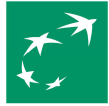


BNP PARIBAS

BNP Paribas Response to the EBA Draft RTS on the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets

Object: BNP Paribas Response to the European Banking Authority Draft RTS on the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets under Article 379 of the proposed Capital Requirements Regulation (EBA/CP/2013/07)

General comments

We appreciate the opportunity to comment the consultative document on the determination of the overall exposure to a client in respect of transactions with underlying assets. We share the objective of the EBA to improve the monitoring of large exposures. Significant improvements have already been achieved in that field with the recent implementation of the 2009 December CEBS guidelines that came into force on December 31st 2010. The CEBS guidelines strengthened the previous framework introducing more conservative risk weights, capturing a wider range of exposures and requiring performing a look through approach for new non granular schemes.

The EBA Draft RTS introduces a new set of highly prescriptive provisions related to schemes while banks have just implemented the above mentioned CEBS guidelines on the Large Exposures. Hence we are concerned about the timing of this draft RTS, especially since the draft RTS does not seem to be coordinated with other on-going regulatory developments undertaken at international level, in particular the Basel proposal for Large Exposures regime published in March 2013[1]. We also consider it premature to revisit the current Large Exposures framework without having sufficient hindsight on the shortcomings of the current rules. We therefore advocate the EBA RTS to stick as closely as possible to the 2009 CEBS guidelines.

[1] See http://www.bis.org/publ/bcbs246.pdf

More specifically we wish to share our concern on a few provisions of the new EBA RTS:

1. The systematic use of the look through approach is not appropriate for a large part of bank's exposure to schemes

We regret that some of the alternatives to the look through approach were omitted such as the one relying on the granularity of the underlying portfolio, i.e. the approach based on the mandate of the scheme or the usage of credit enhancement.

A look-through approach is appropriate when funds and securitisation involve exposures to large customers. On the contrary, such a treatment is not justified when schemes hold granular portfolios such as retail exposure, auto loans or even SME (RMBS pools for example are so granular that the amount resulting from the application of the look through would be non-significant and would not significantly contribute to the institution's exposure to an existing group of connected client). Hence, we suggest excluding securitization and funds of retail and SME exposure (RMBS, auto loans, student loans…) from other exposure securitization.

On the other hand, we support EBA's suggestion to introduce a granularity/materiality threshold in the RTS' framework (Details in question 4).

2. The initial intent of the Large Exposure regime is disregarded

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

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

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

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

3. A too restrictive regulation on securitization could have a negative impact on banks' clients

Securitisation is an essential tool for banks and other investors to provide financing on a whole range of assets rather than solely rely on the credit of the seller/borrower, and for these borrowers (including banks) to diversify their sources of funding. As a credit portfolio management tool, the securitisation of self-originated assets allows bank to reduce and diversify their risk profile. As such, securitisation increases credit availability while decreasing its cost. It also heavily supports the real economy while providing an essential, low-cost, alternative funding solution to many manufacturers and corporates through ABS and ABCP products. If regulatory requirements become too restrictive, banks will reduce their securitization production which will have a negative impact on their clients, especially companies (for instance car manufacturers).

4. The notion of unknown client is too conservative

If the RTS was to be applied under this version, the exposure to the unknown client would immediately and automatically exceed the 25% limit because the look-through is technically speaking not applicable in a number of cases:

- Some securitization portfolios rely on thousands of diversified borrowers hence making a look through approach impossible, e.g. the mapping of customers, identification…;
- The name of the borrower cannot be disclosed in all cases, for example for Banking Secrecy reasons;
- For some existing transactions the sponsor and/or originator has not committed himself to provide the name of the final borrower, though high diversification triggers.

