Merrill Lynch Europe PLC
2 King Edward Street
London EC1A 1HQ
Telephone: 020 7628 1000

21st February 2008

Committee of European Banking Supervisors

Dear Sir / Madam

Response to CP16: Second Consultation Paper on CEBS' Technical Advice to the European Commission on the Review of the Large Exposure Rules

Merrill Lynch ('ML' or 'we') very much welcome this opportunity to respond to the Committee of European Banking Supervisors ('CEBS') on its proposals set out in CP16 "Large Exposures Advice Part II" ('CP' or 'the proposals') published on 7th December 2007.

We have addressed many of the questions addressed by the consultation paper in the Annex to this letter. However we would like to take the opportunity to highlight two areas of particular concern in CP16. These are the treatment of:

- Intra-group Exposures
- Trading book

Intra-group Exposures

The EC's call for advice on intra-group exposures in the LE regime indicated a potential for a lightening of the intra-group regime, however the CEBS proposals indicate at best a further restriction of these exposures. We recognise that intra-group exposures are not risk free exposures and agree with CEBS that if a parent fails it should be assumed that the subsidiary would fail, however the following points should be noted.

1. The Large Exposure Regime, as it currently stands and as it is proposed, is not the appropriate primary or sole regulatory tool to manage intra-group risk.

2. All intra-group lending between entities that are subject to the same consolidated supervision oversight should be exempt from the Large Exposures Regime.

3. Limiting intra-group exposures prevents groups and subsidiaries from efficiently managing their risks, particularly in times of stress.

4. Treating intra-group exposures in the same way as third party exposures with a 25% hard limit could result in significant restructuring of the existing operations of many financial institutions, perhaps even restriction of business lines or operations.

5. Restrictions will impede the ability of firms to appropriately and effectively manage their liquidity which could have knock-on effects into the wider market place, especially in times of stress.

6. The proposal fails to adequately acknowledge the lower risk profile of intra-group exposures. Common risk and control procedures exist across groups so that all members of the group will have strong knowledge and experience of the control environment in each subsidiary.

7. One of the stated concerns of the intra-group approach of the LE review is the protection of depositors. In the unlikely event of a parental failure, investment firms do not endanger depositors to the same degree as banks. Accordingly, under this analysis investment firms should not be bound with the same rigour as banks to the suggested penal intra-group large exposures restrictions.

Trading Book

We agree that the trading book and banking book distinction should be maintained. However, subject to our comments on intra-group exposures above, at the very least we would advocate that the treatment of the trading book to be the same as the current regime.

The current treatment of the trading book is distinct as follows:

- A soft limit for the trading book exposures;
- Recognition of credit worthiness when identifying the excess capital requirement.

Not to recognise a soft limit against the volatile and short term nature of trading book instruments could lead to significant fluctuations in capital requirements on a daily basis that would be difficult to plan for, manage and control leading to unnecessary operational and business risk.

Further, failure to recognise credit worthiness without other compensating measures would mean an enormous increase in capital requirements that would not be economically viable.

We hope that you consider our comments helpful. We are very happy to clarify and discuss any matters in this response. Please feel free to call or e-mail Steve Teather (+44-20-7995-4848 or steve_teather@ml.com) or Alex Morrall (+44-20-7995-7377 or alex_morrall @ml.com).

Yours sincerely,

Keith Pearson
MLEMEA Financial Controller

Annex: Detailed Responses to Questions Posed in CEBS CP16, Large Exposures Advice Part II

We have not sought to answer every question in CP16, but offer comments on those questions that are important to us. We have been actively involved in the preparation of the joint Trade Association (LIBA-ISDA-BBA) response that provides a full suite of answers.

Control and Interconnectedness

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.

As highlighted by the response of the Trade Associations, the proposal and definitions of control and interconnectedness are appropriate at a high level, but the principles introduce a level of detail which it would be unfeasible and uneconomic to comply with.

Calculation of Exposure Values

Q8. 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 back stop 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 believe it is appropriate to determine whether the inherent credit risk stems from the scheme or the underlying assets. The principles set out by CEBS are a good first step in addressing this matter, however we would recommend the following as a development of these principles.

