10 June 2009

CEBS's second advice on options and national discretions

Introduction

1. CEBS published its advice to the European Commission (the Commission) on the reduction of options and national discretions in the Capital Requirements Directive (the CRD)[1] on 17 October 2008.[2] CEBS's advice, in parallel with the expiration of some options and national discretions, would result in a very significant reduction of the present discretions available in the CRD.

2. In its advice CEBS proposed to keep as an option or national discretion 28% of the 152 provisions covered in its analysis. However, approximately one third of these national discretions (8% of the total) are transitional provisions, which will expire within a relatively short period. When elaborating its views, CEBS has benefited from input provided by the industry both in a formal consultation and in meetings with experts representing a broad range of market participants.[3] CEBS has also conducted a high-level impact assessment/cost-benefit analysis.

3. On 29 April 2009 the Commission requested further technical advice on eight national discretions and on an additional group of national discretions relating to real-estate '*where more granularity, criteria or impacts is needed, should those options be removed or transformed into a general rule'*.[4] The Commission's request refers to the following national discretions (also referred to as ND).[5]

    - ND 15 (percentages to calculate potential future credit exposures)
    - ND 25 (treatment of public sector entities)
    - ND 32 (list of high risk items)

[1] Capital Requirements Directive is a technical expression which refers to Directive 2006/48/EC and Directive 2006/49/EC.
[2] The CEBS's advice is published under: http://www.c-ebs.org/Publications/Advice/2008/CEBS-technical-advice-to-the-European-Commission.aspx
[3] The composition of the industry expert group is published under: http://www.c-ebs.org/getdoc/1d48fde8-6672-4df5-a526-b406472c6af2/National-Discretions.aspx
[4] The letter from the Commission is published under: http://www.c-ebs.org/Publications/Advice/2009/CEBS-receive-second-call-for-advice-on-options-and.aspx
[5] For simplicity, each national discretion is referred to by the same numbering given to it by CEBS as part of its work in providing the first advice in October 2008. There is one additional discretion which the Commission has added which does not, therefore, have such a sequential number.

- NDs 41 and 45 (other unfunded credit protection for dilution risk)
- ND 49 (other physical collateral)
- ND 51(receivables as collateral)
- ND 82 (specific risk requirement for covered bonds)
- ND 102, 103, 104, 105, 110, 111, 136, 137, 138, 140, 141, 142 and 143 (specific favourable treatment of real estate)
- Option set out in Annex VII, Part 2, point 14 of Directive 2006/48/EC not analysed by CEBS in its first advice (one-day floor for 'other short term exposures')

4. The Commission invited CEBS to deliver its informal advice no later than 10 June 2009 and clarified that the technical advice did not necessarily need to show a consensus, but should outline the different criteria and approaches that may be useful to clarify the identified provisions.
5. CEBS regrets that the time available to develop its advice was not sufficient to allow for public consultation or an impact assessment on its proposals. CEBS did, however, ask for input of the industry expert group[6] on national discretions 41 and 45 as these were highlighted as being of special interest for some parts of the industry in the first advice.
6. CEBS presents in this paper its second advice to the Commission on the above national discretions. CEBS also provides drafting suggestions where appropriate based on the current text of Directive 2006/48/EC and Directive 2006/49/EC. However, the latest thinking of the Commission, as shared with CEBS was taken into account in the assessment. In those cases, where drafting suggestions were not feasible given the time constraint, CEBS highlights possible steps to achieve further harmonisation.

Executive summary

7. It has to be highlighted that CEBS has developed this advice in a very limited period of time. Therefore, in those cases where no final position on a drafting proposal could be reached, the analysis undertaken is not final, but is a starting point for more in-depth analyses to be undertaken in future.
8. On two of the national discretions under analysis, CEBS proposes to include additional criteria in the respective provisions of the CRD:
    - On ND 32 (list of high risk items), CEBS proposes a set of risk characteristics to be taken into account by the competent authorities when assessing whether an exposure is associated with a particularly high-risk item, highlighting the need to further elaborate on them.
    - On ND 49 (other physical collateral), CEBS proposes further criteria on the recognition of other physical collateral building on the criteria currently used by its members.

[6] This is the same group of industry experts which was set up to provide technical input during the development of CEBS's first advice.

9. On five of the national discretions under consideration CEBS presents its preliminary analysis and suggests that further work needs to be taken in the near future:

   - On ND 15 (percentages to calculate potential future credit exposures), CEBS supports the introduction of a review clause, with the understanding that CEBS will provide detailed advice in mid-2011 or preferably in 2014 to tie-in with the timing of the broader commodities review.
   - On ND 25 (treatment of public sector entities (PSEs)), CEBS came to the conclusion that the treatment of PSEs as institutions seems justified given their eligibility criteria. CEBS therefore proposes to develop guidelines for the harmonised treatment of entities as PSEs and supports the introduction of a supervisory disclosure requirement to facilitate cross-border recognition.
   - On ND 82 (specific risk requirement for covered bonds), CEBS's preliminary analysis suggests that overall market risk for covered bonds is likely to be lower than for corporate bonds. However, further in-depth analyses are seen as indispensable (such as for determining whether the current specific risk requirements for corporate bonds, which are taken as benchmarks, are adequate at the present)
   - CEBS's preliminary analysis of the data provided by some members on their national real-estate markets indicates that the national discretions on the recognition of real estate as collateral seems prudent for certain jurisdictions and should be preliminary kept with a binding mutual recognition clause, as advised by CEBS in October 2008.
   - CEBS's preliminary analysis of the national discretion on eligible short-term exposures discussed various types of exposures which could be included in such a list, but concluded that an in-depth analysis and industry input are essential. Therefore, CEBS proposes that the national discretion is kept for the time being and guidelines are provided on the consistent application of this provision in due course in line with the G-20 review and industry input. This solution would ensure sufficient flexibility and allow a quick response to market developments, including in respect of trade finance.

10. CEBS believes that the following two national discretions should be kept:

    - On ND 41 and 45 (other unfunded credit protection for dilution risk) CEBS has taken into account feedback received from the industry experts and is proposing to keep the national discretion with the addition of a binding mutual recognition clause in line with its first advice.
    - On ND 51 (receivables as collateral) CEBS confirms its first advice and proposes to keep it as a national discretion since its exercise depends on the domestic legal framework outside the scope of the Capital Requirements Directive. Further harmonisation in this field is outside the scope of this advice.

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CEBS's advice on ND 15 (percentages to calculate potential future credit exposures)

A. Call for advice

1. CEBS's technical advice is sought about whether the percentages in Table 2, Annex III, Part 3 of Directive 2006/48/EC should be adjusted/increased should this national discretion become the general rule.

B. CEBS's assessment

2. In Annex III, Part 3 of Directive 2006/48/EC the discretion to allow credit institutions to apply the percentages in Table 2 for the purpose of calculating potential future credit exposure is currently given to the competent authorities.
3. The Commission suggests leaving the option to use the alternative percentages of table 2 to the institutions. However, this collides with the prerequisites for applying this method. The obligatory prerequisite for using Table 2 under the Mark-to-Market Method is that an institution makes use of the option set out in Annex IV, point 21 to Directive 2006/49/EC, i.e. the Extended Maturity ladder approach.
4. Making use of the Extended Maturity ladder approach is not at all solely left to the discretion of the institutions, but requires that the competent authority to consider that the institution undertakes significant commodities business, has diversified commodities portfolios and, in particular, is not yet in a position to use internal models. This leaves it to the assessment of the competent authority and whether it considers an institution's commodities portfolios to be sufficiently diversified for justifying assuming a lower risk than the risk assumed by the less-differentiating risk figures under the ordinary Maturity ladder approach. At the same time, the competent authority is in a position to encourage an institution use more sophisticated risk measurement methods in return for recognising increased risk diversification in own funds requirements.
5. Since the supervisory decision for allowing an institution to use the Extended Maturity ladder approach for commodities risk remains unchanged, it would, in any case, implicitly remain to the discretion of the competent authority as to whether an institution may use the percentages according to Table 2 under the Mark-to-Market Method for counterparty credit risk. Therefore, this should be made explicit in order to avoid the impression that the discretion for using the more lenient percentages given in Table 2 would be solely left to the institution.
6. Moreover, for making the use of Table 2 for counterparty credit risk subject to supervisory decision, the same reasons apply as for the use of the Extended Maturity ladders approach for commodities risk. If an institution undertakes significant commodities business, the competent authority should in any case be in the position to encourage an institution use more sophisticated risk measurement methods leading to the recognition of increased risk diversification in own funds requirements, not only for commodities risk but also for counterparty credit risk. Two new methods have been introduced to compute the capital requirement for counterparty credit risk (the Internal

Model Method, IMM and the Standardised Method, SM), both of which are more risk-sensitive compared to the Mark-to-Market Method. In particular, the Standardised Method does not require having an internal model but is methodologically superior to the Mark-to-Market Method, as it links potential future exposure to the underlying market risk factors instead of using a granular differentiation between different types of commodities.

7. Any change to the percentage numbers of Table 2 must be subject to due procedure, including comprehensive data analysis (to determine the numbers that reflect the inherent risk of these contracts and comprise an appropriate degree of prudence), an impact study and a public consultation with market participants, which was not, clearly, feasible within the given timeframe of the current advice.

C. CEBS's advice

8. CEBS's advice is to keep the current wording of the text above Table 2 in Annex III, Part 3 of Directive 2006/48/EC unchanged - i.e. to keep this as supervisory decision and to keep the percentages in Table 2 for the time being.

