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First part of CEBS' technical advice to the European Commission on the review of the Large Exposures rules

Background

1. The Large Exposures (LE) framework currently applies to all credit institutions and investment firms falling within the scope of both Directive 2006/48/EC and Directive 2006/49/EC (both referred to hereafter as the 'CRD'). This includes the full range of banks from large systemically important institutions to small cooperative banks and the full range of investment firms from large broker-dealers to small brokers and asset managers.
2. Article 119 of Directive 2006/48/EC and Article 28 of Directive 2006/49/EC, require the European Commission (the 'Commission') to submit to the European Parliament and to the Council a report on the functioning of the Large Exposures provisions of the CRD. A review of the large exposures framework is therefore being carried out by the Commission together with the European Banking Committee (EBC).
3. In December 2005, the Commission issued a first Call for Advice to CEBS on the review of the large exposures rules. This requested CEBS to carry out a stock take of current supervisory practices and a consultation on current industry practices. In response to this request CEBS has provided to the Commission, and published, a Supervisory Stock Take on Large Exposures¹ and a Report on Industry Practices².
4. In January this year the Commission issued a second Call for Advice to CEBS³. This requested CEBS' advice on substantive aspects of the large exposures framework. This advice was called for in two parts:
 - Part 1 of the advice was requested by end September 2007 on the objectives and purposes of a large exposures regime; the purpose, need

¹ Final Report – Supervisory Stock Take on Large Exposures, 2 April 2006, http://www.c-eps.org/Advice/LE_report.pdf

² Call for Advice from the European Commission on large exposures – Report on industry practices, 31 August 2006, http://www.c-eps.org/Advice/LE_industryreport.pdf

³ Call for Advice (No. 7) to CEBS on the review of the Large Exposures rules, 4 January 2007, http://www.c-eps.org/documents/LE_CfA2.pdf

for and appropriate levels of large exposures limits; whether the large exposures regime can be considered to be achieving its objectives; examination of the 'metrics' for the calculation of exposure values; and consideration of the extent to which the credit quality of the counterparty can or should be recognised.

- Part 2 of the advice was requested by end February 2008 – on the questions of credit risk mitigation; indirect concentration risk; intra-group exposures and other group-related issues; trading book aspects; reporting requirements; and consistency of definitions. In Part 2 CEBS was also requested to address the question whether 'one size fits all' or whether a differentiated approach is desirable, for example, in respect of more sophisticated and less sophisticated institutions, and having regard to the different types of institutions, particularly those that engage in specialised activities or services. The question whether there is further scope for incentives to reward good credit risk management is also to be considered.

5. To tackle the first part of the Commission's second Call for Advice CEBS published on 15 June a Consultation Paper (CP14)⁴ to give an early opportunity for stakeholders to provide their views and comments on CEBS' proposals. Due to very tight timescales the considerations set out in CP14 represented the initial thinking of CEBS on some of the key concepts underpinning a large exposures framework.
6. The present advice provides CEBS' response to the first part of the Commission's second Call for Advice. The Advice takes into account the feedback gathered in the dialogues with the industry, e.g. through the consultation process and also in a public hearing held on 11 July at CEBS' premises. The Advice also includes an update on the work currently being carried out on the main issues to be considered in the second part of the Call for Advice.

Methodology

7. CEBS developed the first part and is developing the second part of its Advice in a manner consistent with the Commission's better regulation agenda. CEBS is doing this by following, as far as time constraints allow, the draft impact assessment guidelines that have been developed by the 3L3 committees⁵. The draft guidelines are consistent with the Commission's own Impact Assessment methodology but have been refined to take account of the regulatory objectives of the committees and their existing working practices.
8. Central to the analysis set out in this report is the use of market failure/regulatory failure analysis as a means of identifying problems that a large exposures regime could seek to address, i.e. the purpose of the regime.

⁴ CEBS Consultation Paper (CP14) on the First Part of its advice to the European Commission on large exposures, 15 June 2007, http://www.c-eps.org/Consultation_papers/documents/CP14_LE_150620072.pdf

⁵ 'Impact Assessment Guidelines for EU Level 3 Committees' May 2007, http://www.c-eps.org/Consultation_papers/documents/IA_GL.pdf

9. Cost benefit analysis (CBA) also forms a key part of the impact assessment process. Preliminary results of the CBA were presented in CEBS' consultation paper CP14 but the CBA is still work in progress. Due to the short timescales CEBS is facing, it has not yet been proven possible to complete the analysis of all the data and evidence gathered. The quantitative results of the on-going CBA will be delivered together with the second part of the Advice.
10. CEBS wishes to thank all the institutions that completed its questionnaire on the costs and benefits of the current regime. Effective stakeholder consultation is a central part of the 3L3 impact assessment methodology. Market participants' views have been gathered at various stages of our process (e.g. survey of industry practices, public consultation and public hearing on CP14, forthcoming consultation on CEBS' response to the Commission).
11. Also, an additional consultation process including all the aspects of the large exposures regime covered by the two parts of the Call for Advice is to be carried out during the next stage. That is because, as many respondents to CP 14 have stressed, the first and second parts of CEBS' advice are closely interlinked. It is necessary to look into some of the detailed aspects of the second part to be able to understand the full scope of Part 1, and it is not possible to consider some of the aspects of Part 2 without revisiting some of the issues in Part 1.

Executive summary

12. This paper sets out CEBS' proposals regarding the key concepts underpinning the regulation of large exposures. It is CEBS' response to the first part of the European Commission's Call for Technical Advice (No. 7) on the review of the Large Exposures Rules.
13. Chapter 1 sets out CEBS' understanding of the objectives and purposes of a large exposures regime. CEBS believes that ensuring that risks arising from large exposures to individual counterparties or groups of connected counterparties are kept to an acceptable level follows from the overarching principles of prudential supervision. CEBS believes that a market failure does arise as a result of large single name exposures that give rise to the risk of traumatic losses due to "unforeseen events" and that this market failure is not (fully) addressed by any of Basel II's three pillars. CEBS' view is that there is therefore a remaining risk related to large exposures that could justify some regulatory intervention (e.g. some kind of limits to large exposures).
14. CEBS has developed the objectives that any large exposures regime should meet:
 - i) ensure that negative externalities arising from large single-name exposures are contained to an acceptable level;
 - ii) minimise moral hazard arising from the existence of safety nets as it affects the management of large exposures;

iii) ensure that public authorities have sufficient regulatory tools to monitor, on a on-going basis, the extent to which the overarching principles of prudential supervision are being achieved; and

iv) if intervention is necessary, ensure that is effected using a tool that is appropriate and proportionate to achieving the stated objectives.

15. Chapter 2 includes a discussion of the different policy options available. CEBS concludes that a limits-based "back-stop" regime is the most appropriate regulatory tool and that the current regime has some short-comings that need to be addressed. It is therefore proposed an amended limits-based backstop regime that should be developed as a simple and easy to understand tool that does not require the development, maintenance or oversight of complex models by either institutions or supervisors.
16. Chapter 3 and Annex II provide an overview of the approach to large exposures in a number of non-EU jurisdictions. There are significant similarities between the regimes in operation in these countries - all of them set limits on the maximum amount of exposure to an individual counterparty or group of connected counterparties. However, although a variety of different large exposures regimes exists across the world, CEBS has concluded that overall the EU regime is not in general more strict than any other individual regime, although it is possible to find some particular transactions that are treated more strictly in the EU than elsewhere.
17. Chapter 4 considers the adequacy of the current large exposures limits. The first issue is whether counterparty creditworthiness should be recognised in the large exposures limits. On the basis of the analysis carried out, and given the nature of unforeseen event risk arising from defaults on large exposures and the low but material default rates of highly rated entities, CEBS has formed the opinion that the introduction of counterparty credit quality so as to relax or remove the regulatory large exposures limits for highly rated counterparties does not fully address the identified market failures. (Part 2 of the Advice will consider potential exceptions to this general conclusion.)
18. In chapter 4, the 800% aggregate limit on large exposures is also discussed. CEBS believes that this limit has merits in providing a harmonised minimum standard to ensure granularity of the credit portfolio. It is also perceived as a mechanism for limiting the extent to which losses not covered under Pillar 1 capital requirements are inherent in the portfolio. CEBS also believes that compliance with this limit should not replace in any way the requirement to manage concentration risk under Pillar 2.
19. Chapter 5 sets out CEBS' current thinking on the calculation of exposure values. For the calculation of exposure values for off-balance sheet items CEBS proposes a set of principles on the basis of which advanced IRB institutions are permitted to use their own exposure calculations as used for regulatory capital requirements purposes. For institutions that have not obtained permission to use their own estimates of conversion factors, CEBS recommends a prudent approach which is a 100% conversion factor for the generality of off-balance sheet items, except low risk items (as defined in the Annex II of the CRD), for which 0% will generally be applied. However, while the 100% conversion factor

might prove to be too conservative for certain transactions, the 0 % conversion factor might prove to be too lenient for others. Therefore CEBS will analyse - within the context and objectives of the LE regime - which transactions can/must be exempted from these flat conversion factors.

