POSITION PAPER

ESBG Response to:
CEBS Consultation Paper (CP16) on the Second Part of its Advice to the European Commission on Large Exposures

22 February 2008

ESBG

DOC 202/08

JEA / JGM

General remarks

The European Savings Banks Group (ESBG) welcomes this opportunity to comment on the Committee of European Banking Supervisors' (CEBS) consultation paper 16 (CP16) on the second part of its advice to the European Commission on large exposures (LE). We welcome the efforts made by CEBS to deliver advice that would result in an improvement of the EU LE regime. Moreover, we believe that CP16 is constructed in a very effective way, with a well-organized methodology, a sound analysis of the current situation, a clear identification of available options and generally clear proposals. We would like to commend CEBS for its efforts to follow an approach in line with the Better Regulation principles.

This being said, we also believe that in a number of issues, CEBS' draft advice should be modified. We refer to our responses below for more detail.

Answers to the questions asked in CP16

Question 1 - CEBS would welcome respondent's view on the high level impact assessment of the policy options (Please see Annex 1)

As mentioned at the occasion of responses to previous consultations, the ESBG believes that option number 6, an **amended limit based backstop regime**, is the preferable approach for a LE regime. In our opinion, the LE regime should respond to a clear objective: prevent the disruption of financial institutions' activities that could arise from an unforeseen event with regard to a single name borrower. An 'amended limit based backstop regime' is the best way to achieve this goal.

In particular, the ESBG does not believe that option 2 (Large Exposures covered under Pillar 2) would be the right way forward, in particular having regard to the fact that the experience with Pillar 2 is still limited and that it would thus be premature to extend the scope of Pillar 2 at this stage. In this context, it is important to differentiate between the objectives pursued by the Large Exposures Regime – a backstop regime against single name risks – and those pursued by Pillar 2 – notably, having systems in place to manage concentration risk.

Finally, we believe that the review of the current LE regime, and its alignment with the provisions of the CRD, should not be biased by the recent events in the financial markets. Concretely, while some aspects of the current turmoil may appear to be related to the rules on Large Exposures, it is our opinion that rushing into regulatory responses would not be the right approach. Further analysis is needed of the causes of the turmoil and accordingly, of the best possible policy response in the EU.

Question 2 - 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.

The ESBG supports the interpretation of 'control', which we regard as an important and useful criterion.

On the other hand, we are concerned by the proposed approach in relation to 'interconnectedness'. As a first comment, we would like to point out that the use of the proposed interpretation would lead to serious practical problems, which would contradict the objective of simplicity of the framework, as argued by CEBS itself. In our view, the recognition of interconnected customers would lead to uncertainties and to further information requests from the competent authorities, resulting in additional burden for the credit institutions.

Another concern with CEBS' proposal is that as it stands, the burden of proof lies with the institutions, which have to assess the connection between their clients and could as a consequence be asked to justify why they did not consider pairs of counterparties as interconnected or to assess the interconnectedness between them.

The ESBG is also concerned by paragraph 95 of CP 16, which proposes that an entity should, in principle, not be included in more that one group of connected clients. In our view, this may prove extremely difficult if we have in mind the cases where clients are "interconnected" or are part of a business conglomerate.

Finally, it is of the utmost importance to clearly differentiate between the Large Exposures regime and Pillar II, which is the best place to address the questions of sectoral and regional risks. We therefore suggest deleting the criterion of interconnectedness as defined in Art. 4 (45) of the CRD.

As a side remark, we would like to highlight that a widening of the definition of interconnectedness with the simultaneous retention of the current limits would lead to a significant tightening of the LE regime. We do not believe that this is the objective pursued by the review.

Question 3 - In your view, how should exposure values for on-balance sheet items be calculated, gross or net of accounting provisions and value adjustments? Please provide examples to illustrate your response and feedback on relevant costs and benefits.

We are of the opinion that exposures shall be calculated net of accounting provisions and value adjustments.

Question 5 - Do you think that low risk items should receive a 0% conversion factor? Do you believe that there is room to apply conversions factors between 0% and 100% in a large exposure regime? Which items could in your opinion receive a conversion factor different of 100%, and for which reasons? Please explain your views and provide feedback on the costs and benefits of such an approach.