9. Furthermore, CEBS's advice is to introduce a review clause, either with the understanding that CEBS will provide detailed advice (feasible by mid 2011 at the earliest), or preferably to tie-in with the timing of the broader commodities review (and the exemption from CRD for specialised commodity investment firms) in 2014.

D. Drafting proposal

Annex III, Part 3 (text above table 2) Directive 2006/48/EC

For the purpose of calculating the potential future credit exposure in accordance with step (b) the competent authorities may allow credit institutions to apply the percentages in Table 2 instead of those prescribed in Table 1 provided that the institutions make use of the option set out in Annex IV, point 21 to Directive 2006/49/EC for contracts relating to commodities other than gold within the meaning of paragraph 3 of Annex IV, to this Directive:

Table 2

Residual maturity	Precious metals (except gold)	Base metals	Agricultural products (softs)	Other, including energy products
One year or less	2%	2,50%	3%	4%
Over one year, not exceeding five years	5%	4%	5%	6%
Over five years	7,50%	8%	9%	10%

By 2014, this provision and table shall be reviewed.

CEBS's advice on ND 25 (treatment of public sector entities)

A. Call for advice

1. CEBS's technical advice is sought about the relevant criteria to treat public sector entities (PSEs) as institutions under Annex VI, Part 1, Point 14 of Directive 2006/48/EC.

B. CEBS's assessment

2. Article 4 Point 18 of Directive 2006/48/EC specifies three types of institutions that qualify as PSEs:
   - non-commercial administrative bodies responsible to central governments, regional governments or local authorities, or authorities that in the view of the competent authorities exercise the same responsibilities as regional and local authorities;
   - non-commercial undertakings owned by central governments that have explicit guarantee arrangements; and
   - self-administered bodies governed by law that are under public supervision.
3. In general, exposures to PSEs receive a risk weight of 100% under the standardised approach. However, exposures to PSEs may under certain circumstances be treated either as exposures to institutions or as exposures to central governments in whose jurisdiction the PSE is established. In the latter case, the CRD specifies the criterion to be applied, namely that there shall be no difference in risk between such exposures because of the existence of an appropriate guarantee by the central government (see Annex VI, Part 1 Point 15 of Directive 2006/48/EC). Criteria regarding the treatment of PSEs as exposures to institutions have not yet been specified in the respective provision.
4. The Basel Accord argues that those PSEs that do not have revenue raising powers or other institutional arrangements that reduce their risk to default do not warrant the same treatment as claims on their sovereign. However, if "strict lending rules apply to these entities and a declaration of bankruptcy is not possible because of their special public status, it may be appropriate to treat these claims in the same manner as claims on banks"[7].
5. The quick stock-take undertaken in preparing for the advice did show that most Member States that exercised the discretion (73%) base their decision on the criteria given in Article 4 Point 18 of Directive 2006/48/EC, sometimes further elaborating on them. E.g. one Member State interprets "non-commercial" along the lines of the definition of "non-profit institution" for private producers according to paragraph 3.31 of Council Regulation 2223/96/EC[8]. Another one interprets the non-commercial criterion as not

[7] See Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version, June 2006 [BCBS 128], Footnote 23.
[8] "A NPI is defined as a legal or social entity created for the purpose of producing goods and services whose status does not permit them to be a source of income, profit or other financial gains

being competitive with other undertakings and being a non-profit body. One Member State explicitly excludes "incorporated public bodies that produce goods and services intended for sale, even where this activity is performed under statutory requirement or on a non-profit basis".

6. The Commission's request to develop criteria to treat some PSEs as institutions implies that a subset of PSEs needs to be identified that qualifies for the more lenient treatment. This can be achieved by requiring that the risk of such PSEs is equivalent to the risk of institutions. CEBS is of the opinion that the criteria given in Article 4 Point 18 of Directive 2006/48/EC about the institutional setting (e.g. non-commercial, responsible to/owned by central governments, explicit guarantee arrangements, public supervision, etc.) safeguard the prudence of this approach.

7. In any case, if further criteria are taken up in Point 14, CEBS would like to point out that Point 17 (treatment of third country PSEs) would have to be amended along the same lines.

C. CEBS's advice

8. CEBS does not fully support the Commission's current suggestion to turn this supervisory decision into an option to credit institutions. CEBS proposes that the institutions should demonstrate, to the satisfaction of the competent authorities, that certain exposures to domestic PSEs have a risk comparable to the risk of exposures to institutions. This proposal should be combined with a binding mutual recognition clause.[9]

9. As the time available was not enough to further elaborate on the criteria defining PSEs exposures to which have a risk comparable to the risk of exposures to institutions, CEBS's proposes to develop guidelines to ensure a harmonised assessment of PSEs.

10. As proposed in CEBS's first advice of October 2008 and also by the Commission's current proposal, CEBS suggests introducing a supervisory disclosure requirement for facilitating cross-border recognition. Feedback from some members suggests that the compulsory disclosure of a list of PSEs would in some Member States create undue burden for supervisory authorities in light of the immense number of PSEs in their jurisdictions and the necessity to update the list on a regular basis. Those members propose that publishing the criteria according to which PSEs qualify for risk-weighting as institutions should be made available as an alternative to publishing an explicit list of PSEs. In any case, any public list maintained by a competent authority would not claim to be exhaustive (for example, it might reflect those potential PSEs for which the relevant competent authority has received

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for the units that establish, control or finance them. In practice, their productive activities are bound to generate either surpluses or deficits but any surpluses they happen to make cannot be appropriated by other institutional units".

[9] One member believes that this provision should remain a discretion for competent authorities, because the current wording would not require institutions to ask the approval of the competent authority if they think the criteria (...difference in risk...) is fulfilled. The concern of this member is that such discretion for institutions might result in a diversity of assessments by different institutions of one and the same PSE whether no difference in risk of this PSE compared to exposures to institutions exists. Therefore this member recommends that recognition of individual risk assessments by institutions should not be introduced into the Standardised Approach for credit risk.

notification from its credit institutions and would satisfy the guidelines and conditions).

D. Drafting proposal

11. CEBS proposes to include the word “domestic” in Point 14 (making the binding mutual recognition clause in Point 16 clearer).

Annex VI, Part 1, Point 14 Directive 2006/48/EC (ND 25)

~~Subject to the discretion of competent authorities~~, Exposures to domestic public sector entities may be treated as exposures to institutions provided that supervised institutions are able to demonstrate, to the satisfaction of the competent authorities, that there is no difference in risk between such exposures and those of institutions. ~~Exercise of this discretion by competent authorities is independent of the exercise of discretion as specified in Article 80(3). The preferential treatment for short-term exposures specified in points 31, 32 and 37 shall not be applied.~~ The competent authorities shall draw up and make public a list of public sector entities treated as institutions or the criteria for identifying these public entities in the context of the supervisory disclosure framework referred to in Article 144 of this Directive.

Annex VI, Part 1, Point 15 Directive 2006/48/EC (ND 26)

In exceptional circumstances, exposures to public-sector entities may be treated as exposures to the central government in whose jurisdiction they are established where in the opinion of the competent authorities there is no difference in risk between such exposures because of the existence of an appropriate guarantee by the central government. The competent authorities shall draw up and make public a list of public sector entities treated as central governments or the criteria for identifying these public entities in the context of the supervisory disclosure framework referred to in Article 144 of this Directive.

Annex VI, Part 1, Point 16 Directive 2006/48/EC

When exposures ~~the discretion to treat exposures~~ to public-sector entities are treated as exposures to institutions or as exposures to the central government in whose jurisdiction they are established ~~is exercised by the competent authorities of one~~ in one Member State, the competent authorities of another Member State shall allow their credit institutions to risk-weight exposures to such public-sector entities in the same manner.

CEBS’s advice on ND 32 (list of high risk items)

A. Call for advice

1. CEBS’s advice is sought as to which other items should deserve a high risk treatment under Annex VI, Part 1, Point 66 of Directive 2006/48/EC.

B. CEBS's assessment

2. CEBS has assessed the request for advice on further items that should be subject to a 'high risk' treatment (in addition to investments in venture capital firms and private equity investments) and considers that the creation of such an exhaustive list seems inappropriate as it excludes potential future innovations or changes in the market. It may also prove to be ineffective in capturing all types of products and could be easily circumvented, i.e. may lead institutions to structure products in a way that avoids the 'high-risk' treatment. Therefore, CEBS proposes that criteria or risk characteristics should be introduced into the provision to guide institutions and supervisory authorities about which exposure items should be considered as 'high-risk'. Developing further on these could be done in CEBS's guidelines.

3. It should be noted that this provision only deals with the requirements for credit risk exposures (under the Standardised Approach) and hence the risk of loss arising from default. Exposure to high risk items such as investments in venture capital firms and private equity investments etc. will also expose an institution to other general risks that are not the subject of this provision and so are not reflected in the criteria offered for identifying 'high risk' items.

C. CEBS's advice

4. CEBS proposes that 'high-risk' exposures should, in general, be characterised by one or more of the following:

    - There is a relatively high extent to which an institution might face a significant loss as a result of a default of the obligor; and
    - There is a relatively high opacity risk – i.e. the extent to which an institution is unable to properly assess whether there is a relatively high risk of loss as a result of a default of the obligor, in particular as a result of a lack of transparency and/or its complexity.

5. CEBS believes that the consistent application of the above characteristics will ensure a harmonised application of the 'high-risk' treatment across the EU. Therefore it proposes to issue implementation guidelines to ensure competent authorities apply these characteristics consistently.