20. For calculating exposure values for financial derivatives and securities financing transactions, it is proposed that institutions should be able to use the same approach for the LE regime as for regulatory capital requirements purposes.
21. For Collective Investment Undertakings, structured transactions and other arrangements where there is exposure to underlying assets, it is considered that there is scope to achieve a degree of principles-based agreement, a set of principles is thus proposed bearing in mind that further work on how to implement the principles will still be necessary.
22. Chapter 6 puts forward CEBS' initial thinking on the main issues to be considered in the second part of CEBS' advice to the Commission. These views are subject to the outcome of the work currently being carried out.

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Chapter 1. Objectives and purposes of a large exposures regime

23. CEBS believes that ensuring that risks arising from large exposures to individual counterparties or groups of connected counterparties are kept to an acceptable level is part of the overarching principles of prudential supervision, which are to ensure continuing financial stability, maintain confidence in financial institutions and protect consumers and in particular depositors.
24. From a market failure analysis perspective the case for regulatory intervention in large exposures is at heart the same as the case for all prudential supervision. This basic case which underpins the Basel Accord and is well established in the literature⁶ is that there are three basic types of market failure namely i) negative externalities associated with systemic risk and market confidence, ii) moral hazard and iii) information asymmetry.
25. Regulation for systemic reasons is warranted when the social costs of the failure of financial institutions, particularly credit institutions, exceed private costs and such social costs are not incorporated in the decision making of the institution. However, systemic issues do not apply equally, or at all, to all institutions. They apply particularly strongly to credit institutions because their balance sheet structure and mutual dependence makes them potentially fragile yet they are the only source of finance for a large number of borrowers and they are crucial to the functioning of payment systems.
26. The moral hazard rationale for prudential regulation is associated with safety net arrangements, such as deposit insurance and “Lender of Last Resort” (LOLR). Explicit or implicit deposit insurance weakens incentives for at least some consumers to monitor banks. More importantly, the existence of systemic risk provides incentives for public authorities to step in to prevent a bank on the brink of failure from collapsing. When doing so, the authorities balance the immediate and substantial benefits of preventing a financial crisis against the longer term distortions to institutions’ incentives and the weakening of market discipline that such intervention can cause.
27. The information asymmetry rationale for prudential regulation is that consumers are not in practice in a position to judge the safety and soundness of financial institutions. Additionally, no amount of information at the time that deposits are made protects against subsequent behaviour of institutions that puts their deposits at undue risk.
28. The CRD addresses these market failures at the portfolio level: Pillar 1 seeks to ensure that institutions have a minimum amount of capital to ensure resilience against losses, and Pillar 2, among other things, seeks to correct for distortions caused by concentration risk to the portfolio level assumptions made by Pillar 1, for example, accounting for increased unexpected losses arising from geographical, sectoral and aggregate single name exposure concentrations. Pillar 3 seeks to enhance market discipline by ensuring that appropriate portfolio level information is publicly disclosed by institutions.

⁶ See for example, Llewellyn (1999), FSA Occasional Paper 1.

29. However, it does not account for market failures arising as a result of large exposures to individual counterparties - the risk that one large exposure could, regardless of the performance of the rest of the portfolio, trigger the unexpected default of an institution, or cause the institution to experience significant difficulties of the sort that could lead to instability, contagion, and/or the need for the central authorities to intervene. In addition to internal fraud, counterparties could default unexpectedly due to unforeseen government action (e.g. banning their products), loss of major customers or markets, or an unexpected breakdown in the validity of their business model. This is what CEBS considers the risk of traumatic loss due to "unforeseen events" to mean.
30. While an institution may be 'adequately capitalised' at the portfolio level, nonetheless events can occur which such a model is not (well) designed to capture. Therefore, the central purpose of a large exposures framework is to limit the degree to which institutions are exposed to incidents of traumatic loss likely to threaten their solvency, due to the occurrence of an event which is outside the parameters of portfolio capital allocation - whether that be regulatory or economic capital allocation.
31. Large exposures to individual counterparties can give rise to negative externalities associated with systemic risk so that the unexpected default of a single counterparty that resulted in the failure of a bank or investment firm could, via contagion, cause a wider systemic crisis.
32. CEBS believes that moral hazard acts in two ways regarding large exposures to individual counterparties. First, institutions that could in certain circumstances be considered to pose a systemic threat - and therefore be candidates to receive public support in case of difficulty - may have incentives to invest less resource in single-name exposure risk management systems and/or allow larger exposures than they would without the perception of implicit state support. Second, any other institution that is itself exposed to such an institution may have incentives to invest less resource in managing that particular counterparty credit risk. This adds to the problem of systemic risk, and is economically inefficient.
33. Large single-name exposures are also subject to information asymmetry. CEBS considers that banks' private incentives do not lead them to disclose the size, nature and counterparty details of their large exposures to individual counterparties. Furthermore, even the most well-informed depositors are not able continuously to monitor their banks' large exposures even if such information was made available to them at the time of making their (initial) deposit.
34. Information asymmetry also contributes to the problem of negative externalities. Depositors and other creditors do not know the extent to which an institution may be exposed to a particular single large counterparty, and even knowing it, they cannot truly assess its potential impact. In the event of the failure of a major counterparty rumoured to be financed by a particular bank they may pre-emptively withdraw funds thereby triggering or worsening a financial crisis. Conditions in European money markets in August and September 2007 demonstrated that uncertainty regarding potential counterparties' exposures (single-name or otherwise) can prevent markets from functioning properly.

35. Industry has put forward the view that firms are already well incentivised to manage the risk associated with large exposures within prudent limits. Whilst CEBS accepts this is likely to be true for many exposure types and that the majority of institutions generally act prudently, CEBS' view is that prudential regulation is designed to impose minimum standards on institutions and therefore we should not be surprised if many institutions hold themselves to a higher standard than the regulatory minimum. The real question is whether in practice in the absence of regulation market failures would be likely to remain due to a smaller number of institutions acting imprudently at least some of the time. The CEBS' view is that market failures would remain.
36. Moreover, CEBS does not believe the large exposure challenge is entirely one of credit risk measurement. In extremis, it is clearly imprudent to extend a very large part of an institution's capital to a single counterparty no matter how accurately the risk associated with this exposure may be measured.
37. It has been suggested that there are not many compelling examples of bank failures due to large exposures. To some extent, this is to be expected since most jurisdictions have had in place a regime to limit the maximum size of exposures. Nevertheless, in Annex I, the Fiat example suggests that the current limit-based regime was effective in enforcing lending discipline. The Norwegian example is useful since the fact that a number of Norwegian banks had exposures in excess of 25% of own funds suggests that at least in some cases, institutions will take on extremely large exposures. Finally, very large committed ABCP liquidity facilities have caused some European banks to encounter difficulties this summer. Although these exposures are allowed under the existing LE regime, for some banks they were in aggregate equivalent to many times their capital base. This suggests that there are circumstances under which institutions' own risk management systems may not be effective in dealing with the risk of traumatic loss due to unforeseen events, such as the sudden drying up of market liquidity.
38. CEBS' view is that an effective LE regime should be forward-looking and based on sound market failure analysis. If bank failures due to LEs have fortunately been historically relatively scarce it is important to remember that banks' ability to take on these exposures has been limited by the current regime. Hence the relative scarcity of examples should not lead to downplaying the structured market failure analysis.
39. Any intervention could itself have undesired side-effects - a regulatory failure. CEBS is mindful of the need to address, where appropriate, regulatory failures created by other interventions (e.g. safety net arrangements) and avoid as far as possible regulatory failures arising from any interventions in the large exposures regime.
40. From this high level market failure analysis, and informed by the overarching prudential objectives as they apply to large exposures to individual counterparties, CEBS considers that the following are appropriate detailed objectives for any large exposures regime:
 - ensure any negative externalities arising from large exposures to individual counterparties that threaten the general prudential objectives outlined above

are contained to an acceptable level - the externalities may vary in extent and nature between different types of exposure;

