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EBF RESPONSE TO CEBS CP 16:

SECOND PART OF ADVICE TO THE EUROPEAN COMMISSION ON THE REVIEW OF THE LARGE EXPOSURES RULES

General remarks

The European Banking Federation welcomes the opportunity to comment on CEBS' orientations for the second part of its technical advice to the European Commission on large exposures. We also wish to welcome the extensive amount of work that CEBS has carried out to deliver this Consultation Paper (CP) in a way that is consistent with the Level 3 Impact Assessment guidelines.

In particular, **we commend CEBS for conducting systematic cost/benefit analysis and for its efforts to present empirical evidence to support its proposals**. Also, we welcome and wish to underline that CEBS has been dedicated from the early stage to involve industry in the process of reviewing the large exposures regime.

The scope of the large exposures rules' review should be strictly limited to its purpose: to establish a backstop regime. **The large exposures regime should not aim at resolving issues related to an ailing institution**. This concerns other work areas e.g. liquidity risk, insolvency laws, crisis management which are currently being reviewed by the European Commission.

Furthermore, the EBF has long called for the elimination of all national discretions from the CRD and has actively been supporting CEBS' work in that respect. We recognise the efforts and progress CEBS has already made in this area and would emphasize that **it is essential that national discretions and options be removed also from the large exposures framework** to relieve the high prudential regulatory and reporting burden which cross-border banks are currently faced with.

Executive Summary

It is undisputed that capital and risk are managed most efficiently and effectively at group level. The nominal allocation of capital to single entities of a consolidated banking group no longer has any practical meaning from a risk management perspective. On the contrary, it only constitutes a **reporting, administrative and IT burden** and has a number of adverse implications, notably in terms of liquidity risk. The recent financial turmoil has shown that the solo level of the legal entity does not reflect the real risks and does not allow taking the necessary corrective measures in a timely manner.

When considering most of **CEBS' proposed measures** from an aggregated perspective, we fear that they would have **severe capital effects on banks** that are organised on a consolidated basis.

At least in cases where banks have organized credit counterparty risk management at group level, **the primary level of application of the large exposures requirements should be the consolidated level**.

We therefore insist that the review of the current **large exposures rules must be aligned with the spirit and the methodologies of the Basel II framework**. This would allow institutions to use the same systems and would facilitate comparability of data. Although in theory there might be

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arguments for differentiated treatments, in practice it would not compensate the additional costs that it would create. Should some CRD articles be considered as inappropriate for large exposures, both the CRD and large exposures rules would have to be changed to ensure that a single set of rules is maintained.

Importantly, the large exposures rules should be neutral vis-à-vis banks' own practices, and against the general background of the holistic treatment of concentration risk under Pillar 2.
In that respect, we also urge CEBS to maintain and ensure the **distinction between overall limits for idiosyncratic risk of large exposures and the more comprehensive management of concentration risk in the portfolio under Pillar 2**, whereby large exposures' limits serve as the last safeguard.

We believe **this is the most cost-efficient approach** for the industry while not imposing a significant cost from a prudential perspective.

Intra-group exposures should not be examined on the basis of the location of the group entities but rather on the basis of whether they are **part of the same consolidated supervision**. Having this in mind, provided that the **parent company has committed itself towards the supervisory authorities** concerned that it would support its subsidiaries should they need funding, **no intra-group limit should apply**.

We oppose introducing limits on interbank exposures. This would bring adverse capital difficulties for banks with no apparent prudential ground. Counterparty diversification would become more complicated, risky and costly, particularly for small banks and for banks located or active in (smaller, concentrated) markets outside the Euro-zone, whereas diversification can already been achieved without the limits.

Detailed remarks

Chapter 1. Summary of CEBS' key findings in Part 1 of its Advice

We welcome the efforts made by CEBS to provide a clear definition of the purpose of the large exposures regime. As regards the regulatory regime that should be applied to large exposures, **we agree with CEBS that the most effective tool would be an amended EU-wide limit-based backstop regime**[1] (option v, p. 16). We understand that supervisors need a supervisory-driven backstop regime or safety-net, as large exposures potentially carry high systemic risks.
Such a regime would allow maintaining the current regime's flexibility provided by the backstop facilities while addressing its shortcomings, such as regulatory arbitrage due to national discretions. However, this implies that **all national discretions should be eliminated from the current regime and a harmonised approach to regulating large exposures be followed**.

Chapter 2. Definition of Large Exposures (connected clients)

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

[1] The British Bankers' Association does not support the EBF view expressed on this point and will send its own position to CEBS separately.

