BNP PARIBAS

M E M O R A N D U M D R A F T

DATE : July 24, 2007

A L'ATTENTION DE - CEBS

DE - *From* : C. LAJOIE

COPIE - *Copy :*

OBJET - *RE* : Large Exposure Regime, comments to the 1st part of the CEBS advice to the EC

BNP Paribas appreciates the opportunity to comment this first part of the consultation advice on Large Exposure to the European Commission, which addresses appropriately most of the issues, even though some positions are quite normally debatable.

We also notice that some issues will rather be handled in the second part of the advice, which will come later on, during the second semester. This two step approach has clear merits in separating otherwise linked issues, however we cannot but underline the importance of the credit risk mitigation, indirect concentration risk, intra-group exposure and trading book exposure issues for the Industry. This is particularly true for the latter case where the time horizon and the management techniques are totally different from those used in the banking book world and probably deserve a specific approach.

We would also like to underline that the Industry needs a simple and/or principle based regulation. The growing burden of the current and planned regulation is such that this phenomenon becomes a true jeopardy for the efficiency of the banking activities.

CEBS Questions:

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

We agree that a Large Exposures regime should mainly aim at preventing **unforeseen event risks** that could negatively and significantly impact a bank's liquidity or solvency.

Materialization of such event risks usually relates to single name concentrations, as fraud or misrepresentations and do not affect whole industries or countries at the same time. Monitoring of single name concentrations in relation to the equity base of the bank should therefore definitely be a prime target of the regime.

We think useful, as the consultative paper seems to do to, not to commingle the L.E. regime with risk concentration management issues even though these two notions may sound quite close. The L.E. regime

should be construed as the ultimate safeguard to prevent institutions from inappropriate and careless lending practices while Pillar 2 requirements should be focused on the improvement and efficiency of risk management. There are therefore two different while related prudential objectives, which then requires two different responses.

We consider that single name, sectoral and geographic concentration issues are clearly to be handled through Pillar 2 and bank's specific monitoring by both its management and its supervisors. These concentration analyses must be tailored to the specific risk profile of the bank and the economic forecast; it cannot fit in a standardized approach. Concentration risk should be dealt internally by each bank with its own rules, the onus being on it to show the adequacy of its management through the ICAAP to its supervisor.

We do also agree that the undiversified idiosyncratic risk should not be considered at this stage in the Pillar 1 process

In short, we are in favour of a L.E. regime that will be a safeguard regulation to rein in careless lending, supplemented by a concentration monitoring which will be part of the ICAAP and Pillar 2 surveillance. The L.E. regime should then be a simple, easily understandable, calculated and verifiable backstop while concentration risk should be principle based, reviewed within the bank's ICAAP. This clear separation would allow and justify different metrics and approaches to tackle these two different but again closely related issues.

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2. 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?

There are growing and new challenges due to the increasing product innovation, complexity, correlations, and potential contagion effect brought in by new financial players (Hedge Funds, CDOs, etc.)

However, banks' internal risk management and discipline have improved a lot and will continue to do so under the pressure of Basel II, including Pillar III but also under the pressure of the management itself whose objectives are also to keep the firm alive, steadily profitable, and efficient in the long run. We do not share the view that there could be an opposition between the management goals and the social interest, embodied by the supervisory body.

The examples given in the paper are not a convincing demonstration of this thesis. They just show examples of mismanagement and bad governance. The usual reaction of management facing unexpected losses is more to wind down its risk appetite than to double its stakes to restore its profitability. They do however show a need to stop these ever possible human deviations through a rather simple but necessarily loose straight jacket, as the current regime is, provided that some improvement, clarification and simplification are made as suggested, later on, in the paper.

3. Do you have any further evidence that you consider useful for deepening the market failure analysis?

No

4. 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 please provide us with a detailed explanation of where you consider that competitive distortions arise?

We do not have experienced any systematic competitive disadvantage across countries, except for the existence of variations which does not help for the management and reporting of these issues. However, we are not familiar with the investment bank regulation and a comparative study would be useful.

5. 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?

