European Banking Federation

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EBF RESPONSE TO CEBS CP 14: FIRST PART OF ADVICE TO THE EUROPEAN COMMISSION ON LARGE EXPOSURES

General remarks

1. The European Banking Federation welcomes the opportunity to comment on CEBS' initial orientations for the first 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 date on large exposures, which gives proof of CEBS' valuable commitment to evidence-based regulation.

2. We believe that CEBS' conclusions and envisaged approach broadly go in the right direction, although we would request CEBS to formulate the main objective for European large exposures regulation more explicitly.

3. If the intention is to create a regulatory backstop for very unlikely events which CEBS estimates not to be sufficiently covered by the Basel II framework, then we would **support the idea of turning the current large exposures into a relatively 'light touch' regime, within which institutions retain much flexibility to manage risks through their own systems, policies and practices**.

4. We agree with CEBS that in this case, the purpose of the review should be to **remove unnecessary frictions between the regulatory framework and institutions' own practices**, and we look forward to the frictions being given more consideration in the second part of CEBS' advice to the Commission. It is therefore also important not to see the two parts in isolation.

5. Issues of particular priority for CEBS' second part of advice will from our point of view be the difficult questions of **reporting requirements, credit risk mitigation, and the limits for intra-group exposures**, which imply a significant obstacle for banks' liquidity management and cannot be justified in the case of centrally managed institutions.

6. As regards the present report, we also note that some areas might be reviewed from a methodological point of view. Most importantly, we would suggest that the international comparison be enhanced to also consider the practical application of the formal rules and the possible use of exemptions.

Detailed remarks

Do you agree with our analysis of the prudential objectives of a large exposures regime?

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7. We broadly agree with CEBS' assessment of the concept behind the large exposures rules, although we wish to clarify that the large exposures limits should not be seen in the context of a separate credit risk category, but rather to make additional provision for tail events.

8. We understand that CEBS estimates that the Basel II rules do not sufficiently take these tail events into account, and that it therefore wishes to maintain an additional regulatory backstop. We would suggest that this rationale be made more explicit in the report.

9. We welcome CEBS' acknowledgement, otherwise, that the **LE limits should not seek to develop a broader Pillar 1 treatment for undiversified idiosyncratic risk, or to develop a Pillar 1 treatment for sectoral and geographic risk, as both issues are adequately dealt with under Pillar 2**. In particular, IRB banks already use stress tests within their internal risk models in the Internal Capital Adequacy Assessment Process.

With regard to the market failure analysis set out in Section IV, do you agree with the analysis that there remains a material degree of market failure in respect of unforeseen event risk?

10. We welcome CEBS' intention of establishing clearly the extent of market failure that could justify the regulatory LE limits, as well as the extent of regulatory failure that might exist at the moment. We consider this to be a much appreciated precedent in terms of CEBS' working practices and expect that the experience CEBS gained at this occasion with in depth-analytical work will be very valuable for future work streams.

11. We also believe that the **potential market failures that CEBS has identified should rather be seen as cases of bad management, and that the gap between institutions' interest and the social interest is not as wide as CEBS now seems to assume**. In particular, the paragraph on management compensation and incentives is far-fetched in our view.

12. Market discipline, on the other hand, may theoretically provide an incentive for institutions to manage their large exposures with particular care. However, institutions should be assumed to act responsibly out of their own motivation, with the objectives of long-term and sound growth and avoiding overly high earnings volatility. This is also evidenced by the fact that institutions' internal limits are typically stricter than the supervisory limits.

13. In this context, we wish to note that the requirement to disclose the distribution of exposures by industry or counterparty type, broken down by exposure classes, as referred to in paragraph 90 is overly granular in our view and does not add to the market's understanding of a firm's risk profile.

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14. On the other hand, we wish to broadly **support CEBS' conclusions in paragraph 110**. A light touch approach that leaves much flexibility for institutions' own approaches and establishes a 25% limit for single name exposures is from our point of view a conceivable solution.