CEBS has responded to the European Commission's call for technical advice by proposing an interpretation of the definition of "connected clients" in Art. 4(45) of the CRD with the aim of making the corresponding rule easier to apply in practice and achieving greater consistency in its application across Europe. We support this objective and welcome the exercise. Nevertheless, we believe the results show that **it is not possible to arrive at an interpretation which would support the prudential objective and make the rule feasible to implement in practice.**

As things stand, **the "control" criterion** is usually used to establish the existence of a group of connected clients. Basically, it is examined whether a legal person is able to control a majority of voting rights or exert power over company affairs by virtue of some other legal basis. This information is normally readily available and can therefore be given due consideration by the banks. In essence, CEBS' **proposed interpretation is consistent with current industry practice**.

The second criterion of "interconnectedness" normally plays a less important role. This is largely because it is difficult, if not impossible, to make a meaningful distinction on this basis between idiosyncratic risk affecting only the borrower and sectoral or regional risk. That is why **many European Member States currently interpret "interconnectedness" as presupposing a mutual dependency between clients. Such cases are, however, very rare or often the relevant information is not available to the banks** (especially where large-scale international business is concerned).

The economic dependency between clients belongs to the more general aspects of concentration risk under Pillar 2.

The **interpretation** proposed in paragraph 91 envisaging **that even a one-way dependency would be sufficient to qualify under the criterion of interconnectedness is**, in our view, **inappropriate and totally impracticable**. It would result in the appearance of huge groups of connected clients, often constituting sectoral or regional concentrations of risk. This is demonstrated by the examples given in paragraph 92 concerning loans to both producers and vendors of a product and to companies with the same client base.

In CP14, CEBS concludes that sectoral and regional risk cannot be adequately addressed in the context of the large exposures regime and should be dealt with under Pillar 2. Yet the broad interpretation of "group of connected clients" suggested in CP16 is an attempt to solve the problem with the wrong prudential instrument. Requiring borrowers to be considered as a group by virtue of a sectoral or industry-specific connection might lead to an inappropriate reduction in lending since it would not be possible to take account of portfolio diversification. Given the **difficulties in making a distinction between interconnectedness and portfolio concentration risk**, we suggest dropping the former as a criterion for determining the existence of a group of clients. **The interconnectedness criterion should therefore be deleted from Article 4 (45) of the CRD.**

Furthermore, **CEBS' analysis of the IKB case is questionable**. CEBS argues that the bank's difficulties were actually caused by a large exposure problem. It believes the various conduits of Rhineland Funding should have been regarded as a group of connected clients as they were all financed by commercial paper and that the large exposure rules should have therefore been applied, which would have prevented IKB from providing Rhineland Funding with liquidity facilities much in excess of its regulatory capital. In our view, however, **the large exposure rules would not have been the right tool** to prevent banks from engaging in this type of business on an excessive scale.

The assets invested by the various conduits operating as trusts under the Rhineland trustee came from different regions and sectors. It is easy to demonstrate that the trusts and trustee were legally

independent from one another. The control criterion is therefore not satisfied. Moreover, even if regulators insisted on treating trusts and trustee as a single entity, banks could still continue these operations on an unlimited scale by constantly creating new trustees.

As the conduits had been invested in different regions and sectors, the interconnectedness criterion is not fulfilled either. Applying this criterion to a refinancing tool would place an unreasonable restriction on doing business in the short term and encourage the creation of alternative refinancing tools in the long term. This can, therefore, not be considered as the adequate approach. **The correct instrument for addressing this problem is Pillar 2**, under which all the risks associated with such transactions have to be weighed against the bank's regulatory and economic capital and a suitable means of monitoring these risks agreed in consultation with regulators.

We would therefore suggest that the **treatment of the risk resulting from common major sources be placed in Annex V of the CRD to allow supervisors to address it through a dialogue with banks**.

Chapter 3. Definition of Exposure Values

We would like to point out that the CP16 does not mention the formula for calculating the exposures amount to be compared with own funds.

We would ask CEBS to clarify their intentions in that respect and would be prepared to discuss it with them.

Our preliminary thinking would be that for advanced institutions, the Probability of Default (PD) should not be considered for large exposures purposes as exposure values give a view of the risk linked to a particular position, independently of the PD of that position. On the other hand, credit risk mitigation should be taken into account.

On-balance sheet items

We agree that exposure value should be considered net of provisions and value adjustments. We nevertheless believe that this **general rule should not apply to gains in value of available-for-sale securities (GV)**, which have been included in the balance sheet but do no impact profit and loss (P&L). Reason for this is that should these GV result from an improvement in the counterparty's credit quality which is reflected in the security's price an increase in the use of the 25% limit would follow, with a consequent perverse effect: the availability to lend to this counterparty would be reduced, even if those gains were fully considered in regulatory capital. This goes against the principle of non-consideration of the counterparty's credit quality.

