counterparties, local to their market. This is exacerbated when the language in the paper suggests that the specific issues on smaller banks have not been appropriately considered and therefore appreciated in drawing conclusions. This is not acceptable.
- 3.7 Whilst the conclusions of the CBA appear compelling at a macro level, when drilling down to implications on a specific bank the micro implications are wide ranging and contrary to the objectives of LE regulation and wider competitiveness of the banking sector. There is a real concern that adoption of a blanket limit to IBE could drive many smaller banks out of business and consequently increase concentration of exposures amongst fewer organisations. An outcome we believe the regulators, categorically, do not seek, nor is it in the best interests of the industry or of its customers.

32 Would a 25% limit on all interbank exposures unduly affect institutions ability to manage their liquidity? Should maturity of the exposure continue to play a role? CEBS would find any practical examples useful as aids to its thinking.

- 3.8 In short, YES! Liquidity depends on what can be placed in the market and this is prone to difficulties for small ticket amounts. In reality, many of the more creditworthy organisations with which smaller banks place their funds require minimum deposits in the region of £10mn - £50mn. With some of the smaller niche banks having capital bases below £40mn-£200mn the ability for them to redistribute their exposures cost effectively to meet imposed IBE LE rules would be seriously impacted.

33 If you believe there is a market failure but a hard 25% limit would not be appropriate, what would you consider to an appropriate treatment for interbank exposures?

- 3.9 See response to 3.1 above.

Concluding Remarks

- 3.10 Proposals indicating withdrawal of the exemption for IBE of maturities less than 12 months demonstrates a lack of understanding of how the interbank markets operate by the policy makers. Moreover, the simplistic and macro-level CBA along with its host of assumptions and caveats renders the conclusions in this area redundant. The implications at the micro level have not been fully considered and, given the short timescale, cannot be accurately considered. Therefore there should be no changes in this area.
- 3.11 If the Commission pushes ahead with changes based on inaccurate information then it will show the consultation process to be ineffective. Moreover, the lasting impact on the overall operational efficiency of the markets would be counter-productive and could have implications on the global competitiveness of my members.
- 3.12 In summary the practical consequences of an extension of the IBE limits to exposures with maturities of less than 12 months would manifest in any or all of the following consequences:
- Banks would be required to increase the number of eligible counterparties, with accompanying increases in operational monitoring costs and a commensurate increase in operational risk.
 - This would necessitate a reduction in the credit quality of eligible counterparties by default, forcing banks to trade with banks of creditworthiness ratings they would not have previously considered. This would increase credit risk.

- An increase in market risk from additional use of treasury instruments.
- An increase in currency risk if banks are forced to do business with counterparties from other countries
- Reduction in size of balance sheet or an increase in capital that far exceeds the CRD requirements.
- Immediate and recurring breaches due to use of nostro accounts for day to day banking. For instance, when a customer sends an unexpected large sum or, say, a T-Bill purchase fails to settle resulting in funds being left on the nostro account or late settlement of real estate sales when funds arrive too late to move from the clearing bank account to another home. Exceptionally large balances can arise temporarily and it would be quite impractical to restrict these under the 25% rule.
- Because firms would be forced to trade in smaller ticket amounts this would mean:
 - Trades would be excluded by some of the existing higher quality counterparties as too small
 - A reduction in returns on smaller ticket amounts obtained would reduce returns to customers
 - A disproportionate impact on smaller banks, meaning they could lose business to larger banks
 - Reduction in credit quality of eligible counterparties would be exacerbated as banks would be forced to relax their exposure criteria to be able to place monies with lower rated institutions.
 - Any increase in costs/reduction in returns would be passed on to customers which could ultimately result in reduced customer base and could ultimately result in banks withdrawing from the market. The consequence of this would be fewer banks in the market and therefore an increase in concentration risk
 - Some smaller banks tend to be local niche banks dealing with specific industry sectors or geographical regions. These regions and industry sectors that rely on their local and specialist knowledge would be forced to bank elsewhere. The local knowledge, built up over years of strong relationships would be lost.
 - Some smaller banks rely on the interbank market for their funding because they are not active in the retail or private banking sector. The implications of an extension of the IBE limits would be for these banks to reassess their business model which is a hugely costly exercise, the costs of which should not be underestimated.
- The costs associated with these changes are disproportionately high for banks with a smaller capital base. There is a real risk that the extension of the IBE limits to all maturities will result in the closure of many smaller banks and the specialist services they provide would be lost for their customers.

