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Second consultation paper on technical advice to the European Commission on the review of the large exposure rules – CP16

Dear Madam, dear Sir,

On 6 December 2007 CEBS published its second consultation paper on large exposures (CP16) and opened a consultation phase scheduled to run until 22 February 2008.

We thank CEBS for the opportunity to respond the paper and hereby submit the comments of the German banking industry.

General comments

Before commenting on CP16 in detail we should like to make a few basic observations.

On the whole, we consider CP16 to be a sound document. It endeavours to analyse the rationale behind prudential rules and evaluate their benefits and drawbacks. We warmly welcome this approach and urge CEBS to continue to seek dialogue with the industry in this way. We also strongly support the intention to retain the current large exposure rules as a

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backstop regime. However, CP16 contains some proposals for tightening existing rules which, if implemented, would radically change the current large exposures regime and significantly limit the banks' scope to grant loans. We would therefore ask CEBS to give greater consideration to the backstop concept when evaluating the advantages and disadvantages of its proposals.

We especially support CEBS's acknowledgement of the fact that large exposure rules should focus only on limiting loss from single name risk and that Pillar II is the more suitable instrument for dealing with sectoral and regional risk.

May we underline once again how important we believe it is for the solvency and large exposures regimes to be consistent with one another. The resulting synergies between processes and systems offer enormous cost-cutting potential and would do much to reduce bureaucracy. CEBS has clearly recognised the importance of a coherent approach, but has regrettably failed to put it into practice in all areas.

In conclusion, we should like to ask CEBS to grant a consultation period of at least three months in future. Due to the somewhat tight deadline we have confined ourselves in this response to addressing issues we regard as especially significant. We reserve the right to comment at a later date on further points dealt with in CP16.

Specific comments

1. Proposed interpretation of the definition of counterparty

With regard to the definition of "connected clients" in Art. 4(45) of the CRD, CEBS aims

a) at clarifying the definition so that it is easier to apply in practice and can be applied more consistently across Europe and,
b) in light of recent difficulties at certain banks (paras 84, 93), at broadening the interpretation of "interconnectedness" to cover a wider range of relationships than at present.

In our view, however, broadening the interpretation of "interconnectedness" in order to expand the "connected clients" concept would result in considerable lack of clarity. This would make the rules extremely difficult to apply and risk practices diverging even more widely across

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member states. The interpretation of the cases outlined in para. 92 illustrate the potential problems.

Only the criterion of potential control can be applied consistently by all banks. This criterion expresses the fact that the possibility of a third party controlling a borrower triggers a specific risk for the lender, who is no longer in a position to evaluate the borrower's ability to bear risks (due to a transfer of profits, for example). In practice, control is essentially deemed to exist if legal persons are in a position to influence a majority of voting rights or exert power over company affairs by virtue of some other legal basis. This information is normally readily available, is objective and can therefore be given due consideration by the banks.

We therefore support the paper's interpretation of "control" in principle, but would like to point out the following:

- The criteria must be clear-cut and distinguishable from one another. This is not the case with "power to decide on crucial transactions", for example (para. 88).
- The opportunity to demonstrate that potential control does not exist (para. 86) is vitally important and should be mandatory in all member states.
- The envisaged authority of supervisors to decide whether or not to group clients (para. 94) is to be rejected because it would give rise to considerable legal uncertainty.

The "interconnectedness" criterion is too imprecise and would be impracticable because it could cover virtually any type of relationship. Clients would have to be grouped if one borrower's inability to pay made it probable that the other would default. But there is no legislative motivation for such grouping since it is unclear what type of unique and precisely definable connection has to exist between the clients to trigger this synchronicity of risk.

We also reject the criterion because it is difficult if not impossible to distinguish **idionsyncratic single-name risk** from other potential relationships and dependencies between companies without describing sectoral or regional risks, which are not at issue here.