This perverse effect would be bigger in jurisdictions where supervisors allow a lower increase in Tier II, as they apply a bigger haircut to GV (national discretion). Consequently, to mitigate this negative effect, **the amount of GV included in the exposure value for large exposures purposes should be aligned with the amount allowed for inclusion in regulatory own funds.**
Even if the review of the large exposures regime is indeed not intended to eliminate the national discretions on Pillar I or eligible capital contained in the CRD, it should try to neutralise their distorting impacts.

Nevertheless, GV could also obey general market factors. It would therefore be unreasonable to propose an entire neutralization. Having in mind the difficulty to establish a large exposures' regime which would consider separately both causes of value increase, we would propose that **banks be allowed certain flexibility so that they would be able to mitigate the above-mentioned perverse effect when required**. For instance, all banks could be given the **option not to consider the GV in their exposure to an individual counterparty if at the same time these exposures are excluded from their regulatory own funds**.

Q. 4 to 7. Off-balance sheet items (other than derivative instruments and securities financing transactions)

For standardized and foundation IRB institutions, CEBS' initial view to **apply a 100% conversion factor for medium/low risk items** (e.g. undrawn credit facilities of up to 1 year maturity) **would be unnecessarily conservative**. The CRD provides for a 100% conversion factor only for full risk items: this should also apply to large exposures.

We share the arguments set out against this view, which are presented in paragraphs 109 and 110 of the CP.

We believe that those cases where undrawn credit facilities are not cancelled for reputational reasons are clearly exceptional and **do not justify applying a higher conversion factor than 0%**. The CRD already sets a sufficient number of qualitative requirements to comply with before applying a 0% conversion factor to address prudential concerns.

For Advanced IRB institutions, we do not share the view that additional principles for the use of internal exposures calculation, as those proposed in paragraph 113, should be placed on top of the already existing requirements to be allowed to use internal calculation for regulatory capital purposes. **Provided that their own calculation method for regulatory capital has been approved by their supervisor, advanced IRB institutions should be permitted to use it for large exposures purposes**.

3.3. Financial derivatives and securities financing transactions

In paragraph 116, CEBS states that "Institutions that have obtained permission to use the Internal Model Method (…) also need to comply with the same principles as the Advanced IRB institutions". In our understanding these principles refer to those mentioned in paragraph 113.

We would like to draw your attention on an important issue: **the use test requirements in the context of the Internal Model Method must not result in a request to use Potential Future Exposure (PFE) for large exposures purpose**s. The use of PFE would mean that large exposures calculation could differ widely from one institution to another, simply because of internal model differences in their PFE approaches (level of confidence used, etc...).

We therefore propose that, for large exposure purposes, institutions should use their Expected Positive Exposure (EPE) while internally they carry on using PFE. We believe that the use of PFE will satisfy the use test requirement for EPE because both measures are based on the same simulation.

Chapter 4. Credit Risk Mitigation and indirect exposures

Q9. Do you agree that for large exposures purposes there can be cases where it is justified to treat mitigation techniques in a different way from the treatment under the minimum capital requirements framework? Please explain your view and provide examples. And where relevant, please provide feed back on the costs and benefits.

We disagree with the proposal to treat mitigation techniques in a different way from the CRD. We do not fully support CEBS' conclusions and theoretical findings respectively in that respect and it would create important additional costs with no added value from a risk management perspective.

We accept CEBS' initial view that the recovery of the amounts should be certain and timely to avoid traumatic losses (paragraph 130). However, the real question is not whether collateral can be recovered within a specific period of time but whether **the haircuts applied are conservative enough to guarantee the quality of the underlying assets**. This key issue has already appropriately been addressed within the CRD. As a result, the CRD minimum requirements for and calculations of risk mitigation instruments do satisfy the needs of the large exposures regime.

We support CEBS intention to follow as closely as possible the CRD framework for eligible credit protections. This would contribute to further harmonising differences between institutions but also between jurisdictions.

Nevertheless, some institutions are currently more advanced in their risk management practices than others. Consequently, a certain degree of flexibility should, at this stage, be upheld to recognise some differences between institutions' management of credit protections for large exposures purposes.

Q. 10. Do you agree that the three alternative set out for the recognition of CRM techniques are the relevant ones? Do you think there are other alternatives CEBS should consider? Please explain your views and provide examples. And where relevant, please provide feedback on the costs and benefits.

Consistently with our positions expressed above, we support proposal # 1 to accept the same protection treatment in both the large exposures and the minimum capital frameworks.

Q. 13. Do you agree that physical collateral should not in general be eligible for large exposures purposes? Do you support CEBS' views that residential and commercial real estate should be eligible and that the current large exposures rules should be applied instead of the minimum capital rules? Please explain your views and provide examples. And where relevant, please provide feedback on the costs and benefits.