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

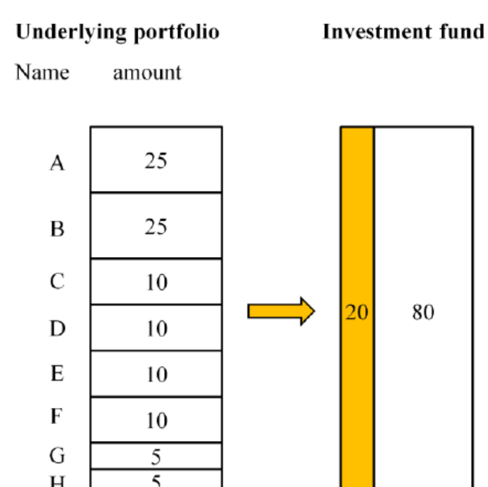
Yes, it is clear enough, but we strongly disagree with the proposed methodology.

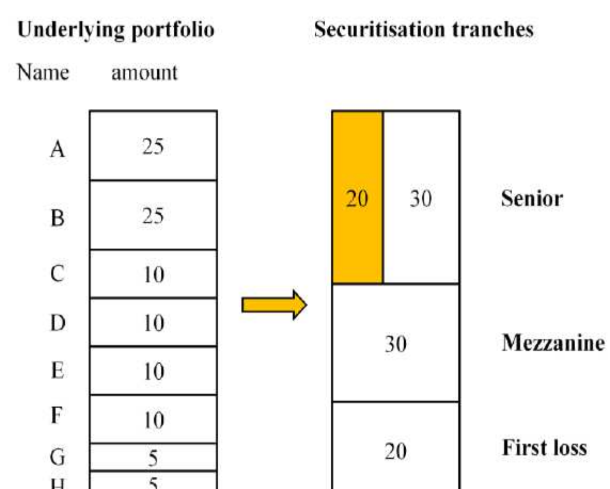
Example 4 raises several issues on the appropriateness of the proposed framework:

1. Indeed the situation described in this example assumes that the institution knows in detail the level of credit enhancement (because the institution is investing in the junior and the senior tranche). In this situation, the credit institution should be allowed to recognise the credit protection provided by the equity piece in the structure and thus not report any exposure in regard to the senior exposure. EBA assumes that institutions are able to know the total amount issued on their investment but suggests that institutions would be unable to know the amount of the subordinated tranches. This seems contradictory.

2. In addition, we think that the pro-rata approach on securitisation structure can lead to inconsistent results because the amount of the exposure reported on the underlying asset depends not only on the amount invested in the structure and the amount of each underlying exposure but also on the **proportion** of a given investment in the issuance of the tranche.

The examples provided by the EBA illustrate this inconsistency:





EBA's proposal leads to the following results in term of exposure assignment:

	Example 1	Example 3
	CIU (pari passu exposure)	**Senior tranche exposure**
A to B	5	10
C to F	2	4
G and H	1	2

The result is that, for a same amount invested in the same portfolio, the exposure amount reported for a senior tranche exposure, **on each underlying issuer is 2 times higher than on the pari passu structure** which is totally counterintuitive in term of credit risk management.

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

The large exposures risk mitigation framework set out by the CRR allows banks to reduce their exposures by adjusting the exposure value in case of financial collateral using the Financial Collateral Simple Method or the Financial Collateral Comprehensive Method. To be consistent with those principles, the credit enhancement should be taken into account. As a consequence, when the credit enhancement is funded, we propose to assimilate it to cash collateral and thus reduce the exposure of the underlying names up to the amount of collateral received.

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

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

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

1. As mentioned above, we consider that it is not justified in term of risk management and not possible (the CEBS guidelines §65 recognised this "*because it is not possible or feasible to look-through the scheme, the guidelines should provide prudent alternative*") to apply a look through approach on schemes where the underlying asset is a retail class (RMBS, Student loan, consumer loan, credit card, auto loan) or a highly granular portfolio (SME):

   a. The amount to be reported would be non-significant in regard to the amount invested by the institution or to the institution's eligible capital;
   b. The beneficiary would be reported on a single line without any connection with other group of connected clients and thus not reported.