As regards the application of conversion factors, we believe that there should be a perfect alignment between the LE regime and the CRD, thus with conversion factors between 0% and 100% in the LE regime. In this context, we would like to highlight that the CCF are meant to provide the best estimate of an exposure in the event of a default of a specific client. As such, it could be argued that these CCFs are in fact even conservative for the LE regime, if we take into account the sudden nature of "unforeseen events", especially if they relate to larger counterparties.

Question 7 - CEBS would welcome comments on the proposed set of principles. Are they appropriate for allowing Advanced IRB institutions to use their own exposure calculations? Please provide feedback on the costs and benefits that you consider would arise from adopting such an approach.

In our opinion, the use of the institutions' own exposure calculation methods for LE regulation as well as for capital requirements and internal steering would allow institutions to harmonise and streamline calculations, risk monitoring and internal/external/regulatory reporting. The proposed set of principles is clear and acceptable. The harmonisation would also reduce IT and reporting costs.

Question 8 - In the context of schemes with underlying assets do you agree that for large exposures purposes it is necessary to determine whether the inherent credit risk stems from the scheme, the underlying assets or both? Do you agree that the proposed principles are appropriate to identify the relevant risk in a large exposures backstop regime? Are there other relevant criteria that you wish CEBS to consider? Please explain your views and where relevant please provide feedback on the costs and benefits.

We fully agree with CEBS' view that a case-by-case approach is needed as regards such transactions due to the difficulties to set up a fixed set of rules that can be applied consistently for all structured transactions. As a consequence, it is preferable to have a principles-based approach.

The issues addressed in question 8 were heavily discussed at the occasion of a meeting between CEBS and the industry, held in October 2007. On that occasion, it was generally argued that the example proposed by CEBS, which is now included in Annex 3 of CP 16, presents a number of serious of limitations, notably by being applicable only in a limited number of cases. In our view, it can therefore not be regarded as useful guidance, neither for the industry nor for supervisors. We would therefore recommend removing example 3 from the final advice of CEBS to the Commission.

Question 9 - 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 do not share CEBS´ view on this issue. Rather, we believe that the treatment of mitigation techniques should not differ from the capital requirements regime as this would lead to disproportionate costs for the institutions. Especially in terms of physical collaterals, we do consider that there are more liquid markets for collaterals than just real estate collaterals. A "one size fits all" approach does not appear to be the best solution from our point of view. For that reason, and due to the fact that the implementation of new CRM techniques would cause disproportionate costs to institutions with little benefits, we would strongly recommend aligning the CRM techniques with those already applied in the CRD.

Question 10 - Do you agree that the three alternatives 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.

We agree with proposal 1 made by CEBS. In our view, proposal 2 and even more so, proposal 3 would lead to disproportionately high implementation costs as well as to higher costs resulting from running a further calculation model.

Question 12 - Do you support CEBS' proposal that institutions that use the simple method should follow the minimum capital rules (substitution approach) instead of applying the haircuts included in the current large exposure rules? Please explain your views and where relevant provide feedback on the costs and benefits.

We support the idea of using the substitution approach as this would represent a welcome alignment with the CRD. At the same time we see no reason to penalize SA institutions using the simple approach vs. the ones using the comprehensive approach. Therefore, in our view, entities should be able to choose in a consistent manner whether they apply the substitution approach or the approach used for institutions under the comprehensive approach.

Question 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.

As mentioned in CP 16, special attention should be given to the liquidity of physical collaterals. As such, if institutions can prove the existence of liquid markets, we do not see a reason to have a difference in treatment between physical collaterals and other types of collaterals.

As far as residential and commercial real estate are concerned we support the analysis made by CEBS and its conclusion that the current large exposures rules should be kept in place. They have proven to be a reliable instrument to assess the risks adequately.

The ESBG regrets that CEBS did not intend to achieve further alignment between the Large Exposures regime and the solvency regime beyond the rules on collateral. In this respect, we would like to emphasize the benefits of such an alignment and ask CEBS to consider this question once more.

Question 15 - Do you consider that two different set of large exposures rules for banking and trading book are necessary in order to reflect the different risks in the respective businesses? What could be the costs/benefits of this? Please explain your views and provide as appropriate feedback on the cost and benefits of this.