We believe that the proposed treatment of physical collateral is (1) too conservative, (2) diverges unnecessarily from CRD rules and (3) falls short of rewarding good risk management practices:

1) The proposal is deemed too conservative as recognised protection for real estate collateral would be only 50% and 0% for other physical assets. Within this latter category of collaterals, in the case of assets such as receivables and commodities, which are characterized by their liquidity and widespread use by the industry, we would like to stress the importance of protection recognition.

2) It diverges unnecessarily from the CRD, which would mean increased costs for institutions because:

- the capital rules already take into account different conservative elements for physical assets:
  - Downturn adjustment of LGD;
  - Liquidity requirement for other physical assets (see Annex VIII – Part 1 – Par. 21);
  - Other requirements for the recognition of real estate and other physical collateral (Annex VIII – Part 2 – Par. 8 and 10).

- It would require banks to implement two IT systems: one for the calculation of the credit risk mitigation effects for the minimum capital requirements and another one for large exposures.

- It overstates costs from a prudential perspective. CP 16 already recognises in paragraph 117 that given that "it is unlikely that a large exposure could arise from these transactions (...) there is not much gain from a prudential perspective in not accepting these elements [real estate collateral] as eligible protection". We believe that is also the case for other physical collaterals which comply with CRD requirements.

3) It does not sufficiently reward good risk management practices as it does not recognise a type of CRM instrument which is widely used in risk management.

The proposed treatment for unfunded credit protection (p.36) is aligned with that of the CRD except in the case of the application of double default. We find there are merits in recognising the double default effect also for large exposures purposes and funded credit protection. Applying only a

substitution approach would, in our view, clearly overestimate the risk of a guaranteed exposure since it would be treated as any other unsecured exposure of the guarantor.

In conclusion, we believe that applying alternative #1 would have very limited prudential cost and would at the same time reduce costs for institutions while enhancing good risk management practices.

Chapter 6. Intra-group exposures

Q.19. Do you have any comments on the market failure analysis on intra-group exposures?

The macro-economic approach of CEBS' market failure analysis leads to questionable results from a micro-economic, i.e. individual bank's, perspective.

Q.20. Could intra-group large exposures limits give rise to other costs and benefits? Please explain your response.

Imposing intra-group large exposure limits would give rise to the following costs:

- For the global economy, they would create an additional barrier to the free movement of capital within the EU and to the progress towards the single European market for financial services.

- **But more fundamentally, they would increase dramatically the liquidity risk for affiliates.** When a "failure rumour" on a particular counterparty is starting to circulate in the market, banks immediately start to cut first the limits of the counterparty and of its affiliates and then reduce the limit of its parent. If intra-group limits hinder that parent or its affiliates to help that counterparty, the liquidity risk could endanger the counterparty; moreover it could affect other affiliates that are not really concerned by the rumour. Small entities are particularly at risk.

- Intra-group limits would imply that banks deeply review their funding policy. Banks would indeed lose authority on their funding resources because **captive intra-group funding would disappear**. They would have to rely more extensively on the interbank money market, which is by nature more instable and more expensive than the intra-group funding.

- Intra-group limits would oblige small subsidiaries to equip themselves with new dealing room personnel and equipment for managing their liquidity and third party exposure, thereby **increasing their cost base and operational risks**. Many banking groups have concentrated their dealing room investment and expertise in very few centres of excellence, based on the assumption that intra-group liquidity may freely circulate.

- As banks tend to give a preference to their local market, subsidiaries that are limited by an intra-group large exposures limit would certainly place most of their surplus funds with a small number of local counterparties. That could **increase counterparty and geographic concentration risks**, especially for banks situated in small countries and would probably also have opportunity costs.

- Intra-group large exposures limits would oblige affiliates to give each other more collateral, thus incurring significant additional costs:

- The **cost of collateral would significantly increase**, given that collateral markets within the EU are neither perfectly liquid nor efficient. It is indeed acknowledged that there is a lack of consistency in collateral eligibility and transferability between central banks in different countries, and that there is no common definition of what "good" collateral means.
- **Administrative costs** to manage and control the collateral **would rise**.

- The **direct interference with liquidity management** within the banking group seems underestimated in CP 16. Taking into account intra-group exposures might prevent banking groups from managing their liquidity centrally and efficiently allocating it amongst their different entities.

- The cumulative impact of imposing intra-group limits and limits on interbank exposures with a maturity of less than one year would **unduly interfere with the capital allocation policy of banking groups**: in order to maintain their existing volume of transactions and some existing business models, banks would have to:
  - reallocate capital amongst the group;
  - raise the capital of some subsidiaries, which would not necessarily be required for solvency purposes according to the CRD.

