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IBF COMMENTS TO CEBS' SECOND CONSULTATION PAPER ON TECHNICAL ADVICE TO THE EUROPEAN COMMISSION ON THE REVIEW OF THE LARGE EXPOSURE RULES

1.0 The Irish Banking Federation welcomes the opportunity to comment on CEBS' second Consultation Paper (CP16) on technical advice to the European Commission on the review of the large exposures rules. Our specific comments to the consultation paper are set out below. Before addressing these points, we would like to highlight that while we welcome a number of CEBS proposals, we are particularly concerned with the proposals regarding intra-group exposures and interbank lending. Both sets of proposals will significantly restrict banks' access to liquidity and when considered together, the effects are even more severe. The proposed intra-group restrictions will also seriously impact the business models of a number of specialist institutions operating in Ireland, including those that act as funding vehicles for group operations and those that rely on parental guarantees. We are also of the view that further attempts to align the large exposure rules with the credit risk component of the Capital requirements Directive (CRD) could be made.

Chapter 1: Summary of CEBS' Key Findings on Part 1 of its Advice

2.0 As noted in our response to CP14, we are of the view that the objectives of the large exposures framework could be addressed by the Pillar 2 framework. While we accept CEBS' cost-benefit analysis and its findings in this regard, we are of the view that further consideration should be given to this approach, and that any such analysis should consider more than monetary costs and benefits.

Chapter 2: Definition of Large Exposure (connected clients)

3.0 We welcome CEBS efforts to clarify the interpretations of 'control' and 'interconnectedness'. However, the proposed interpretation of 'interconnectedness' is likely to cause problems for banks as it will prove very difficult to determine and demonstrate unilateral control. The fact that it is proposed to include this definition within the CRD causes particular issue. As such, we would suggest that the 'interconnectedness' criterion be removed. At a very minimum, the suggested

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interpretations should remain as principles rather than strict rules, with the individual institution still determining whether two clients are connected.

3.1 On the proposed interpretation of control, we would suggest that the definition be widened to also include entities where there is effective control. The proposed definition would therefore read; ""Two or more natural or legal persons who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly, has control, or effective control over the other or others".

3.2 We would also like to highlight the importance of the principle of mutual recognition in this context. If one Regulator recognises that two clients are not connected, all other impacted Regulators should also accept this determination. Institutions should not be forced to apply different treatments to the same counterparty based on whether the assessment is being made in the home or a host country.

3.3 In paragraph 90, it is proposed that subsidiaries of central governments, regional governments, or local authorities would not normally be grouped together as connected clients. It is our members' view that for prudence purposes, such subsidiaries should in fact be grouped together, as a number of situations have occurred in an Irish context to highlight the fact that such subsidiaries are not completely detached from one another.

Chapter 3: Definition of Exposure Value

4.0 We welcome CEBS' proposals to allow banks to calculate their exposure values for on-balance sheet items using relevant accounting standards, net of accounting provisions and value adjustments.

4.1 We are however concerned with CEBS' proposed treatment of off-balance sheet items for Standardised and Foundation IRB banks. We see no justification for increasing the Credit Conversion Factor (CCF) applied to medium/low risk off-balance sheet items from 50% to 100%. This proposal is in our view overly conservative, further misaligns the credit risk and large exposure rules, and will cause system issues for banks.

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4.2 On the proposed treatment of off-balance sheet items, we welcome CEBS decision to allow institutions adopting the Advanced-IRB approach to use their own exposure calculations as used for credit risk purposes. We do not however see the justification for limiting this provision to Advanced-IRB banks and are of the view that institutions capable of determining their own exposure calculations should be permitted to base their large exposure management on these figures.

Chapter 4: Credit Risk Mitigation & Indirect Exposures

5.0 The Irish Banking Federation welcome CEBS' efforts to align the recognition of credit risk mitigants under the credit risk and large exposure rules. We would support proposal 1 which would involve accepting the same protection treatment in both the large exposures and minimum capital frameworks.

5.1 We do not fully support the stance that has been taken on physical collateral, particularly with regard to real estate collateral. While we recognise that some form of haircut should be applied to this form of collateral, the proposal to recognise only 50% of the value is in our view overly conservative. The quality of the collateral rather than the liquidity of the collateral should be the determining factor for recognition.

Chapter 5: Trading Book Issues

6.0 The Irish Banking Federation supports CEBS' decision to maintain the current trading book large exposure rules. The distinction between the banking book and trading book rules is in our view justified.

6.1 In line with this, we do not support the proposal that banks with excess exposures in the trading book deduct the excess from capital instead of applying a charge for the excess. The current approach operates satisfactorily and any amendments are in our view unnecessary.

Chapter 6: Intra-Group Exposures

i) Entities within the same Member State

7.0 The Irish Banking Federation supports CEBS proposal that intra-group exposures between entities located within the same member state should be exempt from the

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large exposure limits. However, CEBS position in this regard is not entirely clear from the paper. Paragraph 211 of the paper 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). 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 states where that credit institution is subject to authorisation and supervision by the member state concerned.

Paragraph 214 states that provided the conditions as set out 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 exempt from the limits. Articles 80.7 and 80.8 set out the following criteria;

e) the counterparty is an institution or a financial holding company, financial institution, asset management company, or ancillary services undertaking subject to prudential requirements,
f) the counterparty is included in the same consolidation,

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g) the counterparty is subject to the same risk evaluation measurement and control procedures as the credit institution,
h) the counterparty is established in the same member state,
i) 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 can be seen 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.