The ESBG supports the existence of a different set of rules for trading book exposures due to the different nature of these exposures (short term and profit orientation). In addition, the current rules are implemented and work well. As such, we do not see a need for changes.

Question 17 - Instead of the current risk based capital charge for excess exposures in the trading book, would a simple approach that allows any excess in the trading book to be deducted from an institution's capital resources be more appropriate in the context of a limit based back stop regime? Please explain your views. Please provide examples and feedback on relevant costs and benefits.

In our view, the current rules have the benefit of working well and of being already implemented to date. As such, we do not see a need for change.

Question 21 - What are your views on the proposals/options for the scope of application of the large exposure regime?

In our view, intra-group exposures should continue to be generally exempted from the LE regime, as provided for in Art. 113.2 of Directive 2006/48/EC. We believe that the negative consequences of imposing such limits outweigh the possible prudential benefits. In this context, we would like to highlight that a detrimental consequence of imposing limits on intra-group exposures would be that instead of relying on intra-group funding, banks would have to rely more extensively on the money market, which by its very nature is more instable and more expensive than intra-group funding.

Furthermore, in practice, liquidity risk management is generally based in a few centres of excellence within a group. Therefore, any change in the regulation affecting the flow of funds within a group would result in additional costs and operational risks for small entities that would have to set up their own treasury departments. In fact, the combination of imposing intra-group limits and interbank limits would impede the free flow of funds in the banking sector, thus increasing vulnerability to liquidity crisis.

The idea of case by case exemptions mentioned in item 212 leads to competitive distortions and does not support the idea of convergence. Therefore we are not in favour of such an option.

Regarding the proposal to set limits on the intra-group exposures within the EEA we would like to draw CEBS attention to its own analysis where it stated under point 206: "Imposing limits on all cross-border intra-group exposures within the EU could put some EU Member States at a competitive disadvantage to other States as there are significant differences in banking industries across the EU. Countries in which banks do a lot of cross-border business and which have a limited depositor base could potentially be at a particular disadvantage." We fully agree with this analysis and therefore object CEBS' intention to set limits on intra-group exposures within the EEA.

Question 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? Please explain your response.

We believe that the national discretion in Art. 113 of 2006/48/EC must be kept because a limitation of the intra-group exposures would undermine the benefits of a centralised group liquidity management and could even set banks in smaller Member States at a competitive disadvantage.

(i) We believe that for intra-group exposures to entities within the same member state, no limits should be applied. As CEBS already mentioned in its analysis, these exposures do not present a credit risk. A limitation of these exposures is therefore not necessary and would even constrain a group's liquidity management.

(ii) We object the application of a strict limit to LE to entities within the EEA due to the following reasons: (a) the limitation describes a discrimination of institutions situated in smaller Member States as they would face serious competitive disadvantages; (b) a limitation of intra-group exposures would limit a group's ability to manage liquidity. For this reason, we would recommend not to apply any limits to intra-group exposures within the EEA.

iii) As already mentioned, a limit would cause a competitive disadvantage to banks situated in smaller Member States, therefore we believe that there should be no limit for exposures to group members outside the EEA.

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

Assuming that the national discretion stated in Art 113 of 2006/48EC is kept (0% risk weight for all intra-group exposures), which in our view is the right approach (see response to question 22), we share CEBS' views on the high level principles on how to define intra-group limits.

Question 25 - Do you agree with the proposal? Please explain your response.

We agree in general with CEBS proposal. It is however of importance to make sure that any solution based on the proposed approach is in line with the principle of "same business, same risks, same rules'".

Question 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 welcome CEBS proposal to exempt exposures to sovereigns and other international organisations as well as some regional governments and local authorities from the LE regime and we therefore support the thereto related removal of the national discretion.

Question 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 other comments on the cost/benefit analysis?

Under the condition that the currently applied risk weights (Art 113 of 2006/48/EC) are kept, we believe that, even if in some countries the costs of imposing interbank limits may outweigh the benefits, other benefits not included in the cost/benefit analysis should not be forgotten, e.g. the benefits of protecting banks whose failure would not precipitate a systemic crisis, as the failure of such bank would at least undermine confidence in the banking system. In addition, the 25% limit on maximum exposure towards a single counterparty gives comfort to the banking market in case of a counterparty running into difficulties.