For this reason, many European countries currently interpret "interconnectedness" to presuppose a mutual dependency between clients. Such cases are very rare, however, or it is at least often the case that the relevant information is not available to the banks (especially where large-scale international business is concerned). The interpretation proposed in par. 91 envisaging that even a one-way dependency will be sufficient to qualify as interconnectedness is inappropriate and totally impracticable in our view. The result of this interpretation would be

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huge groups of connected clients, often constituting sectoral or regional concentrations of risk. Furthermore, this interpretation would significantly reduce the scope to lend to small and medium-sized enterprises if, for example, they were the main subcontractors of a large firm. This would have a negative impact on small regional banks, whose clients are often strongly financially dependent on one another.

The fact that the criteria "control" and "interconnectedness" are not to be regarded as alternatives but would have a cumulative effect expands the scope of entities needing to be grouped to an extent that can only be described as excessive. A group in the sense of an economic unit operating over and controlling legally independent companies will be expanded to include all companies which have any kind of economic link with any of its members.

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 issue with the wrong prudential instrument. Requiring borrowers to be considered as a group by virtue of a sectoral or industry-specific connection could lead to an inappropriate reduction in lending since it would not be possible to take account of portfolio diversification.

In top of this, the suggested broadening of the definition would sharply increase both the number and volume of large exposures. This is at odds with CEBS's objective of retaining the existing system as a backstop regime.

For these reasons, we firmly reject the proposed broad interpretation of "interconnectedness" and the explanation provided in the suggested examples. Given the difficulties of making a distinction between interconnectedness and portfolio concentration risk, we recommend instead that the former be dropped as a criterion for determining the existence of a group of clients. The interconnectedness criterion should therefore be deleted from Art. 4(45) of the CRD.

Finally, we would question CEBS's analysis of the IKB case. 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 because they were all financed by commercial paper. Then, according to the large exposure rules it would not have been possible for IKB to provide Rhineland Funding with liquidity facilities far in excess of its regulatory capital.

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In our view, however, the large exposures regime is not the right tool for ensuring that banks engage in this kind of business only on an appropriate scale.

The assets invested in 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. And since the conduits invested in different regions and sectors, the interconnectedness criterion is not fulfilled either. Applying the 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 cannot be considered the right approach. We believe the correct instrument for addressing the problem is to be found in Pillar 2, under which all the risks associated with such transactions have to be weighed against the bank's regulatory capital and a suitable means of monitoring these risks agreed in consultation with regulators. We therefore suggest including the monitoring of risk concentration arising from the use of the same refinancing tools as a criterion in Annex V of the CRD.

2. Definition of exposures value

In line with our general approach, we advocate consistency between the solvency regime and future large exposures rules on the definition of exposures value. The resulting synergies between processes and systems offer enormous cost-cutting potential and would be a welcome contribution to reducing bureaucracy.

Banks using the standardised or foundation IRB approach to calculate regulatory capital requirements should consequently use the conversion factors required by the solvency rules. As CEBS rightly indicates in para. 106, general application of a 100% conversion factor would be too conservative and would considerably disrupt the present system. We do not consider such disruption justified from a risk perspective. Though conversion factors of less than 100% are currently used in around 80% of member states, their application to off-balance sheet items has not as yet caused any problems in the area of large exposures. There can therefore be no question of market failure.

We welcome the proposal in para. 112 that banks applying the advanced IRB approach should also be able to use their own calculations to calculate large exposures. However, as clearly indicated in our response to CP14, we strongly reject any requirement over and above the use

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test to demonstrate the suitability of calculations, such as that envisaged in para. 113, point 2). We should like to point out once again that exposures are calculated on the basis of methods which have been approved by supervisors. There is no reason for any further approval test. Furthermore, we were taken aback to note that para. 114, unlike CP14, proposes a mandatory 100% conversion factor. There is no prudential rationale, in our view, for introducing a more conservative factor than in the solvency regime. We therefore assume that the banks' estimates are also in a position to deliver appropriate results for so-called higher risk items.

There is one further important point we would like to highlight: the use test requirements in the context of the Internal Model Method must not result in a requirement to use Potential Future Exposure (PFE) for large exposures purposes. The use of PFE would mean that large exposure calculations could differ widely from one bank to another simply because of internal model differences in their PFE approaches (level of confidence used, etc.).