Q. 21. What are your views on the proposals/options for the scope of application of the large exposures regime?

Intra-group limits fall outside the scope of the large exposures regulations. Indeed, the large exposures regime is based on the principle that groups should be considered as one when assessing exposures. Large exposures limits on sub-consolidated levels and on individual group members thus have **no value from a risk management perspective and only constitute a reporting and administrative burden**.

We would like to draw CEBS' attention to Article 111(2) of the CRD which provides for a 20% limit to group entities.
As a group possesses a much wider and more detailed amount of information on its entities than as regards third parties, we fail to see the prudential rationale behind imposing a stricter limit on group entities than the 25% limit assigned to third parties. **We strongly oppose this 20% limit and therefore propose to delete Article 111(2).**

Q. 22. Which treatment do you believe is the most appropriate for intra-group exposures i) to entities within the same Member State; ii) to group entities in different Member States and iii) to group entities in non-EEA jurisdictions?

As a general rule, limits for intra-group exposures imply a significant obstacle for banks' liquidity management and cannot be justified in the case of centrally-managed institutions.

Consequently, we believe that **all intra-group lending between entities that are subject to the same consolidated supervision should be exempted from the large exposure limits**, regardless of the location in which these entities operate, provided that the parent company committed itself vis-à-vis the supervisors that its subsidiaries would be supported should it need funding.

Holdings or investments of the parent company in other credit or financial institutions, considered as equity exposures on the parent company's individual balance sheet, where such holdings or investments are part of the consolidated risk management of the group and where these credit or financial institutions are controlled and supervised on a consolidated basis, **should be**

exempted from the scope of the large exposures regime and not subject to any limits. This would otherwise restrict the way cross-border groups are managed and unduly affect their investment decisions in other credit institutions. The existing prudential mechanisms already sufficiently address investment issues.

i) Intra-group exposures to entities within the same Member State

We would ask CEBS to clarify its position regarding the conditions to fulfil to benefit from the exemption from the large exposures rules.

Paragraph 211 of the CP states that third party large exposure limits should not apply to subsidiaries that meet the criteria set out in Article 69(1), 69(2) and 69(3) of the CRD. Article 69(1) refers to subsidiaries of a credit institution, where both the subsidiary and the credit institution are subject to authorisation and supervision by the Member State concerned and the subsidiary is included in the supervision on a consolidated basis of the credit institution which is the parent undertaking. The following further conditions must also be satisfied:

a) there is no current or foreseen material, practical or legal impediment to the prompt transfer of own funds or repayment of liabilities by its parent undertaking;
b) either the parent undertaking satisfies the competent authority regarding the prudent management of the subsidiary and has declared, with the consent of the competent authority, that it guarantees the commitments entered into by the subsidiary, or the risks in the subsidiary are of negligent interest;
c) the risk evaluation measurement and control procedures of the parent undertaking cover the subsidiary;
d) the parent undertaking holds more than 50% of the voting rights attached to shares in the capital of the subsidiary and/or has the right to appoint or remove a majority of the members of the management body of the subsidiary.

Articles 69(2) and (3) extend this provision to situations where the parent undertaking is a financial holding company and a parent credit institution in a Member State where that credit institution is subject to authorisation and supervision by the Member State concerned.

Paragraph 214 states that provided the conditions in Article 80(7) and 80(8) are met, intra-group exposures of creditor entities located in the same Member State as debtor entities should be exempted from the limits. Articles 80(7) and 80(8) set out the following criteria:

a) the counterparty is an institution or a financial holding company, financial institution, asset management company, or ancillary services undertaking subject to prudential requirements;
b) the counterparty is included in the same consolidation;
c) the counterparty is subject to the same risk evaluation measurement and control procedures as the credit institution;
d) the counterparty is established in the same member state;
e) there is no current or foreseen material, practical or legal impediment to the prompt transfer of own funds or repayment of liabilities from the counterparty to the credit institution.

As it appears from these listings, the conditions as set out in Article 69 do not directly overlap with the conditions set out in Article 80(7). **Clarification is therefore required as to which criteria must be satisfied in order for intra-group exposures between entities within the same Member State to qualify for exemption from the large exposure rules.**

The CRD currently provides for an exemption for intra-group exposures from the large exposure limits. This exemption is contained in Article 113(2), which states that Member States may fully or partially exempt exposure incurred by a credit institution to its parent undertaking, to other subsidiaries of that parent undertaking or its own subsidiaries provided those undertakings are covered by the supervision on a consolidated basis to which the credit institution itself is subject.