In addition, we share CEBS' conclusion that large banks with access to the international capital markets would find it easier to broaden their refinancing base than would be the case for small, local banks. The envisaged tightening of the rules would therefore give larger banks a significant competitive advantage over their smaller competitors. Against

this background, we do not regard as appropriate the proposed solution of a different treatment for big and small banks, as this would lead to definitions problems and competitive distortions.

Question 31 - Given the market failure and cost/benefit analysis set out above, what treatment would you consider appropriate for interbank exposures?

In our view, the cost-benefit analysis of CEBS is not correct. First, the additional costs of collateralization would be very high, since markets are not as deep and liquid as CEBS presumes. In order to secure liquidity of markets the lower risk of short-term exposures has to be taken into account. In addition, it is important to note that, as pointed out in CP 16, institutions tend to use well-known and local counterparties for their funding and liquidity management; having a 25% limit would result in higher operational costs, and having to work with less known counterparties could result in higher risk. Finally, we would like to point out that in normal circumstances, interbank exposures canalize the funds resulting from the treasury management of the institutions and thus rarely represent long-term funding, as it would be the case with other types of counterparties.

Against this background, we suggest exempting from the Large Exposures regime interbank exposures that do not represent a permanent or long term way of financing, defined as interbank exposures of up to 1 year. However, supervisors should be informed by regulatory reporting on the issue.

Question 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 (CEBS would not disclose confidential information).

See response to question 31.

Question 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.

As we argue that the LE regime should consist of a backstop regime, the general rule should be that the limits set in the regime should not be breached, apart from exceptional circumstances.

Transitional measures should therefore be foreseen for those cases where the limits are

breached. In particular, in such cases, the entities should agree with the supervisors on the length of period of maintenance and on the excess of the limit which should be deducted from own funds, as proposed in paragraph 301.

As regards the proposal to deduct the exposure from own funds, the deduction of the full amount would undoubtedly be a disproportionate measure. On the other hand, we regard as a reasonable proposal the deduction from the own funds of the amount in excess of the limit.

Question 35 - What are your views on the 3 reporting options? Please explain and provide feedback on the costs/benefits of CEBS´ initial views.

The ESBG is in favour of the proposal to have supervisory reporting with immediate indication of breaches of the backstop limit. However, we would like to stress our concerns of repeating the experience of COREP. Specifically, the goal of developing at EU level a standardised reporting template could result in agreeing to adopt the most voluminous and detailed reporting regime currently in use in the EU. In the context of the LE framework especially, there is a need to use a simple reporting format.

On the other hand, we are opposed to any reporting under Pillar III, as the market in not in a position to control the extent to which an institution complies with a supervisory regime. In addition, the disclosure of information relating to large exposures would raise confidentiality problems.

Question 36 - Do you support CEBS´ thinking on the purpose and the benefits of regular reporting using predefined reporting templates?

As mentioned above, we could accept reporting on the basis of a predefined report as long as this report does not lead to a higher administrative burden for the institutions. In particular, the exclusions currently laid down in Art. 110(2) should continue to apply.

Question 37 - What is your opinion on CEBS´ initial thinking regarding the elements to be reported under the large exposure regime?

We believe that most of the points proposed by CEBS have already been applied in different Member States and, consequently, this will not lead to a higher workload for the institutions. However, we would like to strongly engourage CEBS to carry out a consultation on the elements to be reported under the LE regime.

Question 38 - Do you agree with CEBS' views on the recognition of good credit management? Please explain your views.

Yes, we agree with CEBS that the recognition of good credit management is somehow included in the proposals and that developing it further could introduce a not desired degree of complexity into the framework. We also agree that, under a limit based backstop regime, it is not justified to exempt advanced institutions.

About ESBG (European Savings Banks Group)

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of € 5215 billion (1 January 2006). It represents the interest of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG Members are typically savings and *retail* banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their *region*. ESBG Member banks have reinvested *responsibly* in their region for many decades and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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Published by ESBG. February 2008