- minimise as far as appropriate moral hazard arising from the existence of safety nets (a "regulatory failure") as it affects the management of large exposures;
- ensure that public authorities have sufficient regulatory tools to monitor, on an on-going basis, the extent to which the overarching principles of prudential supervision are being achieved; and
- if intervention is necessary, ensure that it is effected using a tool that is appropriate and proportionate to achieving the stated objectives.

41. In summary, CEBS considers that the core aim of a large exposures regime is to protect against the risk of a regulated institution incurring traumatic loss as the result of the default of an individual counterparty. The high-level market/regulatory failure analysis provides the evidence that there is the need for official intervention to achieve this aim.

Chapter 2. Policy Options – different regulatory tools

42. The Level 3 Impact Assessment guidelines advise policymakers to consider a reasonable number of alternative policies in order to ensure that they are proposing the most appropriate policy. Furthermore, responses to CP14 suggested the need for CEBS to set out the various options, including a Pillar 2 treatment. A discussion of the different options considered by CEBS follows.

2.1 No specific regime

43. This option would effectively entail removing Title 5, Chapter 2, Section 5 of Directive 2006/48/EC and Chapter V, Section 4 of Directive 2006/49/EC. Institutions would then operate within their own internal practices.
44. CEBS believes this option would not ensure that the risk arising from large exposures to individual counterparties would be kept to an acceptable level. CEBS accepts that in most circumstances institutions do in practice operate within the existing limits, however, CEBS considers there are some circumstances where individual institutions would expose themselves imprudently, at least with the benefit of hindsight, to individual counterparties. Additionally, CEBS will investigate whether there are certain types of large exposure where normal market discipline may not apply (these circumstances will be discussed in more detail in Part 2).

2.2 Pillar 2

45. This option would effectively entail removing Title 5, Chapter 2, Section 5 of Directive 2006/48/EC and Chapter V, Section 4 of Directive 2006/49/EC. Institutions would then operate within their own internal practice subject to whatever constraints were imposed upon them by themselves and national supervisory authorities under Pillar 2.

46. CEBS however believes that market failures associated with exposures to individual single counterparties cannot be sufficiently addressed under Pillar 2 (for example as part of Pillar 2 discussions around sectoral and geographic concentrations and portfolio granularity). In CEBS' view the primary reasons are:
- The transitory and highly complex nature of many large exposures would require significant specialist supervisory resources to review these exposures effectively. For example, large exposures associated with M&A transactions are typically short-lived and a Pillar 2 review would necessarily be 'after the event' in many cases.
 - A successful Pillar 2 regime would depend on an appropriate level of reporting, which would have to reflect the nature and duration of the exposures in question.
 - More generally, CEBS believes there is the risk of crowding out in Pillar 2 where a discussion of each large exposure to individual counterparties would not be proportionate.
 - Variation in implementation of Pillar 2 across Member States might lead to an "uneven" playing field with a possible mixture of capital and non-capital supervisory treatment, especially during the early stages of the new Pillar 2 regime.
 - There would be uncertainty among market participants over the maximum potential size of an institution's exposure to a given counterparty, since different institutions would inevitably come to different conclusions with individual supervisors on the maximum acceptable size of exposures allowed. This could contribute to instability if an institution were rumoured to have a large exposure to a failed or failing counterparty.
 - Moreover, CEBS does not believe the large exposure challenge is entirely one of credit risk measurement. In extremis, it is clearly imprudent to extend the equivalent of a very large part of an institution's capital to a single risky counterparty no matter how accurately the risk associated with this exposure may be measured.
47. The advantage of a Pillar 2 approach is that it would provide more flexibility to the institutions.
48. On balance, CEBS considers that a 'Pillar 2 only' approach to large exposures is not sufficient and that other regulatory tools are necessary to meet the stated objectives of an effective LE regime.
49. There has been some discussion on 'hard' vs 'soft' limits and on supervisory responses when limits are breached. As is well documented, various Member States have historically adopted different approaches to supervision and enforcement, and this advice is not the right place for a broader discussion of supervisory methods.
50. It is important to make clear what it is meant by soft limits. It means that firms may regard the 25% limit as akin to guidance which may be exceeded in some cases, possibly requiring more senior approval and agreement with the

supervisor. Under this approach, when the regulatory limit is breached, strict monitoring of that exposure would be required in order to ensure that the exposures taken are adequately managed and in line with the prudential objectives. If this was not the case, appropriate actions should be taken, such as revising caps on exposures, obtaining mitigants, etc. Moreover, the reasons and circumstances for, as well as consequences of, failing to comply with regulatory limits should be clearly documented in an institution's policies and procedures. This then is essentially a modified form of the Pillar 2 approach whereby firms determine their own internal limits and supervisors review and/or challenge them.

51. This approach should be based on an adequate reporting system so as to allow supervisors to assess the risk profile of the institution regarding the unforeseen event risk in an adequate and timely manner. For the same reasons as given for Pillar 2, CEBS does not believe this approach is sufficient to address the stated objectives.
52. Nevertheless, one specific outstanding question is whether firms should be allowed to deduct excess large exposures (over 25%) from capital resources as a way of complying with the limit and CEBS intends to discuss this in Part 2 of the Advice.

2.3. Market discipline enforced by Pillar 3 disclosure

53. A "Pillar 3" regime for large exposures would require institutions to disclose to the market on a timely basis their large exposures to individual counterparties in sufficient detail for market participants to adequately assess and understand the associated risk.
54. For supervisors this would potentially be an attractive option as it allows the market to assess the risks and consequently impose a sufficient level of discipline. CEBS acknowledges some significant challenges in making a Pillar 3 Large Exposure regime operational. The nature of some large exposure is transitory often arising from trading or M & A activities. These are likely to be regarded by institutions as highly confidential. Moreover, the transitory nature of these exposures requires a high frequency of disclosure.
55. It may be very costly for market participants to analyse these data. In addition, market discipline applies very differently across institutions; significant factors affecting this include size, exchange listing and funding mix. Providing these data on a timely and reliable basis may impose significant costs on institutions
56. It has been suggested that rating agencies help enhance market discipline. This role would principally address the 'information asymmetry' market failure. CEBS believes that rating agencies do play an important role in enhancing information available on institutions but CEBS is not convinced that this form of market discipline addresses all of the potential market failures. Specifically:
 - rating agencies tend to focus on credit lending rather than short term trading or treasury exposures so only partly address the information asymmetry;

- rating agencies typically act to rate bonds or other issues; depositors can often be subordinated to these exposures so that the market discipline is not always aligned with depositor interests;
 - the largest 4 ratings agencies implicitly, and explicitly in some cases, include the possibility of central government support in their ratings, which means the ratings may not be the same as if the institution were rated on a 'stand-alone' basis. (Moral hazard); and
 - finally, it is not clear that rating agency discipline always addresses any possible market failures associated with intra-group exposures; it is certainly worth observing that rating agencies themselves often appear unsure of the extent to which cross-group support would be forthcoming in stressed times.
57. A Pillar 3 approach also would not ensure that market participants would be able to assess accurately the maximum exposure to failed or failing counterparties⁷.
58. On balance, CEBS considers that market discipline alone is not an effective or efficient way of meeting the objectives of a large exposures regime as stated in chapter 1 of this report.