Effort Versus Impact: It should be helpfully acknowledged specifically in the principles that the large majority of structured transactions will have a de minimus effect on any given large exposure, even if the underlying assets meet the classification of a large exposure based on the firm's other business with the relevant counterparty.

Given the manually intensive nature of a look-through approach, we would also suggest that a look-through approach fails cost benefit analysis except where there is the distinct and real possibility of explicit and material increase in large exposures.

An acknowledgement of a recovery value concept should also be included in the principles. This is because insurance and other loss reducing factors mean that a default in most vehicles with an underlying large exposure would not create a significant change in overall loss. Hence certain structures would be known not to materially change exposure values.[1]

Recognition of the Payment Waterfall: CP14 included a prescriptive treatment of structured transactions, whereby the structure was looked at in terms of both tranches and underlying assets. Under this arrangement, if the loss of the total value of any given underlying was exceeded in value by investments lower down the waterfall than the firm's interest, then no amount would be added to the LE calculation. In other words, the exposure to a counterparty underlying a structure was reduced by the loss absorbency of tranches lower than the firm's interests.

While this treatment was described as overly prescriptive by industry, a *principle* allowing firms not to need to calculate exposures which would never individually be incurred by their interest in the vehicle is necessary in order to best reflect the actual risk.

No Large Exposures in the Structure: A further rule not carried forward from CP14 allowed firms to ignore structures where it was known that the underlying assets would not have an impact on the large exposures. For example, this would mean that firms would not have to look at securitisations of loans to individuals, knowing that any individual person would not constitute a large exposure.

Whilst this rule was considered overly prescriptive in industry feedback, as it required firms to find out if any counterparty exposures would be brought to a total greater than 5% of capital, the concept behind the rule could still be usefully addressed in a principle.

Changing the Underlying Assets: We believe that it is important to look at the nature of the underlying exposures. For example, where the underlying asset is a tracker product, the index named on the mandate of the vehicle may change regularly. Clearly, in structured transactions where the underlying will often change, this would indicate that the risk is present at the vehicle level, rather than at the underlying asset level, implying that a look-through approach is inappropriate.

We would also like to take the opportunity to raise some other comments on structured transactions that we feel are pertinent.

Scope: Further clarification is needed as to what falls under the definition of 'Structured Transactions'. The name itself implies that the scope is limited to tranched vehicles, but CP16 states that single tranche vehicles are in scope. In CP14, the approach under discussion was under the heading of 'Collective Investment Undertakings, Structured

[1] This is not the same as recognising credit-worthiness in the calculation of large exposures.

Merrill Lynch

Transactions, and other arrangements where there is exposure to underlying assets'. This in itself was not a clear definition, as say, nth to default items were not included in the category. We would appreciate clarity in this area.

Practicality: There is a feasibility issue with applying a look-through approach on anything but the simplest of structures. The means of achieving look-through would be very manually intensive, requiring specialists to book every underlying on every single SPV position. This underlying data will often need updating daily. Developing this process would only be possible following industry wide reform in market disclosure and is likely to be more than a Europe-wide issue.

Credit Risk Mitigation

Q14. Do you agree that the development of a set of principles or guidance to require institutions to take indirect exposures into account when addressing 'unforeseen event risk' is the best way forward? Which principles do you think are relevant? Do you have suggestions for possible principles? Please explain your responses and provide feedback on the costs and benefits where relevant.

As the 'double default' approach incorporates probability in the assessment of the possible loss, and the LE approach does not incorporate a probability element but an 'all or nothing' approach, the theoretically pure treatment of double default would be to recognise neither the guarantor nor the guaranteed. While this may initially appear to be an undue concession, it would be consistent with the entire approach of the advice so far given to the Commission.

For a firm to come into financial difficulties in this scenario, both guaranteed and guarantor parties would have to fail. Identifying scenarios whereby more than one counterparty simultaneously defaults is inconsistent with the entire LE approach as described by CEBS so far. Accordingly, if this concept was part of the overall proposed regime, then:

- all the large exposures would have to be added together[2]; and
- credit-worthiness would be a valid concept in the regime.[3]

[2] To explain with an example:
If the firm's exposure to counterparty A is 15% of its capital base, and the firm's exposure to (unconnected) counterpary B is 15% of its capital base, it would not be appropriate under the LE regime to consider the scenario that both counterparties fail, and hence be concerned that the combination of the (unconnected) exposures is 30% of the capital base, because this type of risk is addressed by the CRD and appropriately incorporates credit-worthiness.
Similarly, if a firm had lent to counterparty A, and bought protection on this loan from (unconnected) counterparty B, both counterparties would have to fail to incur a loss.