15. We appreciate that the most specific questions will be part of CEBS' second piece of advice to the Commission, but also wish to mention **reporting requirements as one of the most important "frictions"** between regulatory requirements and institutions' internal practices.

16. Given the central management of more complex banking groups and as a priority point of the review**, intra-group exposures should in our view in any case be exempted from the LE requirements**.

17. Furthermore, consideration as to the **recognition of credit risk mitigation techniques** will be another central aspect of CEBS' second piece of advice.

Do you agree with our perception that there are broad consistencies between the EU LE regime and those in other jurisdictions such that there is no systematic competitive disadvantage for EU institutions? If not, could you provide us with a detailed explanation of where you consider the competitive distortions arise?

18. We believe that the countries chosen for CEBS' comparison are the right ones. However, **CEBS' comparison should in our view be deepened in order to truly assess** the competitive implications of the LE regime. This is especially true as regards the practical applications of the official rules, including possible exemptions, as well as the scope of application and the way of exposure calculation.

19. We suspect in particular the use of exemptions to be a major source of level playing field distortions, for example in the case of the short-term financing of mergers and acquisitions. As well as making its assessment of the handling of LE in other jurisdictions more thorough, we would therefore encourage CEBS to give careful consideration to the competitive implications of the use of exemptions in third countries.

20. We believe that competitive concerns are in particular relevant in comparison with the US rules, as also briefly mentioned by CEBS in paragraph 11 of Annex II. In addition, to our knowledge only the current exposure of derivatives, with no add-ons, is in the US taken into account for large exposures purposes.

What are your views in respect of the analysis of the recognition of credit quality in large exposure limits and our orientation not to reflect further the credit quality of highly rated counterparties in large exposure limits?

21. We would agree that the 25% limit be understood as a general regulatory backstop but as is currently the case, we do believe that **some exemptions to this rule should be maintained for rather implausible events**.

22. In particular, the 0% risk weight for exposures rated AA- or better should be maintained, as this implies that the risk is considered zero. In addition, to avoid regulatory contradictions mandatory exposures to central banks should be fully exempt from the large exposures requirements. We also note, in that context, that the losses on these exposures have been historically nil, even for more 'risky' countries.

23. In line with the Basel 2 rules, we would also suggest considering a specific risk weighting for banks and the netting of the exposures with particularly secure guarantees, such as sovereign guarantees.

24. Further exemptions should in our view apply to exposures with very short maturities and first-rate credit quality.

25. In addition, we would suggest that CEBS consider in its second part of advice the treatment of underwriting in the LE regime. According to the current rules, banks have to report these exposures in full in the period between offering to underwrite a deal and selling it down to other institutions. This is too conservative in our view, as the exposure has to be taken into account before it is actually lent. We would therefore suggest that some preferential weighting be considered, which is already the case for the underwriting of securities issues.

What do you consider to be the risks addressed by the 800% aggregate limit? What are your views as to the benefits of the 800% limit?

26. From a methodological point of view, global concentration to single counterparties should in our view be considered in the context of general concentration risk management, i.e. under Pillar 2 only. However, we acknowledge that the maintenance of the 800% limit as a general rule could be helpful to make provision against poor concentration risk management, or might be used as a general guideline for simpler institutions.

Do you consider CEBS' proposals for the calculation of exposure values for the Advanced IRB approach and or the Internal Models Method appropriate?

27. We strongly **welcome CEBS' suggestion to permit institutions to use the internal calculation methods for regulatory purposes, and we underline that this should include the recognition of collateral**.

28. However, we object to CEBS' suitability proposals as set out in paragraph 195.4. There should be no separate large exposures approval test in addition to the general IRB requirements, as implied in paragraph a). We are also not clear

how the evidence required in paragraph a) could be provided. As regards paragraph b), these requirements are already comprehensively dealt with in the IRB recognition process. To avoid confusion, we would ask CEBS to clarify that the recognition of EAD and EPE computation methods in the context of IRB approval imply automatic authorisation for their use in the large exposures regime.