The conditions that must currently be satisfied in order to qualify for an exemption are therefore much narrower than those proposed in the present CP. Therefore, **while CEBS' proposals would ensure that all Member States allow for an exemption of intra-group exposures within a same Member State, the conditions that must be satisfied in order to avail of this exemption would be more restrictive under the revised rules.**

Furthermore, the **interpretation of the conditions**, such as the absence of foreseen material, practical or legal impediments **to the transfer of own funds or repayment of liabilities, is likely to differ across supervisors, leading to inconsistencies** in the way the same basic rules would be applied across Europe. For instance, this condition also applies under the amended solo provision, as set out in Article 70.

ii) Intra-group exposures to group entities in different Member States

We support CEBS' fourth option (in paragraph 224) with regards to the treatment of intra-group exposures to group entities in different member states. **It is sensible that no large exposure limits apply to group lending between entities that are subject to the same consolidated supervision**, for the following reasons:

- **Capital and/or liquidity should be transferable cross-border without impediment**. Nevertheless, it seems that capital transferability is a CEBS' concern. We would advise that this be further analysed by CEBS and the subsequent outcome taken into account before issuing any recommendation.

- For the majority of large banking groups (and particularly for cross-border groups), risk management, including **the tracking of large exposures/counterparty risk is highly centralised.** Sophisticated on-line risk management systems are tracking exposures regardless of the affiliate and the instruments (on and off balance sheet). They are calculating the true exposure by applying fair value models and adding a safety margin to cope for market movements. The soundness of this risk management process is further enhanced and monitored through the implementation of the Basel II Framework (stress-testing, back-testing, model review and validation process …).

Intra-group lending and the flexibility thereof are pivotal to the functioning of the financial markets as well as to the banking industry's liquidity management, as evidence has shown over the past months. We do not see the operation of deposit guarantee schemes as a justification for imposing limits on these exposures. The deposit guarantee scheme is a separate scheme, with the specific objective of providing protection to depositors of failed banks. This is not the objective of the large exposures framework.

However, for transparency's sake, **we are in favour of a reporting-only regime whereby supervisors may take remedial actions, if necessary, under Pillar 2 of the CRD**.

iii) Exposures to group entities in non-EEA jurisdictions

We do not support CEBS' outlined approaches in paragraph 226. We believe indeed that exposure limits should not apply to group lending between entities that are subject to the same consolidated supervision in accordance with the CRD or with equivalent standards in a third country. Both options outlined in paragraph 226 would lead to discrepancies in how these large exposure rules would be applied across Europe. CEBS, in conjunction with the industry, is currently working to reduce the number of national discretions contained in the CRD. Options 2 and 3, by adding to the numerous national discretions already enshrined in the CRD, would therefore be totally counterproductive to this work.

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

Consistently with our response to questions 21 and 22 above and our opinion whereby no limit should apply to intra-group exposures, we have no comments to make regarding the high-level principles proposed by CEBS to define intra-group limits.

Q. 24. Do you agree with the proposal to invite the Commission to consider exempting investment managers from a future large exposures regime? Please explain your views and provide feedback on the costs and benefits.

As noted by CEBS, investment management firms, which do not deal on own account, do not create or take on the sort of risk contemplated in the large exposures regime. Similarly, there is essentially no risk to client assets since investment management firms falling within the definition of Article 20(2) of the CRD separate client assets from their own, do not accept deposits and do not lend to clients. Finally, current large exposure rules do create a substantial compliance burden for investment management firms, with minimal (if any) benefit to underlying clients/consumers.

We therefore support CEBS' proposal to exempt investment management firms falling within the definition of Article 20(2) from the large exposures regime.

Chapter 7. Sovereigns…

Q. 26. What are your views on the proposal to remove the national discretion and to automatically exempting exposures to sovereigns and other international organisations (within Art. 113.3 (a-f)), as well as some regional governments and local authorities?

We strongly support the proposal to remove the national discretion to fully or partially exempt the exposures described in Article 113.3 (a-f) from the large exposures limits.

As regards the exemption of exposures to some regional government and local authorities, we understand that direct exposures to and exposures secured by such authorities would also be subject to the exemption.

Whenever a competent national authority recognises an exposure to a regional/local public entity as being equivalent to an exposure to the central government under the CRD, that regional/local public entity the exemption should be exempted from the large exposures regime.

Similarly, and having in mind that national discretions should be removed, the decision of a competent national authority to recognise an exposure to a regional/local public entity as being equivalent to an exposure to the central government should automatically be recognised by the other Member States' competent authorities.

Chapter 8. Interbank exposures

Q. 29. Do you consider that large interbank exposures of all maturities are associated with the market failures identified?

We agree with the market failures described by CEBS, whereby the likeliness of a bank failure leading to multiple defaults would significantly increase in the situation where other institutions would be heavily exposed to that failing bank. However, in our view the chances of such an unforeseen default for low maturities and highly-rated counterparties are non-substantial and the cost of insulating the banking sector from such an event would be too high relatively to the benefits.

Furthermore, the management of interbank exposures would be more adequately addressed within the framework of liquidity risk management than the large exposures regime.