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

3. Credit risk mitigation

In this area, too, we welcome the approach of consistency between large exposure rules and the solvency regime. We believe, however, that the views expressed in paras 128-132 are based on incorrect assumptions, at least as far as real estate collateral is concerned, and that, as a result, false conclusions have been drawn. It is an unfounded assumption, for instance, that an unexpected liquidation of real estate will cause its value to fall below the collateral value used to calculate the large exposure. The haircuts explicitly called for under the Pillar 1 valuation rules ensure that a robust value is determined.

It is also wrong to conclude that the default of a large loan secured by property will always lead to liquidity problems. This would only be the case if the bank did not have an adequate liquidity risk management strategy. The rules in Annex V, points 14 and 15 of the CRD require stress scenarios to be considered and contingency plans put in place to deal with anticipated crises. Consistency between the solvency and large exposures regimes on the treatment of real estate collateral would therefore be appropriate.

We support, in the interests of consistency between the two regimes, CEBS's proposal to include in the large exposures regime the rules on the simple and comprehensive approach to financial collateral and on netting agreements.

CEBS's conclusion that the existing rules on the treatment of real estate collateral should be retained also has our support. Though it would theoretically be possible to adopt the Pillar 1 rules in the large exposures regime, we recognise that formulating the new rules would pose problems. What is more, the existing rules have proved their worth as a reliable means of calculating large exposures. Since they took effect, there have been no cases where the default of a large loan secured by real estate has caused a bank to get into difficulties. In addition, we believe there are competitive issues involved here and therefore welcome the proposed deletion of the national discretion provided for in Art. 113 of the CRD. This would do much to harmonise supervisory rules in Europe.

We should like to draw attention to a point which causes a great deal of unnecessary bureaucracy in everyday practice. The Pillar I and large exposure rules concerning providers of real estate collateral differ slightly from one another. While Art. 113(3) lit. q of the CRD focuses on the "borrower", Annex VI, Part 1, point 45 mentions the "owner". A consistent rule based on Pillar 1 would significantly reduce administrative work for the banks.

May we also suggest adjusting the wording in Art. 113(3)(q) of the CRD concerning the "value" of the property to reflect Annex VI, Part 1, point 55, which provides for a choice between the market value and mortgage lending value. This would create greater legal certainty.

It is regrettable that CEBS does not intend any further alignment of the large exposures and solvency regimes beyond the rules on collateral. We should like to reemphasise the benefits of such an alignment and ask CEBS to give this matter renewed consideration.

The proposals on guarantees are insufficiently clear, in our view. Our understanding is that CEBS wants to base the calculation of the value of the guarantee on the corresponding rules of the Solvency Regulation, but also wishes to use the substitution principle.

The substitution principle is only suitable if the collateral or guarantee provider is a customer of the bank. This is not always the case. Collateral and guarantees are often provided by economic entities which have no relations with the bank.

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We therefore suggest the following calculation method: exposure value (E) - adjusted value of the collateral (C_A) or guarantee (G_A) = adjusted exposure value (E_A). E_A will then count towards the limit of the customer.

4. Trading book

We consider the existing rules on assigning positions to the banking or trading book to be appropriate. There is no need, in our view, to reiterate the arguments put forward during a decades-long discussion of this topic. We would nevertheless like to stress that rules on assigning positions to the trading book were reviewed during the 2004-2005 Trading Book Review to ensure that new banking products are categorised appropriately. As a result of this review, each bank has to have its trading book policy approved by the competent authority. Positions are then assigned to the trading book on the basis of this policy, not with a view to maximising profits. Large exposure rules consequently cannot create an incentive to assign inappropriate business to the trading book.

Given, in addition, that the existing limits have proved their worth over the years, we see no necessity to change them at this stage.