   Excluding this type of structure based on the fact that their underlying asset cannot be linked to our biggest groups of connected clients is a reasonable way to avoid adding such exposure to the unknown client group. This is particularly true for large financial institutions where the amount of eligible capital is sufficient to be comfortable with the absence of any connection with other retail or SME customers.

   We suggest not applying the look through requirement on the schemes where the underlying assets are:
   - **a retail class: RMBS, Student loan, consumer loan, credit card, auto loan**
   - **a highly granular portfolio: in particular SME, where the exposure amount should by definition be negligible.**

   As an illustration of the high granularity of securitization structure, the following table shows the concentration of some securitization structures as illustrated in the FBF answer to the Basel Committee's new securitization framework proposal:

Structure name	Arran Residential Mortgages Funding 2010-1 plc	CLARIS ABS 2011 S.R.L.	FIRST FRANKLIN MORTGAGE LOAN TRUST	HOLLAND MORTGAGE BACKED SERIES (HERMES) XVI B.V.	Phedina Hypotheken 2011-I B.V.
Structure Type	RMBS	Auto loan	RMBS	RMBS	RMBS
Total portfolio	£4 647 089 317	2 616 577 280 €	$1 705 534 713	3 075 145 557 €	1 546 745 823 €
Highest exposure	£2 493 891	4 909 940 €	NC	1 500 000,00 €	NC
Highest exposure %portfolio	0,0537%	0,1876%	NA	0,0488%	NA
Number of loans	33 155	23 411	7 770	14 669	6 786

2. In addition, **we agree with the EBA suggestion to include materiality threshold** for the application of the look-through approach (please refer to question 4 for more details).

The two proposals (1&2) have to be combined.

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

We indeed think that setting a materiality threshold where the reference value would be the institution's eligible capital is more appropriate than taking the underlying portfolio as a reference. **A scheme where the institution exposure does not exceed 0.25% of its eligible capital seems acceptable.**
This materiality threshold has to be combined with our suggestion (2) under question 3 proposing the exclusion of highly granular portfolio, indeed institutions could have exposure to RMBS structure that exceed 0,25% of their eligible capital while transparency remains inappropriate for the reasons developed here above.

Justification of our proposal:

- A 0,25% threshold would mean that an institution would not be compliant with the Large Exposure limit if it holds exposure to 100 schemes invested in the same customer which is unlikely to occur;

- EBA suggest that institutions could "c*ircumvent the large exposures limit by concealing exposures to a certain obligor in opaque structures"*, we think that this situation is unlikely to occur:

    a. For accounting issues (even if an institution creates a scheme in order to book a large exposure, the scheme would have to be consolidated and thus mechanically look through would be performed through accounting consolidation)
    b. The notion of connected client is applicable to the structure itself and thus if the scheme was to be invested in one unique obligor, it should be connected to the group of connected client of this obligor and thus if an institution was investing in multiple schemes with the same obligor, they should be connected altogether as a consequence, institutions would be compliant with the large exposure objectives.

In addition, we advocate the EBA to take in account, when known, the concentration rules of schemes. For instance, if a scheme cannot invest more than [10%] of its asset on one issuer/borrower (maximum possible concentration), and that the underlying names can't be known (for operational or banking secrecy reasons), we suggest to report this amount (ie: 10%*

amount invested by the institution) rather than the full amount invested by the institution. Indeed this will reflect the real maximum possible risk in term of large exposure.

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

The monitoring requirement is not in adequacy with the reporting frequency of most of the securitisation structures who in majority publish quarterly reports rather than monthly reports. In addition we advocate the EBA to take in consideration the risk to breach the limit : if the largest exposure of an institution is far from the limit (for instance at 10%), monitor the monthly exposure to schemes that are negligible in regard to the total balance sheet of an institution would be useless. Shouldn't the frequency be linked to the risk of breaching the LE limit?

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

No