Considering the prudential controls banks are submitted to, it is assumed that the overall risk arising from interbank exposures is lower than exposures to other counterparties.

A full harmonisation of the treatment of interbank exposures is absolutely necessary.

Q. 30. What do you consider to be the implications of the caveats set out above for the conclusions of the cost/benefit analysis? Do you have any comments on the cost/benefit analysis?

We value CEBS' attempt to quantify the impact of introducing a backstop at 25% of banks' capital. However, the cost/benefit analysis of imposing a 25% hard limit on interbank exposures with a maturity of less than one year seems to be based on assumptions and caveats that may have significant impacts for the banking industry. In particular:

- we do not agree that banks would be able to diversify or collateralise their large exposures without excessive costs;
- the assumption that the markets (especially the collateral markets) are deep and liquid enough is questionable;
- the markets are not equally available to all banks, and a 25% limit would unlevel the playing field between large and smaller/medium banks.

Our analysis is that **a 25% hard limit would create huge costs for the banking industry** compared to low benefits. The main issues are the following:

Diversification of counterparties and collateral

A 25% hard limit on interbank exposures of less than one year maturity would force banks:

- to diversify their counterparties and/or
- to collateralise their existing unsecured exposures.

However, **diversification has already been achieved without having the 25% limit** while imposing such a limit would have the following consequences:

- **counterparty and geographic concentration risks,** especially for banks situated in small countries **would increase;**
- **a two-tier system** (large players versus smaller/medium banks) **for the access to and distribution of liquidity and collateral would be created** thus unlevelling the playing field.

Due to their competitive position, large players would indeed have a more direct access to first quality counterparties and to "good" collateral, whereas smaller/medium banks would have to move to more risky counterparties presumably on a non-collateralised basis. Moreover, most small/medium banks would have to act in their local market with a small number of local counterparties.

Impact on liquidity
Liquidity must be transferable across institutions and border without impediment. A large exposures limit for exposures of less than one year would make liquidity management and liquidity risk management more difficult.

It would increase liquidity management costs for large and small banks alike, and could aggravate situations where overall liquidity is scarce. This scenario is particularly problematic for (smaller) countries outside the Euro-zone and where there are few counterparties. We truly believe that this dilemma would be diminished if shorter maturities were exempted from the regime of large exposures' limits.

Funding liquidity management is an activity of a different nature than lending. It is a short-term activity, driven by needs that are often not foreseeable, while longer-term exposures imply a conscious choice by the concerned institution.

A backstop regime for large exposures would not appropriately address liquidity issues. According to Article 113(i) of the CRD, Member States may currently exempt unsecured exposures to institutions of less than one year maturity: this regime has proved very helpful in facilitating the free flow of liquidity in the crisis situation which we have been facing since August 2007.

Impact on capital
In the absence of sufficient collateral available and in order to maintain their existing volume of business, banks would have no other choice than raising more capital. In these times of turmoil, we know that capital is a rare and expensive resource. As a consequence, we anticipate that this would **increase the cost of capital and decrease the risk-adjusted return on capital for the shareholders**.

As for intra-group exposure, another consequence would be a misalignment with the CRD and the capital allocation policy of banking groups: the large exposures rule **would require additional capital, which would otherwise not necessarily be required for solvency purposes according to the CRD.**

Last but not least, the benefit of raising more capital is questionable in the case of a liquidity crisis.

Impact on some business models
Some banks rely primarily on the interbank money markets for their funding because they are not active in the retail or the private banking businesses: their business model would be severely hit by an increased cost of liquidity.

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

A 25% limit may hamper banks' access to liquidity. **Maturity of exposures should absolutely be taken into account**, as this would allow regulators to distinguish between funding liquidity and credit allocation. Most funding liquidity operations have a one to three month timeframe. We favour

retaining the current one year limit to include all liquidity-related operations. **Intraday and overnight-only operations should be excluded** from the regime as they are purely driven by funding liquidity needs.

As stated for intra-group exposures limits, **imposing stricter interbank limits would affect the liquidity management** of banks and would increase both the risk and the potential impact of a liquidity crisis.

Please see under "Impact on liquidity" above and our response to Q. 33 below.

Q. 31. Given the market failure and cost/benefit analysis set out above, what treatment would you consider appropriate for interbank exposures?
Q. 33. If you believe there is a market failure but a hard 25% limit would not be appropriate, what would you consider an appropriate treatment for interbank exposures?

The current rule which allows Member States to exempt interbank exposures of less than one year maturity (**Art. 113.3(i)**) represents a national discretion. In order to secure an equal free flow of liquidity across the EU this **should be amended into an obligatory rule for all Member States**. In this context, we emphasise that an approach which would create different rules for larger and smaller banks would only create problems of definition and an unlevel playing field.