[3] The following example also demonstrates the same concept: In the structured transactions 'look through' model (described in the annex to CP16), if a firm holds a senior tranche; and exposures in the underlying pools are smaller than the junior tranches; these small underlying exposures are not used in the LE regime, even though a simultaneous default of more than one of them would result in a loss to the firm.

However, neither of these outcomes has been considered appropriate. We believe that for the same reasons the inclusion of guaranteed and guaranteeing exposures would be also be inappropriate. Clearly, should guaranteed/guarantor come into financial difficulties, it would then be necessary for a large exposure to be recognised against the remaining guarantor/guaranteed.

There are no other circumstances in which a large exposure would apply without implying that the scenario of both parties simultaneously defaulting should be addressed by the LE regime. As such, we would suggest that further analysis should be considered in this area to ensure that an appropriate treatment is developed that reflects the characteristics of the risk and the concepts behind the LE regime. We would be willing to work with CEBS on this topic.

Trading Book Exposures

Q15. Do you consider that two different sets of large exposures rules for banking and trading book are necessary in order to reflect the different risk 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.

As was fully considered and addressed during the development of the CRD, the trading book/banking distinctions are necessary to recognise the different risks of the books. The current Large Exposure treatment of the trading book is distinct as follows:

- A soft limit for the trading book exposures; and
- Recognition of credit worthiness when identifying the excess capital requirement.

Our comments on these are presented in question 17.

Q16. Since the boundary between trading book and banking book exposures is increasingly blurred, do the current large exposures rules create an incentive to book business in trading book (which would otherwise be disallowed in the banking book)? Please explain your views and provide feed back on relevant costs and benefits.

The question of trading book/banking book boundary has been fully reviewed and addressed in the CRD. Similarly, the "policing" of this boundary is also already fully catered for. The LE regime is merely an extension of this policing and one that works adequately today.

Q17. 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.

The question implies that the current approach may not continue. Failure to recognise credit worthiness without other compensating measures would mean an enormous increase in capital requirements that would not be economically viable.

Further, not to recognise a soft limit against the volatile and short term nature of trading book instruments could lead to significant fluctuations in capital requirements on a daily basis that would be difficult to plan for, manage and control leading to unnecessary operational and business risk.

Given these concerns we would strongly advocate treatment of the trading book to be, at worst, the same as the current regime.

We would like to point out that the feedback given by industry on CP14 relating to CEBS suggestion that credit worthiness was not appropriate for an LE regime was given on the basis that this applied to the banking book, and would not be extended to the trading book which was the subject of CP16.

Lastly, the approach as it is described in the question would be far from simple because a deduction of any type of excess would itself give rise to a further excess as the proportion of capital decreases.

Q18. Do credit related products such as credit derivatives and structured products in the trading book require special attention and a different treatment from other positions in the trading book? Please explain your views, provide examples.

We believe that the proposed principles based approach for the calculation of exposure of structured transactions should not be applied to equivalent structures in the trading book.

As explained in our answer to Q8, trading book structured transactions with trading book underlyers, for example where the underlying asset is a tracker product, the index named on the mandate of the vehicle may change regularly. Clearly, in structured transactions where the underlyings will often change, this would indicate that the risk is present at the vehicle level, rather than at the underlying asset level, implying that a 'look-through' approach is inappropriate.

We further believe that Credit Protection which is hedging out existing protection should not form part of the large exposure calculation. As explained in our answer to Q14, the appropriate treatment of guaranteed and guaranteeing exposures is to recognise neither the guarantor nor the guaranteed. For a firm to come into financial difficulties in this scenario, both guaranteed and guarantor parties would have to fail. Examples to support this assertion can be seen in our response to question 14. Clearly, should

guaranteed/guarantor come into financial difficulties, it would then be necessary for a large exposure to be recognised against the guarantor/guaranteed.

Intra-group Exposures

Q19. Do you have any comments on the market failure analysis on intra-group exposures?