7.1 The CRD currently contains an exemption for intra-group exposures from the large exposure limits. This exemption is contained in Article 113(2) of Directive 2006/48/EC. This articles 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 undertaking 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 this paper. Thus, while CEBS' proposals will ensure that all member states allow for an exemption of intra-group exposures within the same member state, the conditions that must be satisfied in order to avail of this exemption will be more restrictive under the revised rules. Furthermore, the interpretation of the conditions such as there being no current or 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 how the same basic rules are applied across Europe.

7.2 We would also like to take this opportunity to comment on the current limit that applies to exposures to parent, subsidiaries of the parent and subsidiaries of the institution itself that are not subject to the same consolidated supervision. The CRD

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specifies that such exposures are limited to 20% of own funds, rather than the general limit of 25%. On the grounds that institutions will have greater access, and thus, better capabilities to assess the financial strength and risk management capabilities of a group entity as opposed to that of a third party, we question the rationale behind this restriction and suggest that the same limit applies to lending to these entities as applies to a third party.

ii) Entities in different Member States

7.3 We support CEBS fourth option with regards to the treatment of intra-group exposures to group entities in different member states. It is in our view, justifiable that no large exposure limits apply to group lending between entities that are subject to the same consolidated supervision.

7.4 Intra-group lending and the flexibility thereof, is pivotal to the functioning of the financial markets, and the banking industry's liquidity management, as we have seen evidence of over the past number of months. We see no justification to restricting the movement of liquidity within a group, either between sister subsidiaries or between parent and subsidiary entities. Any efforts to do so will force banks to place a heavier reliance on the inter-bank market. This is counterintuitive given that CEBS is also proposing to restrict inter-bank lending.

7.5 In addition to the impact on liquidity, the proposed restrictions could also seriously impact the business models of institutions. A number of subsidiaries operating in Ireland, for example, act as funding vehicles for their parent and subsidiaries of the parent. Such business models may no longer be viable if institutions are restricted in transferring the funding that is generated by the Irish entity throughout the group. As such, the proposals to limit intra-group exposures could lead to a number of operations being withdrawn from Ireland and other locations around Europe.

7.6 It is noted in paragraph 90 of the paper that parental guarantees are provided to subsidiaries to facilitate third-party counterparty exposures. This is quite common in Ireland, particularly for smaller wholesale banking institutions. The provision of a parental guarantee allows these smaller operations to engage in lending that they would not otherwise be in a position to do. The proposed amendments will restrict

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the ability of subsidiary operations to avail of such parental guarantees, therefore endangering the viability of the banking model operated by these small wholesale banks.

7.7 Introducing intra-group limits may also negatively impact the risk management capabilities of institutions. Global banking institutions often transfer exposures of a certain nature to the entities best placed to manage these risk sources. An institution operating in France for example might conduct a transaction with one of its customers in France. However, the subsidiary in Luxembourg might have specialised capabilities in managing these forms of exposure and thus, the French subsidiary would transfer the exposure to Luxembourg. This is an essential and key means of controlling risk for these entities that would be eliminated if restrictions on intra-group lending are introduced.

7.8 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

iii) Entities in non-EEA jurisdictions

7.9 As noted above, it is our view that all intra-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, should be exempt from the large exposure limits. The focus should be on whether the entities are part of the same consolidated supervision, rather than on the location in which these entities operate. The same principles as set out with regard to exposures within the EEA underpin our position; intra-group lending is fundamental to the functioning of the financial markets, and the banking industry's liquidity management. We do however accept that further assurances would be needed with respect to entities in non-EEA jurisdictions and therefore suggest that in order to avail of an exemption for such exposures, a commitment should be provided by the parent to provide funding to the subsidiary if and when required.

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Chapter 7: Sovereigns, International Organisations, MDBs & PSEs

8.0 The Irish Banking Federation supports CEBS proposals to exclude exposures to sovereigns, international organisations, multilateral development banks, and public sector entities from the large exposure limits.

Chapter 8: Interbank Exposures

9.0 The Irish Banking Federation is totally opposed to the proposals on interbank exposures. When the large exposure rules were first introduced, the discretion which allows national supervisory authorities to exempt inter-bank lending with a maturity of less than one year, made a clear distinction between inter-bank and non-inter-bank lending. This distinction reflected the fact that banks are regulated entities, more transparent and monitored to a greater degree by the market. None of these factors have changed. As such, we see no justification for removing this distinction.

9.1 As we have seen evidence of over the past number of months, any reductions in inter-bank lending activities can cause major repercussions. We see no reason why Regulators would want to place regulatory restrictions on such lending, given its importance to the financial markets. Any benefits of introducing the proposed restrictions would be substantially outweighed by the costs of introducing such measures from a liquidity perspective. This will be further compounded if the intra-group restrictions also proposed are introduced in tandem. If Regulators have any particular concerns with regard to certain inter-bank lending, the best place to address these concerns would be under Pillar 2.

9.2 CEBS proposals on inter-bank lending suggest that CEBS are attempting to influence the maturity profile of an institution's cashflow profile by making short-term lending less attractive. If this is the case, the appropriate sphere for this would be a liquidity framework, not the large exposures rules.

Chapter 9: Breach of Limits in the Banking Book

10.0 On the proposed treatment of breaches in the banking book, the Irish Banking Federation supports CEBS' second option, whereby the authorities agree with the institution an adjustment period.

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Chapter 10: Reporting Issues

11.0 On the reporting proposals, we agree with CEBS' determination that reporting based on templates defined by supervisors is the most appropriate approach. We also support the reporting objectives outlined in the paper and the proposal of installing a harmonised template across Europe, which would minimise the reporting burden for institutions operating across Europe. However, it is imperative that lessons are learnt from the COREP package and the approach whereby the most detailed reporting requirements across Europe is used as a starting point should not be adopted. However, some sort of integration with the COREP package would be welcomed.