6. Exposures which CEBS believes may demonstrate the above characteristics include the following:

    - Highly leveraged products, where there is potential for high risk of loss given default of the obligor;
    - Object or project financing exposures where the primary source of repayment of the obligation is the income generated by the assets being financed, rather than the independent capacity of a broader commercial enterprise, that are highly speculative in nature (e.g. a low level of contracted pre-sales or pre-letting has been achieved and/or a high loan-to-value ratio), where the uncertain quality of objects or projects that serve as the primary source of repayment of the obligation can lead to high risk of loss given default of the obligor; and
    - Hedge fund exposures where the individual fund's strategy may be highly leveraged, have a high degree of mismatch, be subject to high performance risk and/or for which there is a lack of transparency with regard to the underlying assets in the fund.

D. Drafting proposal

7. CEBS proposes a slight wording modification of the first sentence of Point 66 so as to reflect that there shall be in any case an assessment about whether the particular type of exposure is indeed associated with particularly high risk. On the one hand, a mandatory categorisation of exposures as high-risk exposures seems inadequate given CEBS's assessment, however, the requirement should be open enough to also allow for potential future innovations.

Annex VI, Part 1, Point 66 Directive 48/2006/EC
~~Subject to the discretion of competent authorities, e~~Exposures including ~~associated with particularly high risks such as~~ investments in venture capital firms, ~~and~~ private equity investments and hedge funds shall be assigned a risk weight of 150% provided that these exposures are associated with particularly high risks. When assessing whether an exposure is associated with particularly high risk, competent authorities shall, on the basis of CEBS guidelines, take into account the following risk characteristics: (a) there is a high risk of loss as a result of a default of the obligor; or (b) there is an inability to adequately assess whether the exposures fall under point (a).

CEBS's advice on ND 41 and 45 (other unfunded credit protection for dilution risk)

A. Call for advice

1. CEBS's advice is sought about which specific criteria/conditions need to be defined in Annex VII, Part 2, Points 5, 7 and 20 and Annex VIII, Part 1, Point 26 of Directive 2006/48/EC for recognising other unfunded credit protection providers for dilution risk.

B. CEBS's assessment

2. Annex VIII, Part 1, Point 26 of Directive 2006/48/EC gives a list of providers of unfunded credit protection recognised as eligible under all approaches is given. Points 5, 7 and 20 of Annex VII, Part 2 of Directive 2006/48/EC give competent authorities the discretion to recognise as eligible additional providers of unfunded credit protection for dilution risk of purchased receivables.

3. The purchasing institution often has recourse to the seller of the receivables with respect to dilution risk, i.e. the seller itself guarantees the legal validity of the claim to the obligor. However, the average seller will typically not qualify for credit quality step (CQS) 1 or 2, a prerequisite for being recognised as eligible provider of unfunded protection for credit risk (cf. point 26(g) of Annex VIII, Part 1 of Directive 2006/48/EC).

4. The requirement of qualifying for CQS 1 or 2 or having a comparable internal rating seeks to ensure that the credit risk of a contingent claim to a corporate entity acting as guarantor is lower than the credit risk assumed for an unrated unsecured credit risk position to the original obligor. The general risk weight for an unrated unsecured credit risk position under the Standardised Approach is 100%. Consequently, the aim of the requirement is achieved for credit risk positions by requiring CQS 1 or 2, since only for these CQS the associated risk weights for corporate entities are lower than 100% [cf. point 41, table 6 of Annex VI, Part 1 of Directive 2006/48/EC].

5. For achieving an aim similar to that for providers of unfunded credit risk protection, the qualifying criteria for providers of unfunded dilution risk protection should also require a lower risk of the contingent claim to the protection provider compared to the risk of a typical unsecured dilution risk position.

6. The particular issue in this case is how to derive a risk weight for a typical unsecured dilution risk position, since only under the IRB approach that own fund requirements for dilution risk from purchased receivables are provided [cf. Article 87 Para. 2 of Directive 2006/48/EC]. In particular, applying the IRB approach requires having a rating by some means and, therefore, no pre-determined risk weight exists that could be used as proxy for the risk of a typical dilution risk position.

7. Practical experience from factoring business shows that purchasers of receivables are rather willing to rely on an even moderate creditworthiness of the seller than to be exposed to dilution risk. This suggests that a typical credit risk position from the contingent claim to the seller/guarantor may have a lower risk than a typical dilution risk position from purchased receivables.

8. Risk weights under the IRB approach are not limited to 100% or 150% as under the Standardised Approach. Consequently, a relatively high dilution risk is accounted for by correspondingly high risk weights for dilution risk exposures. If a guarantee for dilution risk from the seller of the receivable was not recognised as eligible, because of their typically low creditworthiness, this would result in huge and economically unfounded capital requirements for the factoring business.

9. In addition, it should be noted that the Basel Accord[10] establishes this national discretion internationally. If this discretion would be deleted in the CRD, credit institutions in third countries, which keep this discretion in their jurisdiction, would gain advantage over credit institutions in the EU.

10. Therefore, a corporate entity should be recognised as an eligible unfunded protection provider for dilution risk if it is ensured that the credit risk from the claim to this corporate entity is not higher than the credit risk from an unrated unsecured credit risk position to this corporate entity. This is ensured if the CQS for the corporate entity is 3 or better, since in this case the risk

[10] See Para. 373, Footnote 85 of: Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version, June 2006, p. 86 ("At national supervisory discretion, banks may recognise guarantors that are internally rated and associated with a PD equivalent to less than A- under the foundation IRB approach for purposes of determining capital requirements for dilution risk".).

weight assigned to CQS 3 is 100% [cf. point 41, table 6 of Annex VI, Part 1 of Directive 2006/48/EC].

11. Although also CQS 4 would result in a 100% risk weight, it seems questionable whether in this case the credit risk from the claim to the corporate entity is indeed not higher than the credit risk from an unrated unsecured credit risk position to this corporate entity. Given that only 6 CQS exist, CQS 4 is below average.

12. In its assessment of possible criteria to be included in the CRD, CEBS discussed the possibility of extending the list of eligible protection providers given in point 26 of Annex VIII, Part 1 of Directive 2006/48/EC. CEBS came to the preliminary conclusion that, in addition to the providers of unfunded protection currently eligible for credit risk, the following should be eligible as protection providers for dilution risk.

    - any corporate entity which has a credit assessment by a recognised ECAI which would be associated with CQS 3; or
    - where no credit assessment by a recognised ECAI exists, which has a PD equivalent to that associated with credit assessments of ECAIs to be associated with credit quality step 3 under the rules for the risk weighting of exposures to corporate under Articles 78 to 83 of Directive 2006/48/EC.

13. It should be noted that the very limited time for preparing this advice did not allow for a sound assessment of peculiarities of unfunded credit protection for dilution risk of purchased receivables, let alone for a comprehensive consultation with the industry, in particular with the factoring industry. The industry experts on national discretions[11] have been invited to provide input on possible criteria for the recognition of eligible unfunded credit protection providers for dilution risk, and on the impact of a possible deletion of these provisions. However, the input received was limited (reflecting the very short period of time available for their response) and mainly supported CEBS's initial advice of adding a binding mutual recognition clause (for a summary of the industry feedback received see Annex 1). Therefore, this advice must not be understood as final suggestion but rather as reflecting limited input from competent authorities and some industry representatives.

14. No final position could be reached about a closed list of criteria that would justify the deletion of the discretions contained in Points 5, 7 and 20 of Annex VII, Part 2 of Directive 2006/48/EC.

15. With regard to the Commission's latest suggestion on these provisions, CEBS would like to raise the following concerns:

    - As these provisions are currently worded as supervisory decisions ("supervisory authorities may recognise…"), requiring supervisory authorities to base their decision on CEBS guidelines could result in transposition problems as the guidelines are not legally binding (cf. Article 42b (new) of Directive 2006/48/EC: "the competent authorities follow the guidelines, recommendations, standards and other measures agreed by the Committee and shall present the reasons if they do not do so"). I.e. national transposition should not be based solely on CEBS guidelines.

[11] The list of industry experts on national discretions is published on CEBS' website: http://www.c-ebs.org/getdoc/1d48fde8-6672-4df5-a526-b406472c6af2/National-Discretions.aspx

- Moreover, as quoted above, Article 42(b) (new) provides the possibility for deviating from the guidelines if this can be justified by good reasons. Against this background it should be noted that currently a number of Member States have not exercised this discretion, i.e. these Member States had good reasons which are rooted in local market considerations for not recognising any additional provider of unfunded credit protection. A possible solution would be to phrase these requirements as national discretions ("member states may recognise…") from the outset – they are in any case to be exercised for the whole market and should not be supervisory case-by-case decisions. In this case, the reference to CEBS guidelines would not lead to transposition problems.
- CEBS wants to stress its readiness to develop guidelines on these issues to provide the Commission with an in-depth analysis for its review decision.
- Regarding the proposed supervisory disclosure (SD) requirement, CEBS wants to point out that the exercise of these discretions is already currently included in the SD-framework according to Article 144 lit. b) of Directive 2006/48/EC, however an explicit disclosure requirement on the list of individual protection providers could be added to facilitate the exercise of the mutual recognition clause. The reasoning behind the recognition of these other eligible protection providers should be contained in the guidelines and not be disclosed by the individual supervisors.

C. CEBS's advice

16. CEBS keeps to its advice of October 2008 on options and national discretions, i.e. the proposal to keep the provisions in their current form and to add a binding mutual recognition clause. This is particulary essential for own funds requirements on a consolidated level.