5. Intra-group exposures

Germany currently exercises the option provided for in Art. 113(2) of the CRD. This has assisted considerably in overcoming the current liquidity crisis. Liquidity flows into groups through their subsidiaries. Introducing a large exposure limit for a group's subsidiaries would significantly restrict their possibilities of managing liquidity on a group-wide basis. Subsidiaries would have to undergo the cost-intensive process of establishing their own treasury units. Such limits would also have an adverse effect on the intra-group allocation of regulatory capital. To retain existing business models and transaction volumes, capital would have to be transferred with the group. In addition, a situation could arise in which subsidiaries had to be provided with capital that they did not need for solvency purposes. This would drastically increase the cost of capital for group units.

We accept, in principle, CEBS's theoretical concerns. But we believe the benefits of the free flow of funds within a group far outweigh the disadvantages caused by a restriction aimed at avoiding the unlikely event of a group failing to support a subsidiary. We therefore advocate

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retaining Art. 113(2). In the interests of further harmonisation, we would welcome making this rule mandatory in all member states.

The proposal in para. 214 on Art. 80.7 and 80.8 of the CRD has our support since it will further the desired alignment of large exposure and solvency rules. Where the requirements for a zero weighting are met under the solvency regime, exposures should also not have to be considered in the area of large exposures.

Finally, we should like to draw attention to an issue which is not addressed in CP16.
Art. 111(2) of the CRD sets a large exposure limit of 20% for group units which are not banks. Yet the information available about a member of the same group is of far better quality than that about a client outside the group. We are therefore unconvinced of the need for this limit and would ask for it to be raised to the general 25% level.

6. Interbank exposures

We are in favour of a rule which takes account of the lower risk associated with shorter maturities. In particular, we believe zero weighting should be retained for interbank exposures of up to one year since these actually account for most interbank business. Experience shows that there is no risk associated with these short-term exposures. Interbank exposures of more than one year should be given preferential treatment as well since they also form part of the banks' liquidity management.

We do not share the view that the cost of additional collateral would be moderate if a large exposure limit were introduced because collateral markets are sufficiently deep and liquid. CEBS's conclusion that limits would generate a need for more collateral is, if anything, an understatement. We feel that CEBS may be underestimating the extent of additional collateral that would be required. Take derivatives, for instance. Derivative transactions between banks are normally concluded at a market value of zero so that there is no need for collateral to reduce risk. Changes in the market value over time are accommodated by margining. For prudential purposes, however, the add-on of the transactions calculated according to the market valuation method would have to be considered when calculating the large exposure. Yet the add-on would not be covered by margining. For this reason, banks would need to collateralise the add-on amount of a very large number of derivative transactions not because this would have an risk-mitigating effect, but simply to avoid the amount counting towards the large exposure limit.

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CEBS is also right to conclude that big banks with access to the international capital markets would find it easier to broaden their refinancing base than would small local banks. The envisaged tightening of the rules would therefore give larger banks a huge competitive advantage over smaller ones. According different supervisory treatment to big and small banks, as suggested by CEBS, would cause problems of definition and competitive distortions to the detriment of big banks and cannot, therefore, be seen as an appropriate solution.

7. Reporting

We categorically reject mandatory disclosure under Pillar III of large exposures which exceed the limits. There may be good reasons for exceeding a limit temporarily and these must be analysed in confidence with the competent authority. The need to set aside additional regulatory capital is already sufficient disincentive to avoid such a situation; added market pressure is not required. What is more, disclosure could have a negative impact on the market with undesirable consequences for the bank's refinancing.

The proposed option 3 in para. 110 is the most suitable, in our view. In principle, we welcome the idea of harmonising reporting practices across Europe. Based on the results of the widely criticised COREP initiative, however, we are sceptical as to whether CEBS would be able to draft a proposal supported by all member states that did not represent the most complex and detailed reporting regime in Europe. The German banking industry does not therefore consider it advisable for CEBS to draw up the proposed set of principles.

Rather, we would stress that we regard the form and content of the German reporting system as appropriate. We are therefore in favour of retaining the exemptions in Art. 110(2) of the CRD.

Yours sincerely
for the Zentraler Kreditausschuss,
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