3.13 Whilst CEBS has put forward compelling arguments for disregarding credit quality in CP14 when assessing LE, our members wish to reiterate and put the Commission on notice that it should not be disregarded outright. Creditworthiness forms a strong part of LE risk management. Adoption of an IBE limit for smaller banks would force banks to redistribute funds to banks they would not otherwise do business with as they would not meet their credit quality criteria in the existing regime. It increases the credit and operational risks associated with exposures and my smaller members, in particular, are having trouble reconciling the outcome of better risk management proposed for LE with this concept. This conflicts with Basel II which encourages banks to do business with higher rated institutions. It is helpful that in paragraph 289 that CEBS recognises this, but my smaller members feel that it is not given enough consideration.

3.14 If the Authorities insist on pursuing regulatory changes in this area then the timeline for the review should be extended so this can be given the most adequate and proper deliberation. Dedicated workshops and expert groups should be established to understand the implications of any practical outcomes. These groups should be made up of a wide range of institutions and the authorities and a micro-level assessment should be undertaken. My members want to work with the Authorities to achieve a realistic regulatory response. The over-riding concern at the moment is that, given the assumptions and the macro level CBA, any regulatory response would

be ill-conceived, would have disproportionate impacts on smaller banks and could, ultimately, create a contraction in the banking sector with adverse effects on the citizens of the EU, in so much as the very institutions that foster and encourage innovation would become unavailable.

- 3.15 At a time when economies are approaching critical time in the credit cycle, taken together, the combined effect of the imposition of the proposals identified in this paper could have disastrous effects. Authorities should look closely at the combined effect of the practical implications of the proposals.

4. Intra Group Exposures

21 What are your views on the proposals for the scope of application of the LE regime [to IGE]?

- 4.1 It is my members' view that intragroup exposures (IGE) are outside the scope of the LE regime. The suggestion that banks would not support a subsidiary or branch in times of stress seriously underestimates the reputational damage and costs thereof.
- 4.2 Broad sweeping generalisations need to be reconsidered in light of the impacts at the micro level. As with IBE, the impact on individual banks needs to be considered more carefully before the introduction of any regime in this area. Smaller banks are concerned that the banking model to which the proposals have been tested is one of larger cross border banks.
- 4.3 Cross-Border smaller banks have also moved to centralised
- 4.4 Any costs for smaller banks are disproportionately high.

22 Which treatment to you believe is the most appropriate for IGE:

i) to entities within the same Member State (MS)

ii) to group entities in different MS; and

iii) to group entities in non-EEA jurisdictions

- 4.5 My members feel that this analysis is very one-dimensional. It does not recognise that the majority of banks have consistent systems and controls within the group. Activities such as liquidity management and treasury functions are centralised in the modern banking environment and where there are local hubs, these management functions operate to a strict regime of systems and controls implemented at group level.
- 4.6 The key determinant for application of any IGE should be whether or not a parent has committed itself to parental guarantees no matter where the bank is incorporated and especially where regimes are considered equivalent.

19 Do you have any comments on the MFA on IGE?

- 4.7 The LE Regime is not designed to mitigate risks post-insolvency. Indeed the very objectives of the regime as laid out by CEBS in CP14 and reiterated in CP16 do not make reference to post-insolvency. As such, extension of the LE regime to post-insolvency situations is outside the scope of the LE Regime. The MFA is not applicable and therefore cannot be reasonably asserted as a benefit of the LE regime. Instead, regulators should turn their attention to other regulatory tools to solve issues post-insolvency.
- 4.8 There is a wide ranging array of work underway that should seek to resolve issues post insolvency. Key amongst these are the review of the winding-up directive, deposit guarantee schemes and the work being undertaken to respond to the ECOFIN on crisis management. Hijacking the LE regime review to mitigate risks in other areas is again ill-conceived and will not adequately meet this objective. Use of an inappropriate regulatory tool just creates a regulatory burden. My members have not heard any adequate arguments justifying this approach and remain to be convinced

- 4.9 In this respect the Authorities are minded of the Commission's 2005 commitment of a strategy for the simplification of the regulatory environment, aka Better Regulation. Amongst other things, this entails checking whether existing instruments are still needed, that the "right regulatory style" is used and that any burdens imposed are as light as "is compatible with the policy results desired".

20 Could IGE limits give rise to other costs and benefits? Please explain your response.

- 4.10 My members share the views represented in the both EBF and joint BBA/ISDA/LIBA responses of the additional costs attributed and not appropriately considered by CEBS in its deliberations.