D. Drafting proposal

Annex VII, Part 2, Point 5 (second sentence)
(…) For dilution risk, however, <u>on the basis of guidelines provided by the Committee of European Banking Supervisors</u>, unfunded credit protection providers other than those indicated in Annex VIII, Part 1 may be recognised as eligible. <u>The competent authorities shall disclose within the framework of Article 144 the list of those other eligible protection providers.</u>
<u>Annex VII, Part 2, Point […] Directive 48/2006/EC</u>
<u>When the discretion contained in points 5, 7 and 20 is exercised by the competent authorities of one Member State, the competent authorities of another Member State shall allow their credit institutions to use as eligible unfunded credit protection providers those recognised by that competent authorities.</u>

CEBS's advice on ND 49 (other physical collateral)

A. Call for advice

1. CEBS's advice is sought about which specific criteria or collateral need to be defined in Annex VIII, Part 1, Point 21 of Directive 2006/48/EC for the recognition of other physical collateral. As an alternative, this option may be deleted.

B. CEBS's assessment

2. CEBS believes that the requirements set out in Annex VIII Part 1 and Part 2 of the Directive 2006/48/EC provide a high degree of operational and legal certainty to determine the eligibility of other physical collateral. However, the criteria given in Point 21 of Annex VIII, Part 1 of Directive 2006/48/EC could be further elaborated based on the criteria Member States currently use to recognise other physical collateral as eligible. To this end, a quick stock-take on the national transposition of this discretion was undertaken.

C. CEBS's advice

3. CEBS advises to develop the requirements further building on the criteria its members currently use to recognise other physical collateral as eligible as set out in the drafting proposal below.

D. Drafting proposal

Annex VIII, Part 1, Point 21 Directive 2006/48/EC

The competent authorities shall ~~may~~ recognise as eligible collateral physical items of a type other than those types indicated in points 13 to 19 if satisfied as to the following:

(a) the existence of liquid markets for the disposal of the collateral in an expeditious and economically efficient manner. In case of a movable asset, this condition need not be assessed only with respect to the local market. The institution must be able to demonstrate that the relevant market for the collateral is sufficiently liquid. Fulfilment of this requirement will include assessment of frequency of the transactions made in the relevant market and will be reviewed when information indicates that the quantity of transactions or the collateral prices may have declined materially.; ~~and~~

(b) the existence of well-established publicly available market prices for the collateral. The market prices may be considered well-established if they come from reliable sources of information such as public indexes and reflect the price of the transactions under normal conditions. To be considered publicly available, these prices must be disclosed, easily accessible, obtainable regularly and without any undue burden, either administrative or financial; and

(c) ~~T~~the credit institution shall analyse the empirical evidence, including the market prices, time required to realise the collateral and the recovery rates and must be able to demonstrate that there is no evidence that the net prices it receives when the asset taken as collateral is realised deviates significantly from these market prices. The fulfilment of these requirements and those specified in Annex VIII, Part 2, point 10 must be sufficiently documented. In case of material volatility in the market prices, the institution must be able to demonstrate that its valuation of the collateral is sufficiently conservative.

CEBS's advice on ND 51 (receivables as collateral)

A. Call for advice

1. CEBS's technical advice is sought as to which criteria/conditions might be defined in Annex VIII, Part 2, Point 9 (a) (ii) of Directive 2006/48/EC for the recognition of receivables as collateral.

B. CEBS's assessment

2. The exercise of this national discretion depends on the domestic legal framework outside the scope of the CRD, e.g. the commercial code, civil code, insolvency law, mortgage law, etc. The legal construct of preferential creditors does not necessarily exist in every Member State in the same form, i.e. what is considered to be 'preferential creditors' claims' may differ considerably across Member States. A possible harmonisation in this field goes clearly beyond the scope of the current work of reducing national discretions available in the CRD.
3. The condition for the recognition of receivables as collateral that the lender shall have a first priority claim over, can only be waived if specific (national) legislative or implementing provisions exist. These requirements should be clear at the national level.

C. CEBS's advice

4. CEBS proposes to clarify in the text that the discretion should not be a case-by-case decision by the competent authorities but rather a national discretion ('Member States may allow...') based on national law. In this context, CEBS recalls the findings of its advice of October 2008 on options and national discretions – that is, the divergent exercise of this discretion is not perceived as problematic. As the preferential creditors' claims have to be provided for in legislative or implementing provisions, the development of criteria at level 3 is not considered necessary.
5. It is CEBS's view that in general its guidelines aim at harmonising supervisory practices across the EU, but not national legal frameworks. Therefore, CEBS is hesitant as to whether guidelines would be an appropriate instrument for harmonisation in this case, given the divergence in the national legal frameworks, and therefore proposes to delete this reference. In any case, formulating criteria that are consistent with the various legal frameworks would not be feasible within the limited period of time CEBS had to develop its advice.

6. Regarding the supervisory disclosure requirement brought forward in the current Commission's suggestion, as the national exercise of the discretion is already disclosed under the supervisory disclosure framework of Article 144 of Directive 2006/48/EC, CEBS does not see value in an additional disclosure requirement. Requiring supervisory authorities to disclose references to the respective legislative, or implementing provisions providing for first-priority claims is seen as too burdensome as it requires them to monitor legal material outside their scope of responsibility and possibly evolving over time. A disclosure of the reasons why this approach is considered appropriate seems inadequate. On the one hand, the reasons might not differ markedly across Member States and on the other hand, the supervisory disclosure framework should not be seen as an instrument for justifying supervisory decisions/policies but rather to increase comparability.

D. Drafting proposal

Annex VIII, Part 2, Point 9 (a) (ii) Directive2006/48/EC

For the recognition of receivables as collateral the following conditions shall be met:

(a) Legal certainty: [...]

(ii) Credit institutions must take all steps necessary to fulfil local requirements in respect of the enforceability of security interest. There shall be a framework which allows the lender to have a first priority claim over the collateral, subject to the discretion of Member States to allow such claims to be subject to the claims of preferential creditors provided for in legislative or implementing provisions<u>; When this national discretion is exercised by one Member State, other Member State shall allow their institutions to treat as a first priority claim a security interest in the Member State that has recognized it as such, subject to the previously mentioned preferential creditors' claims</u>.

CEBS's advice on ND 82 (specific risk requirement for covered bonds)

A. Call for advice

1. CEBS technical advice is sought about the appropriate treatment of covered bonds based on the national implementation of the discretion set out in Article 19.2 of Directive 2006/49/EC.

B. CEBS's assessemnt

2. The present wording of Article 19.2 of Directive 2006/49/EC allows for bonds falling within points 68 to 70 of Part 1 of Annex VI to Directive 2006/48/EC (covered bonds) to receive preferential treatment in relation to specific risk.

3. This preferential treatment shall be in line with the preferential treatment covered bonds receive for credit risk purposes. The preferential treatment for credit risk is based on the fact that qualifying covered bonds i.e. those as defined in Article 22 Para. 4 of Directive 85/611/EEC are issued within very stringent legislative frameworks that provides investors with significant protection. While it is clear that these frameworks substantially reduce the credit risk, thus justifying the preferential treatment, further assessment seems necessary about whether such bonds also exhibit substantially lower market risk.

4. The Commission's request is understood as to cover the following two points:

    a. whether the preferential treatment of covered bonds for credit risk is prudent for specific risk; and

    b. whether it should constitute in the same percentage reduction as for credit risk.

5. As an initial examination of this issue CEBS has carried out some preliminary studies (based on both the Danish covered bond market and the pan-European market) in relation to the volatility of covered bonds. The results of these preliminary studies indicate that, overall, the volatility of price/yield movements of covered bonds is substantially less than for similar corporate bonds[12].

6. On the basis of these findings, CEBS comes to the preliminary conclusion that the overall market risk for covered bonds is likely to be lower than for corporate bonds and therefore it seems prudent to stipulate a specific risk requirement that is lower than that applied to a corporate bond. However, given the restricted timeframe of the advice, CEBS is not in a position to make a proposal about the risk-adequate percentage reduction. Further in-depth analyses are indispensable (and also needed to determine whether the current specific risk requirements for corporate bonds, taken as benchmarks, are themselves adequate at present).

C. CEBS's advice

7. CEBS proposes that the current preferential specific risk treatment as set out in Article 19.2 of Directive 2006/49/EC of bonds falling within points 68 to 70 of Part 1 of Annex VI to Directive 2006/48/EC be maintained as a national discretion pending further review.

8. CEBS supports the inclusion of a review clause as contained in the current Commission's suggestion in order to revisit the most appropriate treatment in line with the fundamental review of capital requirements in the trading book undertaken by the Basel Committee.

D. Drafting proposal

Article 19.2 Directive 2006/49/EC

[12] One member believes that the degree of volatility could still vary between jurisdictions, as for example in its own national market for covered bonds which does not benefit from the same degree of implicit government support as for some other jurisdictions.

By way of derogation from points 13 and 14 of Annex I, Member States may set a specific risk requirement for any bonds falling within points 68 to 70 of Part 1 of Annex VI to Directive 2006/48/EC which shall be equal to the specific risk requirement for a qualifying item with the same residual maturity as such bonds and reduced in accordance with the percentages given in point 71 of Part 1 to Annex VI to that Directive.

The Commission shall review the implementation of this provision by 31 December 2012.

CEBS's advice on NDs 102, 103, 104, 105, 110, 111, 136, 137, 138, 140, 141, 142, 143 (real-estate collateral)

A. Call for advice

1. In view of the expected losses on real-estate markets, CEBS's advice is sought as to whether the discretions allowing for a specific favourable treatment of real estate are prudentially sound. This request is referring to the provisions in: Annex VIII, Part 1, Points 16 (first and last sentence), 17 and 19, and Part 3, Points 73 and 75; Annex VI, Part 1, Points 49, 50, 51, 53, 57, 58, and 60 Directive 2006/48/EC.