2.4. Current regime

59. For completeness, CEBS has also considered the pros and cons of the current regime which is essentially a backstop limits-based regime. Although CEBS believes that a limits based regime is the most appropriate regulatory tool (see next section), CEBS has identified some shortcomings in the current regime:
- There is no clear stated underlying rationale. In particular, there may be some market failures that the current regime does not address. National discretions allow an uneven application of the regime across Member States. (CEBS acknowledges that some national discretion may be necessary because not all market failures apply equally across Member States but it is CEBS' intention to propose a reduction of the number of national discretions included in the LE regime in order to have a LE regime that is as harmonised as possible).
 - Measurement of exposures in the LE regime may not be consistent with the CRD and/or internal practices and may therefore impose an undue burden on institutions.
 - There is wide variety in the implementation of the reporting requirements across Member States that may go beyond what is required to conduct the necessary institution specific and systemic risk assessments.
 - The interpretation of "group of connected clients"⁸ has sometimes been narrowly interpreted to focus on ownership and the asset side of the balance sheet and in any case varies across Member States.
 - There is a possible regulatory failure arising from an extended scope (application of the LE regime to fees of investment managers).

⁸ Article 4 (45)

- Some further consideration is required whether, and if so what role, additional capital requirements have to play in a backstop regime (particularly with regard to the current scale of capital charges for excess large exposures in the trading book).
60. Therefore CEBS does not propose to maintain the regime as it currently stands. The final report will discuss how the identified issues could be tackled.

2.5 Amended limit based "back-stop" regime

61. Although CEBS believes significant improvements can be made to the current regime it nevertheless considers that the most effective supervisory tool to address the relevant market failures would be a targeted limits-based "back-stop" regime.
62. The remaining work in Part 2 of the Advice will focus on further refining CEBS' differentiated market failure analysis to address any regulatory failures associated with the current regime and will also provide an opportunity to address any outstanding market failures.
63. An EU-wide limit-based "back-stop" regime has the following advantages:
- caps negative externalities arising from single-name large exposures, irrespective of institutions' risk management practices and oversight;
 - delivers certainty to creditors, shareholders and other stakeholders that an institution's exposure to a particular failed or failing counterparty is limited to a particular amount (informational benefit);
 - avoids distortion caused by regulatory arbitrage across Member States;
 - is simple and easy to understand, and does not require the development, maintenance or oversight of complex models by either institutions or supervisors; and
 - avoids undue interference with institutions' day-to-day risk management practices.
64. CEBS intends to be explicit in advising the Commission that the focus of the regime should be on individual counterparty risk and therefore CEBS does not make any proposals here for geographical, sectoral or granularity risk.
65. This solution – an amended "backstop" regime, is therefore the CEBS' recommendation.

Chapter 3. Other jurisdictions

66. In considering the market failure/regulatory failure analysis, CEBS must take into account the approach to the regulation of single name counterparty risk in a number of other jurisdictions. It is clearly of interest to see whether other jurisdictions have concluded that single name concentration risk represents an

aspect of market failure that requires intervention and if so whether that is to a greater or lesser degree than in the EU.

67. CEBS has reviewed to the extent practicable the regimes in operation in the US, Canada, Japan, Switzerland and Australia. In general CEBS has found significant degrees of similarity between the regimes in operation in these countries and the current EU regime. This is likely to reflect to a material degree the influence of a 1991 paper of the Basel Committee on large exposures⁹ and of principle 9 of the Core Principles for Effective Banking Supervision published in September 1997: "Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers"¹⁰.
68. In particular, all countries set limits on the maximum amount of exposure to a counterparty or group of connected counterparties. In general these limits are not higher, and in some cases are lower, than the limits in operation in the EU. A range of exemptions is permitted. The credit quality of the counterparty is not taken into account, except in one jurisdiction where the domestic regime for smaller banks allows risk weights to be applied. Further details of our analysis are set out in Annex II.
69. Indeed, although a variety of different large exposures regimes exists across the world, CEBS has concluded that overall the EU regime is not generally more strict than any other regime, although it is possible to find some particular transactions that are treated more strictly in the EU than elsewhere.

Chapter 4. The large exposures limits

70. This section analyses whether counterparty credit quality should be recognised in the large exposures limits, and also gives consideration to the current 800% aggregate limit on large exposures.

4.1. The recognition of credit quality in large exposures limits

71. CEBS thinks it is important to give careful consideration to the question of the recognition of creditworthiness in the large exposure limits, having regard to the objectives of a large exposures regime explained in chapter 1 of this report. CEBS is aware that some credit institutions have suggested that any limits designed to determine the maximum exposure to a single counterparty should incorporate the credit quality of the counterparty.
72. It should be noted that this section does not deal with the question of whether institutions' own estimates of PDs and/or LGDs should be recognised for the

⁹ Basel Committee on Banking Supervision – Measuring and controlling large credit exposures (January 1991)

¹⁰ In October 2006, the Basel Committee of Banking Supervision published an amended version of the Core Principles and included a principle 10: "supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties"

purpose of large exposure limits¹¹. Rather the discussion is confined to the general question of the extent to which, in principle, the credit quality of the counterparty should be recognised in such limits.

73. Given that CEBS considers that the aim of the LE regime is to protect against the impact of unforeseen events, a key question is whether there is a market failure that justifies setting regulatory limits regardless the quality of the credit counterparty.
74. On the basis of the analysis made, CEBS has formed the opinion that the introduction of counterparty credit quality so as to relax or remove the regulatory large exposures limits for highly rated counterparties does not fully address the identified market failures. CEBS' opinion is that unforeseen event risks are by their very nature not related with the *a priori* quality of the counterparty (e.g. the default of a counterparty due to fraud, government action, loss of a major customer or market, or breakdown of a business model for an unforeseen reason is usually not reflected in *ex-ante* credit quality assessments).
75. Notwithstanding this, CEBS is also of the view that it could be inefficient to require limits on exposures whose default is implausible.
76. Thus CEBS has explored the extent to which implausibility can be inferred from counterparty credit ratings. For example, how plausible is that an AAA counterparty will default.
77. While there is little or no evidence of defaults in the AAA category, there are also relatively few corporates that achieve and sustain this rating. This could be considered a classic 'low default portfolio' situation where it is simply the lack of data that is causing the appearance of such exposures being without risk. Data on AA rated entities are better and suggest an extremely, but plausible, low default rate. It could also be pointed out that ratings represent ranges of default risks - i.e. the "AAA" category contains a number of distinct credit qualities. For instance a particular "AAA" rating may just be on the border line between "AAA" and "AA+".
78. In respect of other investment grade entities below the AA threshold there is evidence of material levels of default in particular years. The greater the number of such large exposures held by an institution, the more significant the risk.
79. However, it is not necessary for a default to be experienced in order for an institution to experience significant losses; although it is relatively unlikely for an AAA or AA rated instrument to default, the probability of being downgraded (and the associated economic loss) could be significant. For example, S&P's 2006 transition study showed that on average, based on 1981-2006 data, over 10% of AAA rated issuers could be expected to lose their AAA rating over a 1-year period; similarly over 10% of AA rated issuers could expect to be downgraded.
80. CEBS view is that 25% of own funds remains a large amount. It is noted that an exposure equal to 25% of own funds, could equal 50% of Tier 1 capital under

¹¹ Note however that the question of firms' own calculations of exposure values is addressed in chapter 5.

the Directive provisions. CEBS believes that the default of a counterparty exposure of this size should be considered in itself close to the threshold of what an institution could sustain without imposing negative externalities to the system. This contributes to CEBS' view that it would be undesirable to increase the limit for high credit quality counterparties.