Do you support harmonisation of the conversion factors applied to the off-balance sheet items set out above? How important are these national discretions?

29. We believe indeed that the divergent use of conversion factors implies a distortion of the level playing field across Europe and would strongly welcome that a common approach across CEBS' members be adapted.

How do you calculate, for internal purposes, exposure values for liquidity facilities provided to structured finance transactions or nth-to-default products?

30. For structured finance and/or basket products, most more sophisticated institutions would simulate a change in market value for each individual transaction according to a jump-to-default approach. The difference between this simulated value and the current value is then considered.

31. However, this method would in our view be too complex and costly for a 'light touch' regulatory regime. Any regulatory guidance in this context should therefore remain as simple as possible, along the lines of the table proposed in §213,. In addition, we recommend differentiating between baskets according to the number of transactions they contain. In baskets with a large number of transactions (e.g. retail exposures), the size of each individual transaction is very low. These exposures should therefore be excluded from the large exposures regime.

Do you consider the suggested principles set out in Section IX.III appropriate for application to institutions' exposures to collective investment schemes and/or structured finance transactions?

32. The treatment of arrangements where there is exposure to underlying assets is a crucial question for the large exposures regime, and an ill-designed rule could be very damaging. We therefore welcome that careful thought is being given to this topic.

33. The principles currently proposed by CEBS are in our view too complex. It is important that solutions in this area remain as simple as possible. CEBS might consider organising a workshop on this issue, to which we would be happy to contribute.

34. Most importantly, we do not believe that there should be a systematic attempt to theoretically de-structure arrangements through a look-through-approach where there is exposure to underlying assets. We believe that at a minimum, a differentiation should be made depending on the number of borrowers in the pool, and banks be given the option to either categorise the scheme as such as a borrower, or to assign individual components of the scheme to individual borrowers.

35. In our understanding, paragraph 212b) requires banks to scrutinise all transaction possibilities for borrowers to which they have exposure of more of 5% of their Own Funds, with a view to determining the influence of these transaction possibilities on the total exposure value to the counterparty. We strongly object to this requirement, which would lead to a disproportionate multiplication of the workload for institutions.

Summary and conclusions

36. We believe that CEBS' conclusions and envisaged approach broadly go in the right direction. We welcome in particular CEBS' assessment that the review of the large exposures regime should aim to remove unnecessary frictions between the regulatory framework and institutions' own practices. This concerns most importantly the areas of reporting, intra-group limits and credit risk mitigation techniques. We look forward to these issues being tackled in the second part of CEBS' advice to the European Commission.

37. As regards the current report, we believe that a review is needed in some areas. As the general starting point, we would suggest that the main objective for European large exposures regulation be formulated more explicitly. In addition, we would also appreciate that the current report be deepened in some areas, in particular regarding the international comparison.

38. We estimate that the consideration of the large exposures limits as a regulatory backstop regime that leaves much room for institutions' own approaches would be agreeable. However, there is a need for some exemptions for implausible events, for example as regards exposures to sovereigns and central banks. Further cases for exemptions would be exposures to other credit institutions and other first-rate quality exposures, exposures with particularly high-quality guarantees, and exposures with very short maturities.

39. We strongly welcome CEBS' suggestion of allowing institutions to use internal calculation methods for the purposes of the LE regime.

40. The divergent use of conversion factors across supervisory authorities does indeed have important level playing field implications, and we would strongly welcome that a common approach be adopted across CEBS' members.

41. We also agree with CEBS that some principles-based agreement amongst the supervisors in the area of determination of exposure to arrangements with

underlying assets should be achieved. However, this is a complex area and we do not believe that it would be possible to e.g. systematically de-structure packaged exposure structures. Adequate solutions will therefore have to be as plain and simple as possible.