23 What are your views on the high level principles to define intra group limits?

- 4.11 It is my members' view that the LE regime is the wrong tool with which to achieve the underlying objectives of the principles outlined. The LE review is not a tool designed to address issues post-solvency, nor should it be.

Concluding remarks

- 4.12 Intra Group exposures facilitate liquidity management. By allowing banks to take a holistic approach to liquidity management, times of stress are better responded to and managed. Banks can issue liquidity to where it is needed in its group thereby preventing failure of a group member. Quite simply the current analysis far underestimates the influence of reputational risk that banks consider. As was seen over the summer, reputation of a bank has a key role to play in its ongoing viability. The costs of a bank that did not seek all possible resolution to save a group member far outweigh the costs of supporting a group member.
- 4.13 The differentiation between regulated and non-regulated entities should be recognised as alluded to in paragraph 215.
- 4.14 Broad sweeping assumptions and statements at a macro level do not necessarily extrapolate well at the micro level. Full consideration should be given at the micro level of the implications of the introduction of IGE limits. Introduction of an IGE Limits regime would seriously impact the competitiveness of the smaller banks that rely on parental guarantees to ensure they can compete in the market.
- 4.15 Combined with proposals to extend the IBE limits, IGE limits increase the potential for groups to fail. By imposing IGE limits across Europe, banks would be forced to enter the interbank market. Where the interbank market is suffering stress, then banks would have little choice than to approach central banks and one questions if this is an outcome the Authorities actually seek to achieve from the LE review.

5. Definition of Interconnectedness

Q2 Do you agree with the proposal and suggested interpretation of 'control' and of 'interconnectedness'? Do you find the guidance/examples provided in both cases useful? Please explain your views and provide examples and where relevant provide costs and benefits.

- 5.1 My members' key concern is in the area of interconnectedness. One size does not fit all. The consequences to smaller banks are disproportionate due to their business models and the fact that some smaller members tend to specialise in specific industry sectors or geographical regions. Indeed, in order to survive in a healthy competitive environment, some smaller banks have been required to offer specialist, niche and boutique services.
- 5.2 Due to the range of banking models to which these rules would influence this area lends itself perfectly to being addressed through discussions between regulators and the industry on a case by case basis. This tool already exists in the ICAAP/SREP process in Pillar 2 of CRD.
- 5.3 Once again, Authorities are reminded of the principles and commitment to better regulation in considering the most appropriate regulatory tool to address a risk. In this instance, the LE

regime is not the right tool. It would not achieve the effects desired and would add a disproportionate regulatory burden that far outweighs any benefits it seeks to achieve.

- 5.4 In respect of a CBA, once again it is inappropriate to attempt to undertake a CBA at a macro-level concerning these proposals. Of more importance is a detailed study of the costs at a micro level. Again, the time of the review does not lend itself to full and appropriate consideration of costs so my members again suggest that the review is delayed further to enable such a detailed analysis.

Concluding Remarks

- 5.5 CEBS and the Commission should consider very closely here the impacts on all banks, small and large, when considering the best approach here. If there is extra guidance required then let that be in the form of guidance and guidelines rather than strict regulation. Each case needs to be considered on its own merits as the consequences of broad sweeping one size fits all regulation could be disastrous.

6. Closing Remarks

- 6.1 The implications of the proposals on smaller banks or banks with a small capital base should not be taken lightly.
- 6.2 Policy makers are reminded that, by their very nature, smaller banks have limited resources and so are not always able to dedicate resource to policy decisions. Smaller banks can ill afford the man-hours to consider and respond to consultation papers as well as juggle BAU activities and the existing regulatory burdens placed upon them.
- 6.3 Whilst my members will endeavour to support this paper by writing their own responses to show strength of feeling not all are able to do so. That does not mean it is of no concern.
- 6.4 My members recently met with the UK Authorities and are scheduled to meet with the Commission. We are grateful for this opportunity to relay our concerns face to face. This shows the strength of feeling at proposals that have not been properly considered and do not appear to be justified by the evidence presented. This written contribution should be considered as complementary to these discussions.
- 6.5 Whilst we are continuously informed that cries for an extension to the time of review will not be listened to, in light of the clear weaknesses identified my members reiterate the need to conduct a proper and considered review of the LE Regime and so ask, once again, that all stakeholders in the policy making seriously reconsider the existing timeline and delay this review to be aligned to other related reviews. At the very least, sunset clauses and escape clauses should be built in to the articles such that rules can be reconsidered in the light of the outcomes of these other related reviews and, if the worse case scenario ensues, that regulators can undo the harm done by their proposals.



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