81. It might be considered that the 25% limit operates as a long back-stop regulatory limit which provides a very wide space within which reliance is placed on institutions to manage single-name concentration risk, alongside other forms of concentration risk, within their own risk management systems. Although in some ways arbitrary this threshold would reflect the supervisors' approximate risk tolerance and in this regard it is analogous to the 8% capital ratio.
82. Notwithstanding this, CEBS considers that there could be implausible events or events that would not cause a marginal contribution to the negative externalities already imposed by the default of the counterparty that should be excluded from the large exposures limits.
83. It would be the case when the event we are trying to protect against is of such a nature that the failure of the credit institution becomes a secondary issue (e.g.. the failure of a big OECD country is likely to impose negative externalities of such a magnitude on the system that the failure of the bank does not add much in terms of negative effects) or when the event is not at all plausible (e.g. default of a country on its own currency sovereign debt, because of its tax-raising power).
84. This issue will be carefully analyzed in the response to Part 2 of the Commission's Call for Advice in order to include a list of exemptions that is as harmonised as possible.

4.2. The 800% limit

85. The current Directive text imposes an 800% aggregate limit on large exposures (i.e. the sum of exposures to a client or to a group of connected clients exceeding 10% of its own funds shall not exceed 800% of its own funds).
86. CEBS has given some consideration to the purposes of this aggregate limit. CEBS believes that the 800% limit has merits in providing a harmonised minimum standard for ensuring granularity of the credit portfolio, although it is not fully justified either by the market failure analysis which is related to the risk arising from the large exposures to individual counterparties, nor by the objective of the large exposure regime as laid down in this Advice.
87. To the extent that an institution's portfolio exhibits a significant degree of 'lumpiness' this means that the idiosyncratic risk of the portfolio has not been diversified away. In such a case the 'Pillar 1' capital requirements may not be sufficient to cover the unexpected loss on the portfolio. Accordingly, the 800% limit might be argued to be a mechanism for limiting the extent to which losses not covered by Pillar 1 capital requirements are inherent in the portfolio. However, it is important to stress that compliance with this limit should not replace in any way the requirement to manage concentration risk under Pillar 2.

88. There is also the question of concentration risk arising from an institution's portfolio being non-optimally diversified due to excessive concentration in a given sector or sectors, or geographically. It may however be argued that, having regard to this aspect, the unexpected loss on a group, say, of 80 exposures will be the same as the unexpected loss on a group of 800 (where the total amount of exposure is the same). And that any differences in unexpected loss in such cases will derive from the difference in the idiosyncratic risk aspect of the portfolios and not from the sectoral/geographic correlation aspects per se.
89. On balance, CEBS is of the view that the 800% limit can be kept in European regulation because it provides a simple and harmonised minimum standard to ensure credit portfolio granularity. In responding to CP14, some institutions said that the cost to comply with the 800% rule was negligible.

Chapter 5. Calculation of exposure values in a large exposures regime

90. An important issue in the review of the large exposures framework is the calculation of exposure values. In CEBS' review of industry practices carried out during 2006 it emerged that many institutions – in particular more complex institutions – calculate exposure values for their internal risk management and limits systems in manners that are different to those required for the current large exposures requirements.
91. On one hand, for many smaller and less complex institutions it appears that this is a lesser issue as many of them use the large exposures framework as the basis for their internal risk management. On the other hand, for the more complex institutions there appears to be a fairly wide diversity of approaches.
92. CEBS considers it necessary to modify the exposure calculation requirements under the LE framework in order to align them more closely with institutions' internal risk management practices and regulatory measurement systems required under the CRD.
93. CEBS has already stated that the large exposures challenge from a regulatory perspective is not entirely one of measurement in that no matter how accurately the exposure is measured, it is clearly imprudent for an institution to extend a very large part of its capital to a single counterparty. Nevertheless, there are cases (for example, financial derivatives within a netting set or schemes with underlying assets) where there is an additional measurement challenge, and CEBS believes that advanced models used internally by institutions can help to accurately measure the exposure; in these cases, CEBS' view is that the backstop regime proposed should be applied to the most accurate exposure value available.
94. Four broad categories of exposure are relevant for the purposes of this Advice, namely, (1) on-balance sheet items; (2) off-balance sheet items other than

derivative instruments and securities financing transactions¹²; (3) derivative instruments and securities financing transactions; and (4) collective investment undertakings, structured transactions and other arrangements where there is exposure to underlying assets.

95. It should be noted that it is not the purpose of this document to consider the question of the effect of credit risk mitigation on the calculation of exposure values (except in relation to category (3) above where it is appropriate to consider the effects of collateral as an integral aspect of the exposure value calculation).

5.1 On-balance sheet items

96. The CRD does not expressly specify how to calculate exposure values in respect of these items for LE purposes. However, most institutions and supervisors take the view that, consistent with the CRD requirements for solvency purposes, exposure values for these items should be based on relevant accounting standards.

5.2. Off-balance sheet items (other than derivative instruments and securities financing transactions)

97. In determining an appropriate converged approach to the calculation of exposure values one objective is to arrive at exposure value calculations that are fit for the purpose that they are meant to serve. Consistent with this, the mode of calculation of exposure values should minimise the additional burden placed on institutions. In determining the correct exposure value, a distinction will be made between Advanced IRB institutions on the one hand and Standardised and Foundation IRB institutions on the other hand.

Advanced IRB institutions

98. Many institutions that are permitted to use their own exposure calculations for regulatory capital requirements purposes appear to take a considered approach to the calculation of exposure values for the purposes of their internal limits. This suggests that there is an opportunity to move away from the situation where institutions are required to calculate three exposure values – one for capital requirements, one for internal limits, and one for the large exposures requirements.
99. CEBS considers that a fruitful approach to this question is to develop a small number of principles on the basis of which institutions are permitted to use for large exposures purposes their own exposure calculations which are also used for regulatory capital requirements purposes, in accordance with Annex VII, part 3, point 9 (e) of 2006/48/EC. The recommended principles are:

- 1) institutions that have obtained permission to use their own estimates of conversion factors to calculate their risk weighted exposure are permitted to use their own exposure value measurements for the purposes of the large

¹² Securities Financing Transactions includes, according to the definition set out in Annex III of D-2006/48/CE, repurchase transactions, securities or commodities lending or borrowing transactions, long settlement transactions and margin lending transactions.

exposures rules (but this does not include recognition of risk weighting based on counterparty creditworthiness);

2) such exposure values must be demonstrated to the competent authority to be suitable for use in the context of a framework designed to limit the losses of an institution in the event of the unforeseen default of a counterparty; and

3) such exposure values must be arrived at consistently with the approach that the institution uses for estimating exposure values in the context of its internal approach to setting maximum limits for exposures to single counterparties (or groups of connected counterparties).

100. In the exceptional case that the competent authority responsible for the exercise of supervision is, given the above principles, not convinced of the appropriateness of the internally estimated conversion factors for LE purposes, the supervisor can require the institution concerned to apply the regulatory conversion factors that are set out in article 78 or annex VII, part 3 of D-2007/48/CE, as appropriate for LE purposes, according to the following paragraphs.

Standardised and Foundation IRB institutions

101. For institutions that have not obtained permission to use their own estimates of conversion factors (or institutions that have obtained permission but for which the supervisor did not accept their own conversion factors for LE purposes), CEBS is still considering the possibility of not permitting the use in all cases of the same exposure calculations as are used for credit risk capital requirements purposes, as these institutions will not be able to satisfy the principles underlying the requirements set out in the previous paragraphs and it does not seem to be justified by institutions' internal practices.
102. It is therefore considered advisable to take a prudent approach and require such institutions to use the 'worst case scenario' number – that is a 100% conversion factor except for the low risk items included in Annex II of 2006/48/EC, for which generally a 0% conversion factor will be applied. However, while the 100% conversion factor might prove to be too conservative for certain transactions, the 0 % conversion factor might prove to be too lenient for others. Therefore CEBS will analyse - within the context and objectives of the LE regime - which transactions can/must be exempted from these flat conversion factors.
103. It is important to be aware that in respect of the low risk items a 0% conversion factor can only be used where 'an agreement has been concluded with the client or group of connected clients under which the exposure may be incurred only if it has been ascertained that it will not cause the limits applicable under Article 111 (1) to (3) to be exceeded.'¹³

5.3. Financial derivatives and securities financing transactions

104. For solvency purposes there are a range of ways of calculating exposure values for financial derivatives and securities financing transactions. These include the

¹³ Article 113(3)(t)

Mark to Market method, the Standardised Method and the Internal Models Method for financial derivatives, and various volatility adjustment methods, VaR modelling and the Internal Models Method for securities financing transactions.