B. CEBS's assessment

2. As the Commission argues that the current downturn on the real estate market - in particular for commercial real estate (CRE) - might no longer justify a preferential treatment for CRE, it does not take into consideration
    - the CRE markets within the EU differ considerably; and
    - the institutions are required to monitor the values of the properties taken in as collateral and to adjust the value if the market is subject to a significant change in conditions (Annex VIII, Part 2, par. 8 (b) of Directive 2006/48/EC[13]).
3. The provision to monitor the value of the property on a frequent basis should ensure a conservative valuation of real-estate collateral. Therefore, even in the event of a downturn of the real-estate market in a given country, the requirement to monitor and revalue (if necessary) the property values ensures a prudential treatment of real-estate collateral. It should be noted that proper revaluation of property values results in fulfilling the conditions for preferential treatment even under downturn conditions. Even where

[13] "The value of the property shall be monitored on a frequent basis and at a minimum once every year for commercial real estate and once every three years for residential real estate. More frequent monitoring shall be carried out where the market is subject to significant changes in conditions. Statistical methods may be used to monitor the value of the property and to identify property that needs revaluation. The property valuation shall be reviewed by an independent valuer when information indicates that the value of the property may have declined materially relative to general market prices. For loans exceeding EUR 3 million or 5% of the own funds of the credit institution, the property valuation shall be reviewed by an independent valuer at least every three years."

higher losses occur under downturn conditions, this does not necessarily increase the losses for the part of the exposure, which is recognised as fully and completely protected by real-estate. If the value of a real-estate property is appropriately adjusted for downturn conditions, the part considered as fully and completely secured by real-estate collateral will be appropriately reduced as well. Therefore, no increase of losses for this part of the exposure will occur. Higher losses for the unsecured part of the exposure under downturn conditions are assumed to be no concern with respect to credit risk mitigation by real-estate collateral.

4. In its assessment, CEBS also discussed the issue of procyclicality as the value adjustment of real-estate property, which in downturn conditions leads to an increase in capital requirements – to the extent that the value of the collateral decreases, the part of the exposure that becomes uncovered and therefore receives a risk weight of 100% increases. The risk weight applied to the overall exposure therefore gets gradually closer to 100%. The procyclical rise of capital requirements in a time when raising capital might be severely constrained is seen as negative effect of these discretions. However, fixing a risk weight of 100% (for all markets regardless of their development) does not alleviate the situation in a downturn and could be a hampering factor in an economic upturn.[14] The impact that deleting the discretions will have in "good" times should not be overlooked and assessed in particular with regard to real-estate collateral provided by small and medium sized companies.[15] Therefore, CEBS's conclusion does not incorporate the concern of procyclicality when assessing the prudence of the treatment of real-estate collateral. As procyclicality is a general issue which applies to the recognition of any type of credit mitigation technique, this is not an issue that is specifically related to real-estate collateral.[16]

5. In addition to that, the competent authorities that make use of the waiver in Annex VI, Part 1, Point 58 and Annex VIII, Part 1, Point 17 ("Hard Test") of Directive 2006/48/EC have to provide (quantitative) evidence that the local CRE market is well-developed and long-established. The loss rates that are considered in this provisions should ensure that the valuation of the CRE property is sufficiently conservative so that the observed loss rates for the part of the loan that is fully and completely secured (and the part that is fully secured) by CRE collateral are below the given thresholds.

6. To get an impression of the differences in the development of the national real-estate markets, CEBS collected data of CRE and residential real-estate

[14] One member noted it is unclear how this can be reconciled with the fact that the situation in which the waiver would not be available, the quantity of this collateral that is being recognized does not change over the cycle and therefore would not have a procyclical effect.

[15] The same member noted it is unclear in what manner deleting the discretions will have a negative impact in good times in regard to procyclicality. Rather, if discussing procyclicality it would be more prudent if the build up of collateral is constrained in the "good" times. If on the other hand, one holds the view that these two points are not linked to the issue of procyclicality then an argument that could be made is that it cannot be assured however that a deletion of the discretion would not give way for a potential 'over prudence' in which the development of some of the respective market would be unnecessarily constrained.

[16] The same member noted it is unclear how the point made in this sentence is a reason for not considering procyclicality in the analysis. Difficult to reconcile, namely, is that the timely adjustment of collateral (which is presented as having a strong mitigating effect in the previous paragraph) is also not specifically related to real estate collateral. Again, on the other hand, an alternative argument as to why the procyclicality issue is not incorporated in the analysis would be due to the fact it concerns volatility in capital requirements and not loss rates (the CRD only lists loss rates as relevant criteria in this context).

loss rates in a number of Member States (i.e. primarily those having exercised the discretion and responding to the ad hoc stock take). The data where CEBS received an explicit permission to publish can be found in Annex 2 to 6. Some Member States that chose not to apply these discretions explained that they based the decision of non-application on the experience that real-estate markets in their countries can be very volatile. Other Member States that chose not to apply these discretions explained that they based the decision of non-application on principle (prudential) reasons (i.e. regardless of the experience with their real-estate markets).

7. Though the data received is limited (due to the severely constrained timeframe and confidentiality issues) and might be seen as hardly comparable (covering different periods of time, being broken down differently, etc) or perceived as hardly significant (only highly aggregated, possibly not covering entire economic cycles, etc), no evidence was received that would put the prudence of the requirement in question for certain jurisdictions.

8. However, CEBS believes that further analyses might be useful. One Member State for instance raised in this regard the issue of further studies on the relationship within national real-estate markets and the debtors who participate in these markets.

9. CEBS would like to point out, that the explicit supervisory disclosure requirement introduced in the Commission's current suggestion seems dispensable as the exercise of all discretions is already included in the supervisory disclosure framework according to Article 144 lit b) of Directive 2006/48/EC.

C. CEBS's advice

10. As there can be significant differences among the real-estate markets in the individual Member States, CEBS sees a case for preliminary keeping the national discretions regarding the recognition of real-estate property as collateral. The essential reason is that national supervisors find themselves in the best position to judge on those differences, and, at least for those Member States that make use of the waiver in Annex VI, Part 1, Point 58 and Annex VIII, Part 1, Point 17 of Directive 2006/48/EC, they have to provide evidence regarding the quality of their local real-estate market and the prudent valuation of real-estate collateral.

11. Nevertheless, taking into account the increasing interconnections in the mortgage markets, not only within the EU, and the evidence raised by the current crisis, some members note the need for a more in-depth assessment to obtain evidence on whether or not the current treatment remains prudentially sound and if there are reasons to harmonize the approach.

D. Drafting proposal

12. In line with its advice of October 2008 on options and national discretions CEBS proposes to keep the current drafting of the respective provisions, i.e. to keep them (permanently for the time being) as national discretions allowing for differences in the local real-estate markets, and to add a binding mutual recognition clause.

CEBS's advice on the option set out in Annex VII, Part 2, point 14 of Directive 2006/48/EC not analysed before (one-day floor for 'other short term exposures')

A. Call for advice

1. Technical advice of CEBS is sought on eligible short-term exposures with a view of establishing a list of criteria/exposures in Annex VII, Part 2, Point 14 of Directive 2006/48/EC (taking into account the G20 recommendations regarding trade finance[17]).

B. CEBS's assessment

2. The explicit intention of this provision is to make an exemption from the general rule only for exposures that are not part of the credit institutions' ongoing financing of the obligor. Where exposures are part of the ongoing financing of the obligor, it can be assumed that short-term exposures will be replaced by other short-term exposures. For this reason a minimum maturity of one year is generally required even for exposures having a maturity of less than one year. Therefore, as a general rule, the type of the exposures should by itself ensure that this is usually not part of ongoing financing of the obligor.

3. In its assessment, CEBS discussed the inclusion of the following short-term exposures for which – if they are not part of the credit institution's ongoing financing of the obligor – M shall be at least one-day:

   - "*Exposures to institutions arising from foreign exchange settlements*": The concessionary treatment should be limited to settlement of foreign exchange transactions similar to e.g. settlement of securities purchases and sales or settlement of electronic payment transactions;
   - "*Self-liquidating short-term trade financing transactions, import and export letters of credit and similar transactions with a residual maturity of up to one year*": Problems arise here as the term "trade finance" is not fully defined for these purposes (nor indeed in the relevant Basel text). Furthermore it seems unclear whether it would be appropriate to qualify trade finance transactions as needing to be "self-liquidating";
   - "*Exposures arising from settlement of securities purchases and sales within the usual delivery period or two business days*";
   - "*Exposures arising from cash settlements by wire transfer and settlements of electronic payment transactions and prepaid cost, including overdrafts arising from failed transactions that do not exceed a short, fixed agreed number of business days*";
   - "*Exposures to a central bank in a Member State where the credit lending institution is seated, which arise from repurchase transactions*

[17] See International Chamber of Commerce, ICC Banking Commission Recommendations – Impact of Basel II on Trade Finance, 25 March 2009 (http://www.iccwbo.org/uploadedFiles/ICC/policy/banking_technique/Statements/ICC_Recommendations_on_Basel%20II.pdf).

collateralised by notes issued by the central bank, with a residual maturity of up to one year": This possibility was discussed as one Member State indicated problems in terms of repo transactions with short-term bonds issued by its central bank ("though such collateral poses a very low risk, it does not meet all the eligibility requirements stipulated for 'financial collateral' in Annex VIII of the Directive"). However, it was concluded that this proposal would mean the dropping of the requirement of daily remargining for repurchase transactions with domestic central banks (which should not be done without thorough analysis).