CP16 acknowledges that intra-group risk is quite different from third party risks, and that the basic market analysis from the first call from advice does not apply. For example, CP16 states in the market failure analysis[4] that the intra-group risk under consideration relates to a post-insolvency scenario and hence performed the market failure analysis for intra-group exposures on a gone concern basis[5]. However, the basics of the LE regime from the first part of the advice was supported by market failure analysis concerning external counterparties in a going concern scenario[6].

We are concerned that there is a mismatch of risk and solution leading to intra-group risk being shoe-horned into a Large Exposures limit-based regime designed for a different purpose.

In addition to the gone concern analysis cited in the paper, CEBS has also stated at the Open Hearing of 15th February that intra-group risk was more prevalent in a stressed situation when firms may choose to isolate their most risky assets in one entity and leave it to fail without affecting the rest of the group. We find this statement perplexing for a number of reasons. Firstly, as credit quality is not recognised, risky assets would not register in an intra-group treatment in an LE regime. Secondly, it seems a blunt tool to restrict large amounts of funds being borrowed from a subsidiary in order to minimise the remote risk of undue loss if the subsidiary is then allowed to become insolvent. We consider the proposal to be an excessive reaction to this concern for the following reasons:

- This risk is considered minimal in relation to the risk of parent insolvency, or the costs of the regime proposed;
- It should also be considered that this risk will differ from country to country and is better addressed by unifying insolvency regimes than restricting business unnecessarily;
- This risk could more effectively be addressed under the existing Pillar 2 Concentration Risk process.[7] There would, in fact be reputation issues restricting large multinationals from borrowing from smaller subsidiaries in other member states and then allowing the subsidiary to become insolvent; and

[4] Summarised in p200 of CP16
[5] Summarised in p188 of CP16
[6] CP14 'Purpose of the Regime'
[7] It was also proposed in the open hearing that special guarantees from parents might mitigate this risk.

- This forms an unwarranted restriction on business.

The LE regime may be considered by CEBS to be a 'second best' alternative in the absence of an insolvency regime. However the inappropriateness of the LE regime to intra-group exposures, combined with the negative impact to EU business and investment means that the LE regime should not be considered an alternative at all. Application of the proposed LE regime to intra-group exposures could actually precipitate firm failure, as funding options to banks are restricted at a much earlier stage under stressed circumstances; and a firm's risk profile will be altered for the reasons we explained earlier.

CEBS may further feel that in stressed circumstances, parental funding could be hard to come by. This is an issue that should be addressed in the Liquidity regime. An EU firm's ability to borrow from a parent would not form a large exposure, which occurs when a firm lends to a parent.

It is also worth pointing out that the large exposures regime was developed for exposures which do not have the advantages of intra-group exposures. These are mentioned in CP16, but no apparent recognition is given to them in the suggested approach. Some examples include:

- As common risk and control procedures exist across groups there is reduced risk in inter-group exposures. This is due to an internal knowledge and experience of the control environment that subsidiaries are exposed to.
- There are reduced stakeholders in the intra-group risk where the subsidiaries are 100% owned by the parent
- The previous work on supervisory equivalence should be leveraged. There should be acknowledgment of global consolidated supervision of groups.

For these reasons, we believe that the inclusion of intra-group exposures in the 25% limit backstop regime is wholly inappropriate. These exposures should be treated under an approach consistent with the genuine lower risks and greater benefits they bring.

Q20. Could intra-group large exposures limits give rise to other costs and benefits? Please explain your response.

One important reason for intra-group exposures is the cross border re-allocation of risk. Risk management in subsidiaries is often controlled by backing out exposures to other members of the group. This is an essential and key means of controlling risk in large groups, and in some firms forms the main driver behind intra-group exposures. Unfortunately, this benefit has not been recognised by CP16. To limit this control will leave subsidiaries of large multinationals with a large diverse portfolio of risk which they are not sufficiently equipped to manage appropriately.

It is anticipated that if the proposed requirements are unchanged the existing business arrangements and operation of firms would need to be reappraised and could result in rearrangement, rebooking and even, in extremis, closure. All of these would result in unnecessary cost and business disruption.

Additionally, the proposed solution would have a knock-on effect on:

- the liquidity of banks, and
- the liquidity of the market.