105. Institutions can use for the LE regime the exposure values determined within the capital requirements framework. Institutions that have obtained permission to use the Internal Model Method set out in Annex III, Part 6 of the CRD to calculate the exposure value for these transactions, also need to comply with the same principles as the Advanced IRB institutions (see paragraph 99).

5.4. Collective investment undertakings, structured transactions and other arrangements where there is exposure to underlying assets

106. CEBS has verified that there is currently considerable variation in the approaches adopted by supervisors and institutions to the determination of whether or not there is an exposure in the context of schemes (tranching or untranching) with underlying assets.
107. CEBS believes that there is scope to achieve a degree of principles-based agreement which could significantly enhance supervisory convergence in the EU without prescribing detailed rules or imposing undue burdens on the industry.
108. CEBS considers that the following principles may provide a good starting point:
- a) Institutions should identify whether the risk of incurring a loss from exposure to a scheme relates to the possibility of default caused by the underlying assets or of the scheme itself, or both. The institution should determine its exposure accordingly. That means the institution should identify when it is appropriate to look to the scheme itself, to look through the scheme, or both;
 - b) In determining this assessment, institutions must evaluate the economic substance of the transaction. Examples of factors that institutions might take into account in determining this assessment include: sources of repayment, including recourse provisions; size, nature, quality and granularity of the underlying credit exposures; tenor; and the sustainability of the cash flows.
109. However CEBS thinks that further work is still necessary on to how to implement the above principles in order to achieve a common understanding within the industry and among supervisors that guarantees as much as possible a level playing field and at the same time insures that the minimum prudential objectives are reached.
110. CEBS thinks that there is scope for convergence in determining which factors should be taken into account to evaluate the economic substance of a transaction in order to decide whether the risk of incurring a loss from an exposure to a scheme relates to the possibility of default caused by the underlying assets or of the scheme itself, or both.

Chapter 6. Further work

111. Subject to the outcome of the work being currently carried out by CEBS, this chapter puts forward CEBS' initial thinking on the main issues to be considered in the second part of CEBS' advice to the European Commission.

6.1. Connected clients

112. The current LE regime applies to exposures to a 'client or group of connected clients'. This is defined in Article 4 (45) as (a) two or more natural or legal persons who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly, has control over the other or others; or (b) two or more natural or legal persons between whom there is no relationship of control as set out in point (a) but who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, the other or all of the others would be likely to encounter repayment difficulties.
113. CEBS intends to examine the interpretation. For example, part (b) of this definition has been interpreted historically in terms of the assets side of the balance sheet so that exposures to two legally separate entities that are funded via one another or via another entity are seen as single entities that may be regarded as separate. CEBS believes that recent events may warrant a re-evaluation of this interpretation. A practical example would be the provision of liquidity facilities to ABCP conduits.

6.2. Intra-group exposures

114. CEBS knows from industry feedback that institutions do not regard intra-group exposures as normal 'arms length' lending and as such are outside their credit risk framework. In fact, these exposures form an important part of the overall capital structure of the organisation and are typically managed at group level.
115. CEBS will investigate whether there are a number of market failures that could apply specifically to intra-group exposures.
116. First, CEBS will explore whether there may be misaligned incentives across a group (a deposit taking institution could finance, for example, an unregulated factoring company), as well as accompanying information asymmetries. The extent to which these could be addressed by robust systems and controls and by good governance will also be assessed.
117. Second, cross border exposures may present an additional issue. It is currently discussed how robust the legal and political framework governing the efficient and orderly winding-up of a cross-border group is. This may constitute a market failure since it imposes considerable negative externalities post-insolvency. CEBS will be looking carefully at the forthcoming review of the Winding Up Directive to assess whether this potential market failure is (wholly or partially) mitigated for exposures within the EU.
118. Finally, depositor protection is also different between jurisdictions and its potential impact on the issue of intra-group exposures will have to be assessed.

119. However, any changes to the current regime applicable to intra-group exposures could have a considerable impact on institutions' ability to manage liquidity at group level. A number of home/host issues will also be considered as the impact of any potential change to the regime may have very different effects across Member States depending on the proportion of cross-border subsidiaries in a given Member State.

6.3. Inter-bank exposures

120. CEBS is investigating whether there may be particular negative externalities associated with inter-bank exposures. They could lead to bank failures escalating into a systemic crisis and as such are subject to moral hazard. Prudentially regulated institutions are, however, perhaps less likely to fail than other institutions. A differentiated cost-benefit analysis will inform CEBS' opinion on the extent to which the LE regime could apply to such large exposures, as inter-bank exposures arise from a number of activities that have unique and important roles to play in the functioning of the financial system.

6.4. Trading book

121. From the market failure analysis, CEBS initial view is that unforeseen event risk could affect exposures in the trading book as well as those in the banking book. The current trading book LE regime is distinctive in that it combines the 25% limit with a series of exemptions for trading book positions alongside excess capital charges. In some ways, this provides institutions with flexibility to exceed the 25% limit.
122. Further, CEBS observes that institutions have flexibility in defining the trading book and there is a variety of practices. As the distinction between the banking book and the trading book applies to the capital requirements regime as well as to the large exposure regime, the possibility of regulatory arbitrage also occurs in the calculation of capital requirements, where positions held in the trading book get preferential treatment.
123. CEBS believes that it may be necessary to consider the trading book LE regime in the context of recent developments in the CRD, in particular the trading book review and incremental default risk capital charge.

6.5. Investment managers

124. CEBS is conscious that the current regime applies not just to credit institutions but also to investment firms and investment managers.
125. Investment firms come within the scope of the LE regime because of Articles 28 - 32 and Annex VI of the recast CAD. Article 28(1) provides that "Institutions" shall monitor and control their large exposures in accordance with Articles 106-118 of the recast BCD. "Institutions" are defined in Article 3(1)(b) of the recast CAD to include "investment firms" which are in turn defined in Article 4.1(1) of MiFiD to include institutions carrying out a range of investment services.
126. The result is that there is a large category of investment firms that are captured by the current LE regime via CAD and the cross reference in CAD to Article 4.1(1) of MiFiD.

127. Following the more differentiated market failure analysis, investment firms do not pose a direct risk to depositors since they are not able to take deposits. Further, the principle protection for clients is afforded by a conduct of business regime and the segregation of client assets. Hence CEBS believes that the application of an LE regime to investment managers might be an example of regulatory failure since the regime imposes a burden on investment firms (including a reporting burden) without delivering benefits to consumers.
128. As an example of the regulatory failure, supervisors report the situation in which investment firms breach the large exposures limit following periods of successful performance when they accrue large fees owed to them by their clients.
129. CEBS therefore will be considering inviting the Commission to consider fully or partially exempting these institutions from a future LE regime since the market failure analysis does not appear to justify their inclusion.
130. Investment managers licensed to offer portfolio management are part of the broader question of what the scope of a future LE regime should be. CEBS is aware that a number of Member States have included certain non-CRD firms, including e.g. financing companies, within the regime and CEBS will be considering whether there are good reasons that the scope of a future LE regime should be limited to credit institutions and investment firms.

6.6. One size fits all

131. A key point of discussion has been around the 'one size fits all' question. The debate naturally follows the differentiated market failure analysis where different types of institution and exposure seem to justify quite different responses.
132. At a basic level, the market failure analysis would appear to apply to all sizes of institution. However, some of the negative externalities apply particularly to larger institutions since the impact of failure is disproportionately greater, as in addition to prejudicing depositors' interests, it can also affect market confidence and financial stability.
133. Larger institutions may be especially vulnerable to "moral hazard", which encourages inefficient risk-taking.
134. It has been suggested that institutions that have been authorized to use their own estimates for capital requirements purposes should be given freedom to use their own internal practices to set their own limits. CEBS encourages such institutions to continue to do so but does not believe that such practices completely address the market failures described elsewhere, not least because large exposures are not primarily a problem of measurement but one of curtailing extremes.