C. CEBS's advice

4. Given the necessity for more in-depth analysis and also in order to assure sufficient flexibility and to allow a quick response to market developments, including trade finance, CEBS is of the opinion that it would be better to keep the national discretion as it stands for the time being and provide guidelines on the consistent application of this provision in due course in line with the G-20 review and industry input.

D. Drafting proposal

Annex VII, Part 2, point 14 Directive 2006/48/EC

Notwithstanding point 13(a), (b), (d) and (e), M shall be at least one-day for:

— fully or nearly-fully collateralised derivative instruments listed in Annex IV;

— fully or nearly-fully collateralised margin lending transactions; and

— repurchase transactions, securities or commodities lending or borrowing transactions

provided the documentation requires daily re-margining and daily revaluation and includes provisions that allow for the prompt liquidation or setoff of collateral in the event of default or failure to re-margin.

In addition, for other short-term exposures specified by the competent authorities on the basis of guidelines provided by the Committee of European Banking Supervisors which are not p~~P~~art of the credit institution's ongoing financing of the obligor, M shall be at least one-day. A careful review of the particular circumstances shall be made in each case.

Annex 1: Industry Feedback on NDs 41 and 45

The 'industry experts on national discretions'[18] has been invited to provide input on NDs 41 and 45 in particular i) on possible criteria for the recognition of eligible unfunded credit protection providers for dilution risk, and ii) on the impact of the possible deletion of these provisions.

The input received is presented below:

Austrian Federal Economic Chamber (WKO): These national discretions are not applied in Austria and – given that they are IRB-NDs – an impact analysis of the possible deletion of this provisions are not possible at this time.

Because of the different application in Member States (40% applied, 60% not applied) a binding mutual recognition clause would be essential (e.g. for consolidated own funds).

European Association of Public Banks (EAPB): In our point of view, the CEBS proposal (taken up - to our knowledge - in the Commission's latest proposal submitted to the CRD-TG) to keep ND 41 and 45 combined with the introduction of a binding mutual recognition clause, should be upheld.

With regard to any criteria, we take the view, that the seller of the receivables should be recognised as eligible protection provider, if either (i) the seller disposes of an external rating which under the standardised approach would be associated with a credit quality step of 1 - 3 for corporate exposures, or (ii) in case no external rating exists if the seller of the receivables disposes of an equivalent internal rating (as measured by the PD).

With regard to the impact of a possible deletion of these provisions, it is difficult to give any forecast.

Irish Banking Federation: The national discretions under review, Numbers 41 and 45, are not applied in Ireland and so their removal would not have any implications for banks in Ireland.

Italian Banking Association (ABI) and Italian Factoring Association (ASSIFACT): Additional input on possible criteria for the recognition of eligible unfunded credit protection providers for dilution risk

Impact on business

We believe that national supervisory authorities must maintain their right to enlarge the list of eligible guarantors due to the continual evolution of the contract structures of personal guarantees that may differ in the national frameworks and the possible changes to the credit standing of the guarantors already listed.

[18]The list is published on CEBS website: http://www.c-ebs.org/getdoc/1d48fde8-6672-4df5-a526-b406472c6af2/National-Discretions.aspx

With respect to risk mitigation techniques for insolvency, we highlight the absence of insurance policies on credits among the acceptable techniques for risk mitigation: these play a significant role in the type of risk management used in factoring. We underline that recourse to this technique for the transfer of risk associated with the debtors transferred is favoured by the fact that in both factoring and insurance the risk is accepted on portfolio logic, even though each unit in the aggregate is evaluated specifically. We believe that the evolution of the contract structures used, specifically on the matter of the effectiveness of the guarantee with respect to the insured party's obligations, the modality and the times of the execution of the guarantee as well as the maximum limit of the policy, can render this risk mitigation technique acceptable with respect to the requirements set out for personal guarantees.

With respect to the dilution risk, the obligations assumed by the guarantor is not based on mitigating the risks of the principal debtor's insolvency, but rather by mitigating the risk that the transferred debtor will not miss a payment for the outstanding debt due to the underlying commercial relationships, that is to say the supply of goods/services by the transferor. In this context, mitigating the risk of a missed payment by the debtor is reduced by the actions undertaken by the transferor (substituting goods/services, a discount being applied to the debtor purchaser, etc) whose effectiveness is not reflected by insolvency ratings. To this end, we believe that transferring companies with a rating even below the minimum level set out in the Directive, i.e. class 2 should fall within the range of eligible guarantors if the contractual structures attribute to the transferor the role of guarantor for dilution risk as is the case with Italy. Moreover we highlight that the dilution risk involves different types of financial operations based on trade receivables: in light of an international comparison, these operations are different even at a national level, therefore the contractual structures of the guarantees may also be difficult to compare.

In the contract structures adopted in Italy, there are, for example, certain obligations imposed on the assignor, under penalty of termination of the factoring contract. These obligations appear to be sufficient to mitigate dilution risk and allow the recognition of the assignor's role as guarantor with respect to such risk.

Specifically, in the general conditions of the contract, the supplier is obligated to:

- Fulfil precisely and timely the underlying supply contracts, besides naturally guaranteeing certainty and collectability of receivables;
- Make available to the factor all the documentation and information concerning the qualitative characteristics of the assigned claims and the business relations from which these claims arise, including documentation on contracts and supplies, etc;
- Update this documentation and information to enable the factor to verify that the supplier's obligations are met;
- Timely communicate any relevant information concerning the relationship with the debtor, any possible objection, claim or complaint;

- Not modify, without the prior approval of the factor, the conditions of the sale and/or service provision, and not grant rebates, price reductions, return of goods, etc.

In any event, consideration for the assigned claim, generally equal to the value of the claim, will be paid by the factor to the assignor already net of any discounts, rebates, deductions and anything else.

These contractual provisions oblige the assignor to transparently and properly fulfil the supply transactions underlying the claim subject of the assignment, with the obligation to inform the factor of any actions undertaken to perform business relations and enable the factor to use the securities that are regulated by contract, besides putting in place monitoring procedures and systems to verify the quality of the purchased receivables in correlation to the assignor's situation.

In relation to this last passage, these operational requirements, that further protect against the dilution risk, are part of the consolidated good market practice on factoring, even beyond the contractual provisions, and in certain national contexts such as Italy, they are recognized and given value in the prudential supervision guidelines that expressly provide for the implementation of monitoring systems to verify the quality of the purchased portfolio, to resolve issues, check the availability of credit and collections.

Royal Bank of Scotland (RBS): From our perspective the removal of ND 41 and 45 would have negative implications and we believe that the initial CEBS proposals were the right way forward. From our experience the nature and structure of credit risk mitigants in Invoice financing, is different across jurisdictions, particularly for personal and corporate guarantees. As a result we strongly recommend that this be solved via mutual recognition.

Société Générale: French banks are in favour of the deletion of this provision (ND 41 and ND 45).

Annex 2: Data on the Austrian real-estate market

The Financial Market Authority (FMA) believes that these provisions are rooted in market specificities and are prudent in well developed and long established markets. According to their experience the low loss rates of exposures collateralised with real-estate in Austria justify a lower risk weight.

The data for the annual assessment of the Austria real-estate market is not available via regular reporting but is separately collected by the FMA from a representative sample of Austrian banks.

Annex VI, Part 1, Point 58 Dir. 2006/48/EC (CRE)	acceptable loss rate	loss rate in Austria	
		2007	2008
lit. a	0.30%	0.06%	0.10%
lit. b	0.50%	0.09%	0.15%

Annex VI, Part 1, Point 49 Dir. 2006/48/EC (RRE)	acceptable loss rate	loss rate in Austria	
		2007	2008
following Point 58 lit. a	"sufficiently low"	0.01%	0.005%
following Point 58 lit. b	"sufficiently low"	0.02%	0.009%

Annex 3: Data on the German real-estate market

The German institutions have conducted two analyses of the national real-estate markets covering the period from 1988 until 2005. Aim of this data collection was to provide evidence that the Residential Real-estate and Commercial Real-estate market in Germany is well-established and shows low loss rates.

Year	Commercial real-estate loss rates [%]		Residential real-estate loss rates [%]	
	For the fully and completely covered part of the exposure: Up to the lower of 50% market value and 60% mortgage lending value	For the fully covered part of the exposure	For the fully and completely covered part of the exposure: Up to 60% mortgage lending value	For the fully covered part of the exposure
1988	0,039	0,076	0,053	0,115
1989	0,058	0,108	0,035	0,080
1990	0,038	0,074	0,026	0,053
1991	0,030	0,055	0,016	0,035
1992	0,026	0,045	0,018	0,036
1993	0,029	0,053	0,017	0,035
1994	0,044	0,075	0,011	0,024
1995	0,044	0,093	0,014	0,037
1996	0,048	0,105	0,023	0,056
1997	0,034	0,087	0,029	0,054
1998	0,062	0,117	0,038	0,074
1999	0,092	0,393	0,029	0,099
2000	0,133	0,424	0,044	0,189
2001	0,105	0,437	0,050	0,216
2002	0,052	0,345	0,054	0,267
2003	0,104	0,443	0,060	0,288
2004	0,116	0,427	0,078	0,327
2005	0,153	0,432	0,098	0,359

Annex 4: Data on the Swedish real-estate market

In Sweden[19] loans to residential real-estate within 75% LTV are characterised by low losses. This is due to both low PD and low LGD. The Swedish legal system for mortgages is a very robust system, founded on an official register, where all mortgages and their priority are registered. Each lender knows how much of the proceeds of the property they are entitled to and in which priority they are entitled to the proceeds.