In the case of single name concentrations, unforeseen risk events would typically be cases of fraud / misrepresentations on highly rated counterparties, becoming "fallen angels". Their rating would not be relevant. We then concur with the orientation not to reflect further the credit quality of highly rated counterparties in large exposure limits. However we feel that making no difference between OECD sovereigns or banks and any other exposures is rather rough and does not work in favour of the acceptance of the regulation. We would suggest a simple three weighting system: 0% for OECD sovereigns, 20% for OECD banks and 100% for all other exposures.

6. 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?

We believe this limit as being a good compromise; it leaves some leeway to small and specialized banks; it does not interfere with the concentration management that the largest banks will have to develop anyway within Pillar 2.

7. What principles or criteria might be applied for an institution to demonstrate its ability to measure and manage the relevant risks?

Strong internal control, an adequate and effective ICAAP (Analyses of economic capital concentration and stress testing) and, eventually compliance with the L.E. regime are certainly the most relevant ways to control these risks. The L.E. regime, as a backstop, and a concentration management satisfying the Pillar 2 requirements appear to the Industry a satisfactory framework.

8. Do you consider that the principles outlined with respect to off balance sheet items would be suitable to govern the calculation of exposure values by institutions using the Advanced IRB Approach for Corporate exposures and/or the Internal Models Method (EPE) for financial derivatives and/or securities financing transactions?

We believe that the determination of exposure values should be as simple and, hence, as consistent as possible with the Basel 2 EADs. Such an approach would simplify a lot the calculation process and its understanding while the drawbacks, from a methodological standpoint, are minimal. What is good for the capital requirement measurement should also be for the LE regime purpose. We therefore strongly support the use of Basel 2 compliant EADs, whether they are internally defined or based on the regulatory assumptions, to report and verify the L.E. limit compliance

We are then in favour of the two-tier approach to the LE regulatory framework, whereby most sophisticated banks would be allowed to use their own EADs to assess their large exposures.

It seems to us, although the paper outlines well the issues, that the four principles to be met for reporting exposures on financial derivatives and securities financing transactions (multiplicity of possible measures, EPE or high percentile) do not give sufficient clarification and will need to be further elaborated.

Indeed, we believe that the principles should define the time horizon over which to consider potential future exposures, as well as the statistical measure to use.

In terms of time horizon, using a one-year horizon would be the most appropriate as it is consistent with the regulatory and economic capital process.

As for the statistical measure to use, the large exposure value should be derived from the Effective Exposure profile. Indeed, using a percentile approach depending on the limit framework of each bank would create competitive distortions between banks, favouring those who use the lowest percentiles. The EE measure has thus the advantage of being unique, well defined and consistent across all banks. In addition, the EE approach has the advantage of being consistent with the approach for loans thus creating no competitive distortions between different departments of a bank.

9. Do you support harmonisation of the conversion factors applied to the off balance sheet items set out in Section IX.II? How important are these national discretions?

We support harmonisation of the conversion factors.

10. How are these facilities, transactions etc regarded for internal limits setting purposes? What conversion factors do you consider appropriate?

The closer the LE regime will be to the principles we agreed upon above: B2 EADs associated to three counterparty weightings, the easier it will be understood and seen as a useful backstop system for internal purposes. The more principle based the concentration risk analyses within the ICAAP will be, the more tailor made and, hence, useful it will be for management purposes, as well.

11. In the above analysis we have not given consideration to the appropriate treatment of either (a) liquidity facilities provided to structured finance transactions or (b) to default products. How do you calculate exposure values for such products for internal purposes?

We believe that further analyses are needed on these specific topics. Liquidity facilities provided to structured finance transactions are generally almost risk free because of their senior position on the all the underlying assets. Default products may be taken into account through a look through approach, which however overestimate the total risk born by the bank.

12. 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?

As expressed above these issues deserve further work. The pass- through principle may be appropriate in some cases: rather simple structured transactions with few underlying assets.

It is not when the instrument is by construction diversified, which makes the reporting on the underlying assets useless; besides, it is generally both impractical, because of lack of information and complexity of risk allocation, and burdensome.

In some other cases: structures that are meant to modify the underlying risk in a very complex manner, the deconstruction of the instrument may be both almost impossible and misleading. In many instances, ad hoc identification of risk drivers, like for example concentration to the general level of dividends or to specific business activities, i.e. the sub-prime market, is much more adequate to manage and mitigate bank's risks