6.7. Credit Risk Mitigation (CRM)

135. CEBS considers that CRM is a very important issue that deserves due attention. Therefore CEBS is carefully analysing whether there is scope for further alignment between the credit risk mitigation treatment for minimum capital purposes and for large exposures purposes.

136. CEBS' initial view is that there is scope for greater alignment. Although CEBS is still investigating whether, and if so, where departures could be justified in view of the different objectives of the two sets of rules.
137. There is also work in progress in the field of indirect risk where CEBS' preliminary view is that some kind of principles would be needed in order to limit the risk emerging from these positions.

Annex I

Evidence of institutional failures or difficulties

JOHNSON MATTHEY BANKERS (JMB)

JMB, a medium-sized UK bank active in the gold bullion market, was rescued by the Bank of England in October 1984 after it failed to make sufficient provisions against doubtful exposures to two major counterparties, which had grown rapidly in a short period to 76% and 39% of capital, respectively. JMB had hoped that lending further funds would enable the debtors to trade themselves out of trouble. Systems and controls at JMB were inadequate, management was weak, exposures were insufficiently monitored and mitigated and the provisioning policy was insufficiently robust. The UK introduced formal LE limits partly as a result of this episode.

BAWAGP.S.K.

Before the crisis materialized BAWAGP. S.K. was the 4th biggest bank in Austria with total assets of above EUR 50 billion and 1.3 million customers. The banking group was 100% owned by the Austrian Trade Unions and was primarily focused on the Austrian retail market.

The problems of BAWAGP.S.K. **started in October 2005** with the bankruptcy of the world's biggest futures and commodities brokerage firm Refco following a massive accounting scandal. Phillip Bennett, the former chief executive at Refco was charged with securities fraud. Refco said the accounting problem went back at least to 1998. BAWAGP. S.K. group had a long business relation with Refco and Refco's CEO Phillip Bennett. From 1999 until June 2004 BAWAG held a 10% stake in Refco, which was sold to an US buyout firm. On 16 October 2005 it became known that BAWAGP. S.K. had granted a EUR 350 million credit line to Phillip Bennett on 9 October 2005, just one day before the news about the Refco fraud was released. BAWAG had open credit lines to Refco in the total amount of EUR 420 million. The collateral BAWAG had on its books to secure the credit (Refco shares) turned out to be worthless. Despite these losses BAWAGP. S.K. was confident that it would achieve a positive pre-tax profit for the year 2005 and that its capital ratios would stay well above the regulatory requirements.

The BAWAGP. S.K. case *came to the forefront of attention again at the end of March 2006*, when it was revealed that between 1997 and 2000 BAWAG had lost approx. EUR 1.3 billion in speculative trading activities. *The situation escalated at the end of April 2006* when US Refco's creditors claimed USD 1.3 billion in damages from BAWAG for alleged complicity in Refco's deception. In addition, Refco's bankruptcy judge decided to freeze BAWAG's US assets (approx. USD 1 billion). The creditors claimed that BAWAG's business relationship with Refco was much closer than previously stated.

At the beginning of May 2006 the Austrian Chancellor and the Austrian Finance Minister together with the biggest Austrian banking and insurance groups agreed on a rescue package for BAWAG. It was decided that the state would give BAWAG a EUR 900 million guarantee to stop the massive outflow of funds that nearly brought down the bank. The guarantee was valid until 1st July 2007. After the announcement of the state guarantee the outflow of customer funds stopped and the liquidity situation of the bank stabilized in the following months. At the end of December 2006 BAWAG was sold for EUR 3.2 billion to a consortium headed by Cerberus Capital Management LP, a private investment firm headquartered in New York.

The case of FIAT AUTOMOTIVE GROUP

In 2001 Fiat automotive group – for decades the largest industrial group in Italy - experienced a very deep crisis, due to a progressive decline in revenues from the automotive sector and its market share in Italy and Europe.

The total exposure of the Italian banking system to this group was very large, in some cases close to the regulatory limit for large exposures, 25% of regulatory capital.

In these conditions, when Fiat asked for more credit support, Italian banks had to refuse to grant it because of the above mentioned limit. So the limit proved to be very useful and the industrial group was forced to implement a rigorous plan in order to reduce the total debt, transferring most of its non-core business and restructuring all the activities related to its core business.

On the other hand, banks provided constant and significant assistance to the Fiat group in developing these financial activities.

The tightness of the regulatory limit, associated with a rigorous, dynamic control of industrial group's activities, demonstrated the effectiveness of LE regime, particularly for exposures to a large and systemic corporate.

Case study

The impact of introducing regulation of large exposures in Norway in May 1997 ¹⁴

In 1997, there were almost 200 ¹⁵ institutions under supervision. 134 of them were savings banks and 14 commercial banks. Many of the institutions were small. Ahead of the introduction of the LE regime, there was frequent dialogue between the two Norwegian trade associations and FSA Norway. Many questions were solved before the actual implementation and so the banks were well prepared for the new regime and its interpretation. Transitional rules allowed the

¹⁴ Before 1997, single name risk was regulated by Norwegian bank laws, but the 1997 regulation meant a considerable lowering of limits, eradication of exemptions and collateral accepted.

¹⁵ Including also mortgage companies and finance companies, but not investment firms or branches.

institutions to have exposures larger than the 25% limit for a certain period of time after the new legislation was introduced.

The first reports from the banks in 1997, showed that 19 savings banks and 5 commercial banks at that point breached the 25% limit. Some of the banks had more than one net exposure above 25% of own funds. As the institutions had had some time to adjust, we believe that they had a larger number of exposures breaching the 25 % limit before the new regime was introduced. The same is the case with the number of exposures above 10 %. There were no banks close to the 800% limit at the first reporting date.

The connected clients requirement was the part of the new regulation that created most problems in the first two years, 1997 and 1998. Some of the smaller savings banks, operating in a limited geographic area with a small number of individual investors who were involved in most economic activity in the region, had great problems with applying the rule. In general, many of the banks did not adhere to the connected client requirements. They did report a reduction in the number of large exposures and breaches of limits, but when the FSA performed onsite inspections, they discovered in several banks that their interpretation of connected clients was rather liberal. Nevertheless, during 1999 and 2000 they managed to reach a common understanding with the institutions when it came to regarding clients belonging to the same group as connected. The need to regard partly owned companies who are also clients of the bank as connected risk is still frequently being questioned.

By the end of 1998, the commercial banks managed to build the 25 percent limit into their internal risk management routines. The savings banks did not fully adapt to the new regime until the end of 2001, although some breaches of limits occurred later than this. The 800 percent limit continued to effect only a very few institutions. Most of these institutions were small savings banks.

Conclusion

The introduction of large exposure regulation resulted in a significant reduction in single name concentration risk in Norwegian institutions. Commercial and larger banks adjusted to the regulation in a couple of years, medium sized and small savings banks needed 3 to 4 years. 10 years later, supervisors still have discussions with the institutions about the connected clients' requirement and are not confident that compliance with this rule is satisfactory. The number of large exposures (above 10 % of own funds) has steadily decreased since 2003.

Ways the institutions have adapted

The LE regime made it necessary for the institutions to cooperate in a manner that might not have happened without the legislation. After it was implemented, the supervisors answered questions from typically medium sized banks asking whether they were allowed to share exposures in particular ways.

Some of the medium sized banks in the Norwegian market would prefer to be allowed to have larger exposures than the 25 % limit, and consider themselves sufficiently advanced to manage higher risk concentrations than the regulation allows. Most Norwegian banks, however, have internal controls that are in line with the large exposures regime and would not anyway increase their

concentration risk. All the larger banks did adapt to the LE regime immediately and seem never to have had any difficulties or restrictions on their business which incurred extra costs related to the LE regime.

Some of the smallest savings banks have disappeared. For quite a few of these, the large exposures regime effectively limited their capacity to extend exposures to their largest clients and eventually caused them to merge or accept buyouts. For others, increasing their own funds has been the solution.