Another important aspect for the mortgage lending is the system for financing and subsidising the construction of residential real-estate. Up until 1993 the Swedish financing system was "authority-based", which meant that the banks were under hard political pressure and had to finance residential real-estate projects. Hence they could not use their "usual" credit-granting processes. Furthermore, the banks had to finance the projects based on the cost of building, instead of the actual value. As you will see from the two tables below, nearly all the losses that the banks has experienced are on credits granted within this old system. On credits granted within the new system the losses are very close to zero.

In table 1 below are the figures for the loan losses on multifamily residential real-estate in Sweden from 1992 to 2008. The figures in the table are loans, with a LTV ratio no higher than 75%, given by the four largest banking groups in Sweden. These four banks represent more than 80% of the loans to multifamily residential real-estate within the 75% LTV. The losses in the table are actual losses minus recoveries.

Table 1. Loan losses on multifamily residential real-estate (SEK millions)

	Losses (%)
1992	0,37%
1993	0,47%
1994	0,61%
1995	0,79%
1996	0,59%
1997	0,60%
1998	0,53%
1999	0,44%
2000	0,34%
2001	0,11%
2002	0,09%
2003	0,05%
2004	0,03%
2005	0,01%
2006	-0,01%
2007	-0,01%
2008	0,00%

[19] Data provided by the Swedish Bankers´ Association.

In 2002 the Swedish Bankers' Association made a study (Study on Loan Losses on multifamily residential real-estate in Sweden) where loans with the year of origination earlier than 1994 were excluded. The result of the study which is shown in table 2 below shows that the small losses that actually occur in a large part stem from the period before the new system was in place. Due to the short timeframe on the request we have not been able to provide you with an update on these figures, but as you will understand from the tables the figures from 2001 and forward would have been even closer to zero for all the years if the older loans would have been excluded.

Table 2. Loan losses on privately owned multifamily residential real-estate in Sweden

Total number of loans: 35,000
Total number of losses: 29

Year of origination	Losses / Principal
1994	0,0762%
1995	0.0252%
1996	0.0043%
1997	0.0005%
1998	0.0025%
1999	0.0002%
2000	0.0000%

The figures in table 2 are for losses during 1994 - 2001 for loans given between 1994 - 2000 by the four largest banking groups in Sweden. It is for loans with a LTV ratio not higher than 75%, secured by mortgage collateral in privately owned multifamily residential real-estate. The owners are private companies, private persons or housing co-operatives/condominium associations (loans to municipality owned housing companies are not included since losses on such loans are non-existing).

Annex 5: Data on the Danish real-estate market

Based on the data collected about the Danish market a favourable treatment is in fact still justified.

Prior to the implementation of the directive in 2007 an analysis was performed of the Danish market to establish whether this market in fact qualifies to a favourable treatment being a market with a long history and low losses.

The analysis performed back in 2005 showed that this was indeed the case as far as residential real-estate property is concerned, but not commercial real-estate property. The data series established then has for this purpose been extended with the newest data.

The conclusion still remains that it is justified with a preferential treatment in the Danish market of loans secured by residential real-estate property.

It should be noted that regarding the data in table 3 on losses and provisions as part of the outstanding bond debt it has not been possible to renew this data series. The old data are despite of this enclosed because they are themselves proof of the long history of the market.

Data series are based on reporting by the mortgage banks to The Danish FSA (and from Danish Statistics regarding the price movements).

Table 1.

Loss rates (Posted losses/Loans)	1999	2000	2001	2002	2003	2004	Av.[20]
Freehold housing	0,0028	0,0114	0,0100	0,0145	0,0160	0,0134	0,0113
Secondary residences	0,0045	0,0876	0,0020	0,0019	0,0060	-0,0004	0,0169
Subsidized property	0,0055	0,0080	0,0039	0,0138	0,0027	0,0044	0,0064
Rental property	0,0100	0,0170	0,0019	0,0033	0,0405	0,0051	0,0130
Other	0,0102	0,0309	-0,0028	0,0658	-0,0009	0,0004	0,0173

Loss rates (Posted losses/Loans)	2005	2006	2007	2008	Av.[21]
Freehold housing	0,0047	0,0023	0,0009	0,0048	0,0032
Secondary residences	0,0003	0,0000	0,0000	0,0045	0,0012
Subsidized property	0,0032	0,0035	0,0106	0,0038	0,0053
Rental property	0,0021	0,0050	0,0169	0,0010	0,0062
Other	0,0000	0,0000	0,0000	0,0000	0,0000

Table 2.

Loss rates (Posted losses/Loans)	1999	2000	2001	2002	2003	2004	Av.[22]
Properties used for trade and industry	0,1821	0,4656	0,0971	0,3165	0,0698	0,0671	0,1997
Office and business premises	0,1948	0,1712	0,0367	0,0490	0,0324	0,0369	0,0868
Agricultural property	0,0954	0,0537	0,0220	0,0304	0,0265	0,0176	0,0409
Property for social, cultural and educational purposes	0,1409	0,0278	0,0719	-0,0140	0,1052	0,1275	0,0766

[20] average: 1999-2004
[21] average: 2005-2008
[22] average: 1999-2004

Loss rates (Posted losses/Loans)	2005	2006	2007	2008	Av.[23]
Properties used for trade and industry	0,0855	-0,0062	0,0502	-0,0027	0,0317
Office and business premises	0,0110	0,0054	0,0033	0,0033	0,0057
Agricultural property	0,0166	0,0150	0,0050	0,0006	0,0093
Property for social, cultural and educational purposes	0,0217	0,0042	0,0087	0,0267	0,0153

Figure 1.

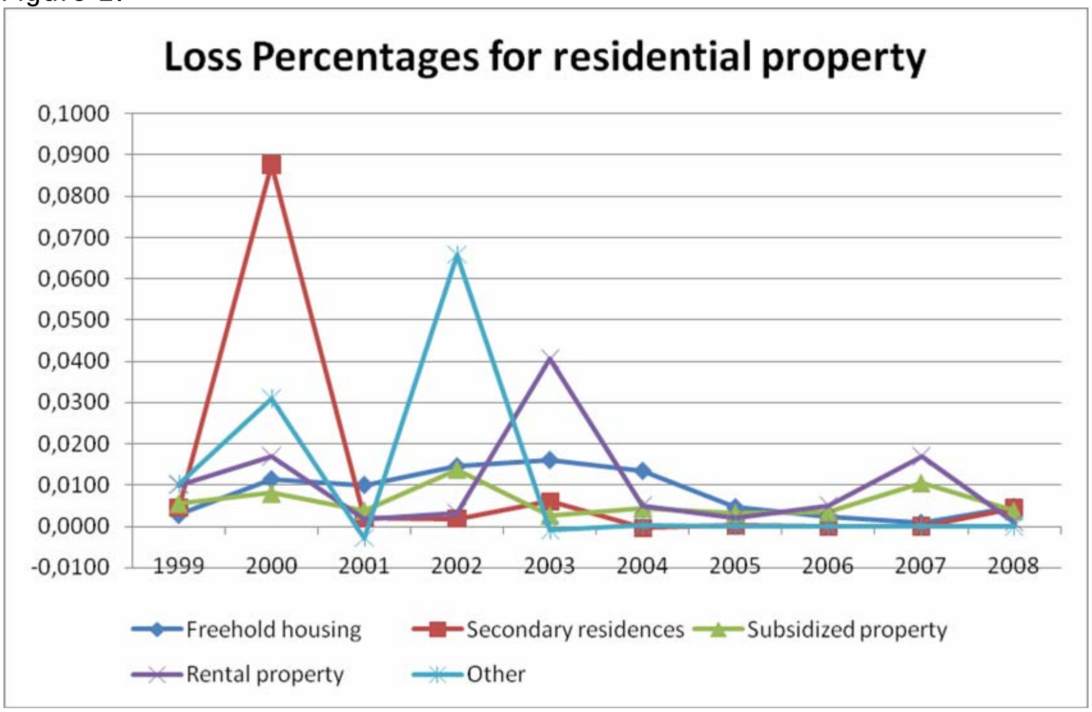
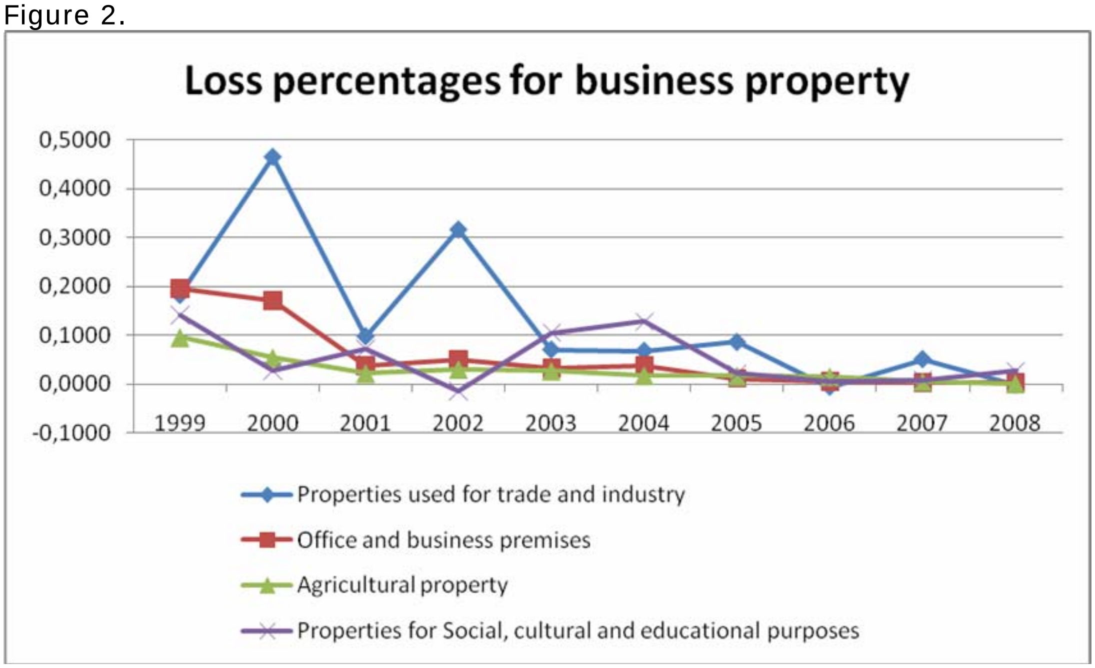


Figure 2.