We support the initial Basel finding of 1988 whereby supervisors have to have sufficient information on the interbank market. This is why all large interbank exposures should be reported within the supervisory large exposure reporting.

Chapter 9. Breach of limits

Q. 34. Respondents' views on the approaches to non trading book breaches of the limits would be welcomed. Please explain your views and provide examples and feedback on relevant costs and benefits.

Consolidated level:

Having in mind that the large exposures regime is meant to be a backstop regime, no breach of limits should be acceptable at the consolidated level, as indicated by CEBS in paragraph 299 as the first option. We refer to our answer to Q. 33 above for the calculation of that limit.

Supervisors must systematically be informed of any breach and anticipated breach. The bank would then explain the kind of action it has taken or planned to take to remedy the situation; supervisors would impose appropriate measures and the excess would be deducted from the banks' own funds. A penalizing deduction, e.g. of the full outstanding exposure to the client, would complicate the situation and increase the risk of systemic consequences. Such a measure should thus be left out.

Subconsolidated or solo levels:

A breach of limit by a subsidiary (at subconsolidated or stand-alone level), which would not involve an overall breach at consolidated level, concerns only the spreading of an acceptable risk position at group level amongst the banking group's entities. It should be possible to maintain the breach over a longer period of time as proposed in option # 3 in paragraph 301, although without deducting the excess from own funds.

A breach at subsidiary level should not lead to a penalty being imposed. It should be discussed within the college of supervisors.

From a general perspective, breaches should be considered acceptable (no capital to set aside) in the following, exceptional, situations:

- When they would result from the failure of a counterparty which would lead to the creation of an indirect exposure – and the possible breach of a large exposure limit. Such a situation would trigger the selling of that collateral for the exposed institution to be able to reimburse the loss. It should however be taken into account that, given the possible impact on the market, such recovery might not be possible within a very short timeframe. It should then be assumed that the bank would aim at selling the collateral and thereby manage its exposure to the collateral issuer downwards.

- When they would result from unforeseen events, e.g. operational errors by counterparties, and resolved within a short timeframe.

- Short-term interbank exposures – and breaches of limits - should be exempted from the large exposures regime overall, as argued under Chapter 8 on interbank exposures above.

Chapter 10. Reporting issues

The increasing centralization of risk management functions should be matched by reporting requirements made only at the top, consolidated level to reduce the burden of duplicative requirements to a minimum. Reporting requirements at statutory or sub-consolidated level would furthermore not serve the prudential objective of the large exposures regime. They would therefore be unjustified and should not apply.

We **reject option 1** in paragraph 310 to **include large exposures reporting into the Pillar 3 reporting** on the following grounds:
- Pillar 3 reporting currently requires to report at least once a year; the merit of reporting breaches which occurred in the previous year and which were then duly solved is questionable;
- Market disclosure of large exposures figures could be misinterpreted by analysts;
- As it concerns *large* exposures, there is a risk that the bank's customer be easily identified, which is contrary to banks' confidentiality rules.

We support option 2 "Reporting to supervisory authorities based on financial institutions' internal reports". This would in practice mean using the concentration risk reporting. This would allow avoiding duplication of reporting for banks while supervisors would benefit from better information and a high added-value SREP.

Reporting **option 3 could be a second-best solution** and would have to duly take into account the following aspects:

- **Reporting should be done on the same accounting (IFRS) basis.** For solvency reporting, the use of IFRS on consolidated level and of local GAAP at the statutory level prevents the integration and comparability of a same institution's different Common Reporting (COREP) templates. Calculations give different results for the minimum required capital, the solvency ratio calculations and general COREP figures under the two standards.

More particularly, Article 74(1) and opening statement 33 in the CRD should be amended to specify that credit institutions which apply the international accounting standards in accordance with Council Directive 86/635/EEC or Regulation (EC) 1606/2002 may **consistently use, for the purpose of regulatory reporting, the international accounting standards for the parent undertaking on a stand-alone basis and for the subsidiaries at both sub-consolidated and stand-alone levels**. This would allow banking groups to use their parent entity's accounting standard consistently throughout the group.

- Reporting on large exposures should be harmonized at EU level through a **unique format, not only as for the reporting content but also concerning its frequencies and delays.**

- **As regards the content of reporting under the large exposures regime, it is essential that inter-operability with COREP be ensured.** The elements which are already required in the COREP templates should not be requested again for large exposures purposes. Moreover, the exposure values should be calculated along the same lines as for the COREP templates (please also see under "Definition of exposure values" above).

- Finally**, we are in favour of the reporting exemptions laid down in Article 110(2)**. These should be maintained as a general rule.

Q. 36. Do you support CEBS' thinking on the purpose and the benefits of regular reporting using predefined reporting templates?

Please see our comments above regarding reporting option 3.