Example - XY Bank

XY Bank is a small, local savings bank. At year end 2002 it had total assets of less than €90 million. It reported at the same time a capital ratio (net own funds) of 10.37%. It is now among the 30 smallest Norwegian banks (out of 160).

In 2000, the bank reported three breaches of the 25 % limit. The exposure to one of these corporations breached the same limit 2 years earlier. In 2000, FSA Norway pointed out the breach of the regulation to the bank in a formal letter, and required it immediately to reduce the exposures and to establish routines to make sure that the large exposure regulation would be adhered to in the future. An onsite inspection was performed in 2001, with the focus on large exposures and credit management/loss. A copy of the report from the inspection was sent to the bank's Control Committee where the responsibility of the Control Committee was made clear. During the following two years, the bank was repeatedly breaching the 25 % limit and was instructed by FSA Norway to reduce/transfer the exposures and even threatened with fines. The bank's assessment of the credit quality of the large clients was very different from that of the supervisors. The reductions that were made through selling the exposures with the lowest risk – because they were the only ones that had any buyers.

In the summer of 2002, the newspapers reported a serious internal fraud by an employee of one of the corporations on the bank's list of breaches of the 25 % limit. Simultaneously, the Control Committee, now being very much aware of its responsibility, informed FSA Norway of the bank's failure to consolidate connected clients. A new onsite inspection was completed at short notice, and FSA Norway concluded that the board and management of XY Bank should be replaced and that considerable loan loss provisions needed to be made. The need to question the board's performance was communicated to the supervisory board. This in turn led to the replacement of the board (with one exception) immediately afterwards. The new board had confidence in the manager of the bank for quite some time, but after approximately 9 months he was also replaced.

Surprisingly, the bank was able to carry through an equity issue with local investors and friendly banks as the main contributors. This should be seen against the background of strong local support of the bank. At the same time, large loan loss provisions were made. The bank is still in business and is not regarded as being at risk of failure as it has improved its credit management considerably.

Annex II

Non EU Large Exposure Regimes

Introduction

1. This annex provides an overview of the approach to large exposures in a number of non-EU jurisdictions (Australia, Canada, Japan, Switzerland and USA).

Scope of the regime

2. The scope of the non EU LE regimes generally cover financial institutions but the exact scope varies depending on the scope of the regulator. For example, in Canada the LE regime covers domestic banks, foreign banks' business in Canada and federal trust and loan companies. Under the US regime there are various national and state regulators that amongst other issues are concerned with banking regulation. The SEC is primarily concerned with the oversight of the securities market.

Definitions

3. **An exposure** is generally defined as any claim on an entity including irrevocable commitments or contingent liabilities. The general case is that in calculating the size of an exposure the regimes do not take account of credit worthiness or risk weight the counterparty.
4. The exception is within the Swiss regime which has two approaches to large exposures: the International Approach and the Swiss Approach. The International Approach is consistent with the EU regime and must be used by banks using the International Standardised Approach and the Internal Ratings Based Approach to credit risk. Under this approach risk weights cannot be used for the purpose of calculating large exposures. However banks using the 'Swiss Standardised Approach'¹⁶ to credit risks may take account of risk weights for the purpose of measuring and calculating the size of large exposures
5. **A related counterparty:** These are identified where exposures constitute a common risk. Common features were found to include: financial interdependency, cross guarantees and common ownership or management.
6. **A large exposure** is generally defined as an exposure above 10% of the institution's capital base or own funds. The Canadian regime does not require an LE to be identified but it has a limit structure based on comparing the size of an exposure to the capital base of the institution extending the credit.

Limits

7. **All of the regimes reviewed include a limit framework, though the details differ.** The Australian and Japanese regimes set different limits according to whether the exposure is to a group member or to a third party outside the group. The Swiss limit framework is the same as the EU LE regime.

¹⁶ The approach is generally used by smaller banks.

	Definition of a large exposure	Limits
Switzerland	Exposure \geq 10% of bank's own funds.	An LE must not exceed 25% of own funds. The total amount of large exposures may not exceed 800% of own funds.
Canada	No requirement to identify exposures as large.	The aggregate exposure of a bank to any entity or connection shall not exceed 25% of total capital on a consolidated basis. Subject to conditions, potentially higher limits for certain intra-group exposures.
Australia	Exposure \geq 10% of an authorised deposit-taking institution's (ADI's) capital base.	Limits on aggregate exposures of an ADI to a counterparty: (i) external parties (other than governments, central banks and ADIs or equivalent overseas deposit-taking institutions) unrelated to the ADI – 25% of capital base; (ii) unrelated ADI (or equivalent overseas deposit-taking institution) and its subsidiaries – 50% of capital base, with aggregate exposure to non-deposit-taking subsidiaries capped at 25% of capital base; and (iii) foreign parents and their subsidiaries – 50% of capital base, with aggregate exposure to non-deposit-taking subsidiaries capped at 25% of capital base.
Japan	Exposure \geq 40 % of bank's capital to a related party and \geq 25 % of bank's capital if to a non-related counterparty.	A large exposure may not exceed 25% of own funds per customer and 40% for a group of related customers.
USA	Various state and federal laws and regulations establish maximum legal lending limits.	A national bank's total outstanding loans and extensions of credit to one borrower may not exceed 15% of the bank's capital and surplus, plus an additional 10% of the bank's capital and surplus, if the amount

		<p>that exceeds the bank's 15% general limit is fully secured by readily marketable collateral. To qualify for the additional 10% limit, the bank must perfect a security interest in the collateral under applicable law and the collateral must have a current market value at all times of at least 100% of the amount of the loan or extension of credit that exceeds the bank's 15% general limit.</p> <p>Under the SEC's capital regime unsecured exposures are required to be deducted 100% from own funds.</p>
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Exceeding the Limit

8. The non-EU regimes reviewed do not generally permit the limits to be exceeded. If they are exceeded then action is required. In the Swiss regime an excess is allowed if it is entirely covered by own funds. Canada does not allow excesses. Australia permits excesses on an exceptional basis and with the prior approval of the supervisor. The Japanese regime requires the institution to explain how it will bring the exposure(s) back into compliance with the limits.

Notification and Reporting

9. Reporting of LE and other financial information is required by all of the regimes reviewed. The frequency of reporting varies across the regimes: Switzerland and Australia require quarterly reporting; the US reporting regime is more complex as there are different state and federal reporting requirements – but most also include regular dialogue between the institution and supervisor. Canada does not specify a reporting regime – instead it is for the Board of Directors of an institution to set its own reporting periods having taken account of the supervisory guidelines.

Exemptions to the regime

10. All regimes reviewed permitted some exemptions to the LE limits, but they varied in nature across the regimes. In a number of cases, exposures were considered exempt if fully deducted from own funds or secured by cash, government securities or a guarantee from a central bank. In Japan, exposures to the state are considered exempt, as well as those to local public authorities, financial public institutions and other public entities and agencies.
11. In the US exemptions are available for exposures to counterparties (to correspondent banks only) with sufficient capitalisation (see 12 CFR, Ch II, Sec 206.4 and 206.5, which applies to inter-bank transactions, primarily transactions of a correspondent nature, namely intraday inter-bank liabilities).

Intra-group aspects

12. Intra-group exposures are exempt under the Swiss regime if the group is fully consolidated. As noted in the section on limits, some regimes apply

different limits to intra group exposures compared to exposures to non-group counterparties.

Conclusions

13. The non-EU LE regimes that were reviewed have a common core of concerns in that they all seek to define an exposure; to take account of single name exposure and to identify related counterparties that in effect represent a single exposure. They also seek to set appropriate limits and thresholds with the intention of promoting diversification and encouraging the appropriate management of risk. These concerns are similarly contained within the EU LE regime.
14. The non-EU regimes reviewed and the EU regime reflect concerns and approaches set out in various Basel Committee publications¹⁷.

¹⁷ For example: Basel Committee on Banking Supervision – Measuring and controlling large credit exposures (January 1991), Core Principles for effective banking supervision (Basle Core Principles) September 1997) and continue to be in alignment with the updated publication –Core Principles for Effective Banking Supervision (October 2006).