[23] average: 2005-2008

Figure 3.

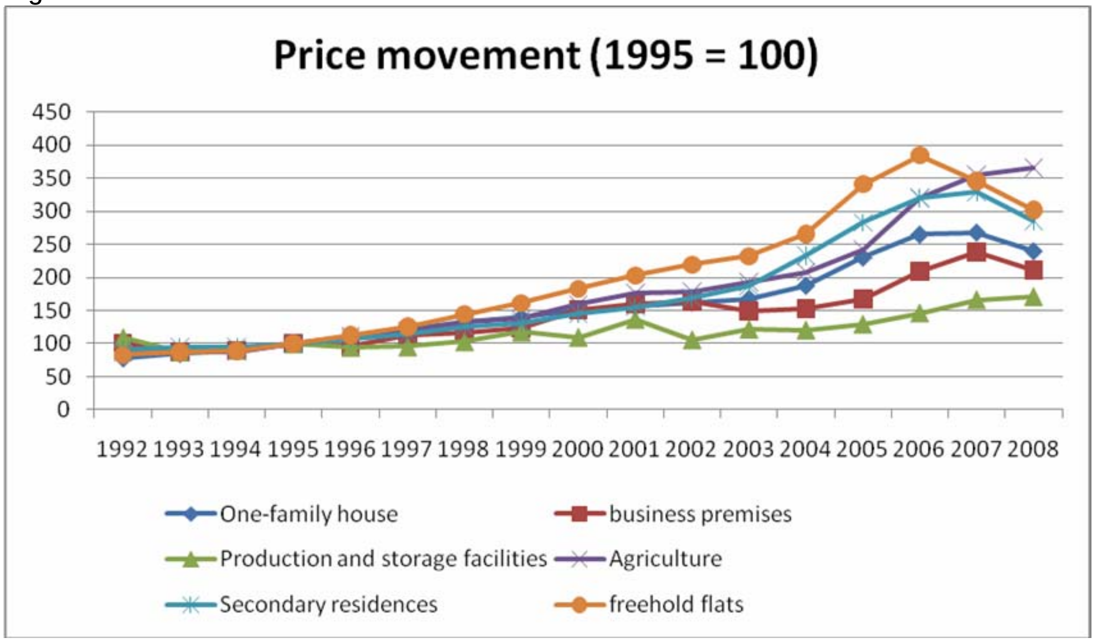


Figure 4.

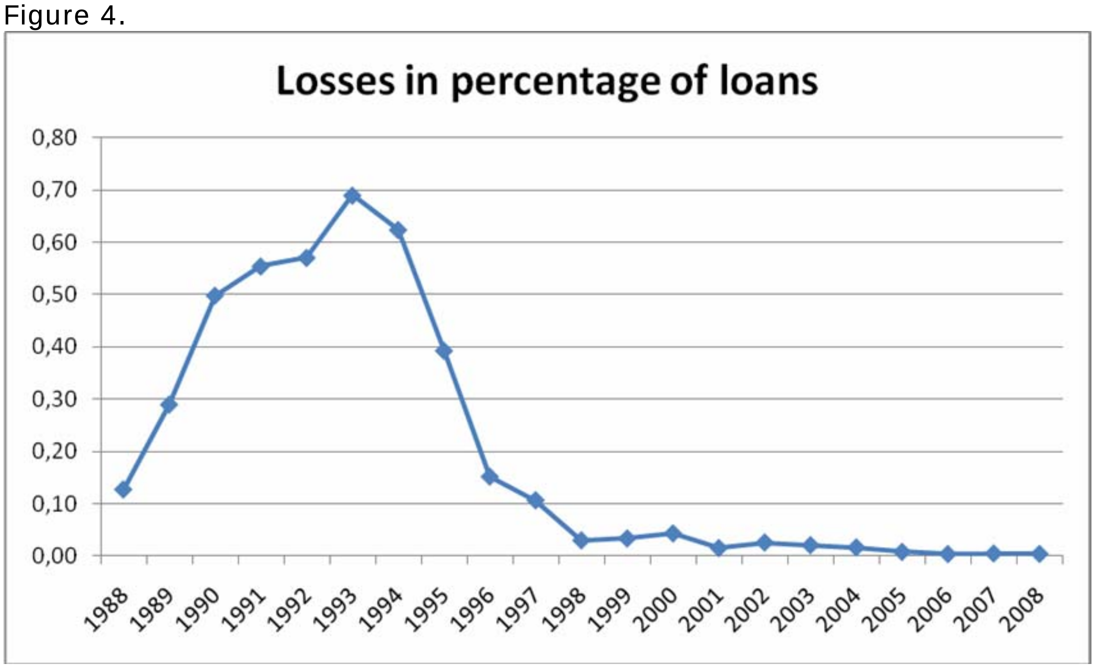


Table 3. Losses and provisions in percentage of outstanding bond debt

	Total	Residential property	Freehold housing	Agriculture	Industry and trade	Office and business	other
1990	0,70		0,90		0,50		
1991	0,62	0,18	0,81	0,45	0,84	1,74	0,45
1992	0,72	0,21	0,51	0,49	0,94	2,40	2,63
1993	0,75	0,24	0,47	0,78	2,44	2,52	1,75
1994	0,40	0,09	0,19	0,43	1,78	1,46	1,08
1995	0,14	0,05	0,03	0,19	1,01	0,39	0,81
1996	0,07	0,01	0,00	0,15	0,23	0,41	0,27
1997	-0,03	-0,01	-0,01	-0,10	0,06	-0,25	0,29
1998	-0,02	0,01	-0,01	0,11	-0,27	-0,19	-0,46
1999	-0,02	0,00	-0,01	0,10	-0,09	-0,20	-0,70
2000	-0,03	-0,01	-0,02	-0,02	-0,28	-0,03	-0,55
2001	0,01	-0,03	0,02	0,01	-0,01	0,01	0,08
2002	0,01	0,00	0,01	-0,01	0,27	0,02	-0,53
2003	0,01	0,01	0,01	0,00	-0,17	0,00	0,36

Annex 6: Data on the Norwegian real-estate market

Norway has not applied the discretion in Directive 2006/48/EC Annex VI, part 1, point 51 to assign a risk weight of 50% to exposures collateralised by CRE. Neither have we applied the waiver in Annex VIII, part 1, point 17, to dispense with the condition in point 13 (b). However, Norway applies mutual recognition.

One of the reasons why Norway has not applied the discretion or waiver is the experienced high loss rates on corporate loans during the banking crisis in Norway from 1987/88 to 1992/93.

Norway does not collect data showing losses on loans collateralised by CRE up to the lower of 50% of the market value and (if applicable) 60% of the mortgage lending value. Neither do they collect data that explicitly shows losses on all loans collateralised by CRE.

Losses on loans for the industry: "real-estate activities[24]", however, gives a good indication of the losses on loans collateralised by CRE and where the risk of the borrower depends upon the performance of the underlying property or project.

Below is set out an overview of the savings banks' and commercial banks' losses on outstanding loans for the industry: "real-estate activities" for the period 1987 to 2008. For comparison, the tables (tables 1 and 2) also show losses as a percentage of total outstanding loans for the period.

Table 1 - Savings banks – Losses as a percentage of outstanding loans

	1987	**1988**	**1989**	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**
Real estate activities	1,4	3,4	4,0	4,4	6,0	5,7	2,5	0,8	0,0	0,2	0,0
Total loans	0,8	1,8	2,5	2,3	2,1	2,5	1,3	0,4	0,3	0,1	0,2

	1998	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Real estate activities	0,3	0,2	0,1	0,3	0,6	0,3	0,1	0,0	0,0	0,0	0,2
Total loans	0,4	0,4	0,1	0,2	0,4	0,4	0,1	0,0	0,0	0,0	0,2

[24] Council regulation No 3037/90 on the statistical classification of economic activities in the European Community

Table 2 Commercial banks – Losses as a percentage of outstanding loans

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Real estate activities	1,5	3,1	3,6	4,6	14,0	6,3	1,8	0,2	0,0	-0,3	-0,2
Total loans	1,3	2,1	2,2	2,6	5,9	2,8	1,8	0,6	-0,1	-0,1	-0,1

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Real estate activities	-0,1	0,0	-0,1	0,2	0,7	0,2	0,1	0,1	-0,4	0,0	0,6
Total loans	0,1	0,2	0,1	0,3	0,9	0,8	0,3	-0,2	-0,2	0,0	0,2