This will occur as banks might be forced to establish their treasury requirements externally, increasing pressure on the liquidity market. CP16 states that intra-group limits are not the only constraint on the ability of a bank to manage its liquidity[8]. However, as these limits become more onerous, regulatory limits are likely to become one of the most significant constraints on liquidity management.

CP16 recognises in its market failure analysis[9] that the intra-group risk and risk to management of group liquidity need to be balanced. However, we note that:

- It is considered that the risk to management of group liquidity, and the subsequent risk to market liquidity exceeds the intra-group large exposure risk; and
- No measures towards protecting these liquidity risks have been proposed in CP16.

Q22. 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.

Our answer only addresses part iii of the question.

Our preferred option for part iii is option III, the imposing of limits with a range of national discretions in addition to the safety valve to allow national authorities to impose looser (or stricter) conditions or limits on intra-group exposures. This would be the only way to prevent smaller states from losing existing and potential investment from non-EEA firms.

However, as set out in our response to question 19, we believe that option III is only a compromise solution, and that intra-group exposures do not actually belong in an LE regime. Accordingly, one or more of the following options should be considered to mitigate the extreme approach described in the paper:

[8] Paragraph 204
[9] Part 6.3

A systems and controls approach to intra-group exposures only. The first part of the advice to the Commission argued that a systems and controls approach was inappropriate to an LE regime. However these arguments do not extend to intra-group exposures. In fact, Pillar 2 would be an effective means of balancing risks and benefits of intra-group exposures, incorporating for example, parental guarantees, and an understanding of the controls between and across entities.

A pragmatic approach, balancing the costs of the limits based back stop regime to intra-group exposures against the simplicity of aligning to the existing model for third party exposures. This could be done, for example, by applying risk weights or conversion factors to these exposures. Clearly, this aspect would benefit from further exploration and analysis.

Continue existing concessions available in some member states. If this is the approach chosen, given the wide disparity in application, then further discussion around the choice of concessions should occur.

Q23. What are your views on the high level principles to define *intra-group limits*?

Given the significant and adverse impact of treating intra-group exposures as if they were third party exposures with no additional concessions or exemptions, our arguments set out in our response to Q19 to 22 demonstrate that a 20% limit should not be considered.

Q25. Do you agree with the proposal on the treatment of other financial institutions for large exposures purposes? Please explain your response.

The following addresses the fact that Investment Firms should not have to include intra-group exposures in their LE regime.

CP16 makes clear that the concerns related to intra-group exposures are as follows:

- The difficulties faced by a subsidiary in the event of failure of its parent, and the associated effect on the depositors of the firm.
- Depositors will be disadvantaged by an unscrupulous parent organisation borrowing heavily from a subsidiary and then allowing the subsidiary to be wound up.

Both scenarios concern the risk of depositors losing out. Neither example would result in a parent being brought into financial difficulties as a result of large exposures. Following CEBS own logic, investment firms should not be required to calculate intra-group large exposures because investment firms do not have depositors to the same extent as banks and building societies, and as such should not be incorporated in the regime.

Importantly, the intra-group LE regime does not address the issue of market confidence, as it assumes that the parent has already failed, and the subsidiary must be assumed to fail.

Merrill Lynch

Sovereigns

Q26. What are your views on the proposal to remove the national discretion and to automatically exempt exposures to sovereigns and other international organisations (within Art 113.3 (a – f)), as well as some regional governments and local authorities? Please explain your views.

This would significantly simplify assessment of large exposures, and, as noted by the analysis, rightly excludes counterparties which would be very unlikely to create issue for firms.

Interbank

Q30. 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?

Given that CEBS already has cost benefit information indicating that for some States the costs of regulation exceed the benefits[10], it would appear inappropriate to prejudice against these jurisdictions by ruling out any exemptions on interbank exposures.

Q31. Given the market failure and costs/benefit analysis set out, what treatment would you consider appropriate for interbank exposures?

Given the costs of treating inter-bank exposures in the same way as other third party exposures, a pragmatic response of excluding intra-bank exposures of less than 12 months would be appropriate. This exclusion is especially valid to aid market liquidity.

Q33. 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?

See response to question 31.

[10] Described in paragraph 264.