CEBS CP16 – Large Exposures

CEBS issued their second consultation paper on its **technical advice to the European Commission on the review of the Large Exposures rules** on December 7, 2007. Feedback to CEBS is required by February 22, 2008.

This note is intended to highlight the most significant issues and serve as Deutsche Bank's input on the proposals outlined in the paper.

In summary, the paper constitutes a step in the right direction but remains in parts disappointing as

- the document lists much thinking in progress without being too concrete
- contrary to CEBS's mandate to truly reform the framework, much unnecessary complexity and exceptions are upheld
- the attempt to align the new large exposures (LE) regime with Basel II succeeds only partially – unnecessarily establishing another separate rule set for which additional processes need to be implemented

Under the proposed principles, Deutsche Bank would also experience some difficulty to implement the new LE regime. We list the most important issues that have been identified by internal experts in the following. Subsequently, individual noteworthy paragraphs from the consultation paper are provided with comments.

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11 January 2008

Top 5 Issues in CP16

Expanded scope of interconnectedness. CEBS proposes to keep the current definition of a large exposure[1] (§71) but provides a new interpretation of its key component, the "group of connected clients". As an indication of relationship of dependency between clients, CEBS has listed (§92) some examples of possible financial dependency where institutions would need to present strong counter arguments for _not_ grouping clients:

- *exposure to a commercial property and to the tenant who pays the majority of the rent;*
- *exposure to the sole producer of a product and to the only buyer of the same;*
- *exposure to a producer and to vendors that this producer is depending on and which it would take time to substitute;*
- *exposures to undertakings that have an identical customer base, consisting of a very small number of undertakings and where the potential for finding new customers is limited;*
- *exposures to undertakings that are financially dependant; and*
- *exposures to undertakings where the same natural persons are involved in the management/board of both clients.*

These examples indicate a much broader scope of financial connectedness than well established within our credit risk management and capital calculation policies & processes (agreed to by BaFin), where only mutual dependency is a criterion for interconnectedness. While Deutsche Bank considers the broader "interconnectedness" as part of its day-to-day risk management, we would have to change credit hierarchies and reporting requirements in order to comply with proposed. In order to avoid unforeseeable impact on our internal and external processes, this proposed interpretation needs to be revisited to follow clear and measurable criteria instead.

Internal Models Method. We welcome CEBS's acknowledgement to permit institutions to use for the large exposures regime the exposure values determined within the capital requirements framework, which includes the Internal Models Method (IMM) for derivatives and securities financing transactions (§116). Not understandably, however, CEBS deviates from the IMM framework by demanding in §113 (3) that the "*exposure values must be arrived at consistently with the approach that the institution uses for estimating exposure values in the context of its internal approach to setting maximum limits*". As many institutions, Deutsche Bank does not use the EPE measure under the IMM for limit setting but a more conservative PFE based on internal netting rules. Prerequisites to use IMM for large exposure calculations should be fully aligned with solvency regulation. In particular a use test in line with the one required for solvency should be sufficient.

Risk mitigation. CEBS shies away from reforming the current framework by retaining the conflicting definitions from the CRD as to what is an exposure for the purpose of the large exposure regime: Therein Art. 106 (1) defines exposure as an asset's exposure value "without application of the risk weight", but Art. 114 allows for "fully adjusted exposure values" for collateralised exposures under the Financial Collateral Comprehensive Methods (IRB with own LGDs). This EU prerequisite, which inaptly mixes exposure (EAD) with loss at default (EAD*LGD), is kept by CEBS (§122ff) and even further complicated by its suggestion to reflect unfunded protection according to the minimum capital rules (§157ff), which would even require recognition of the PD of protection sellers. In our view, the LE regime should not attempt to create an overly complex Basel II copy but rather focus on the EAD alone with wide ranging exceptions applied to collateralised exposures (which attract very low LGDs and JDPs anyway).

Intra-group exposures. By its own admission (§230), CEBS has yet to conclude on what treatment it believes to be the most appropriate for imposing intra-group limits. In our view, the current German framework is fully sufficient in this respect as it distinguishes the group (no LE reporting for exposures to subsidiaries) from entities or closely connected groups

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[1] Exposure value is equal or exceeds 10% of the bank's own funds.

(whose exposures are subject to the local LE regime). The envisaged European solution should follow this established handling.

Preferential treatment. We agree with CEBS that *investment managers* should be exempt from the large exposures regime (§§27, 243&244). We also believe that, for the purpose of functioning financing markets and risk diversification within the system, interbank large exposures should receive a preferential treatment similar to the existing one (§258). However, we remain sceptical with respect to CEBS' proposal is that the exposures to sovereigns or regional governments and local authorities should be exempted from the large exposures limits (§90, §253ff). As explicitly stated by CEBS in §256, this motion appears to be exclusively politically motivated and is not in line with our own default experience (for sub-sovereigns).

Further to the above, CEBS CP16 did not pick up on the following issue:

Non-bank group limit. Art 111 §2 CRD, in deviation from the general large exposure limit of 25% , requires to comply with a stricter limit of only 20% for those clients which are connected to the lending institution itself. Sentence 2 of said provision allows for a more generous treatment but only if specific monitoring measures are being ensured. In practice, this exemption is applied to subsidiaries which are consolidated into the regulatory group (which consists namely of banks/investment firms, financial service providers and financial enterprises). Those subsidiaries which will not be consolidated for regulatory purposes, e.g. operating/industrial companies, real estate firms) are not considered to be exempt - hence the 20% limit applies.
In light of the LE rules perceived objective, there is no reason to subject a "group" of own subsidiaries even if not consolidated to a stricter limit than an unconnected third party group of clients. In other words, we ask for the 25% limit to apply in this case as well without restriction. Why should a bank be permitted to lend to a third party group of clients up to 25% of its own funds whereas its lending limit to a group of entities which it at least controls (though not consolidates) should be kept at 20% only?
In §§67-70, the consultation paper completely ignores the issue. It is unclear whether §229 does as it deals with intra-group exposure only; the problem arises specifically with subs which are not deemed to form part of the group (as understood for regulatory purposes).

Further noteworthy individual items[2] in CP16

Chapter 1. Summary of CEBS' key findings in Part 1 of its Advice

- §68: CEBS view is that 25% of own funds remains a large amount.
- §70: CEBS believes that the 800% aggregate limit has merits in providing a harmonised minimum standard to ensure granularity of the credit portfolio. Deutsche Bank's experience does not support this assessment.

Chapter 2. Definition of Large Exposures (connected clients)

- §71: CEBS proposes to keep the current definition of a large exposure as it is today in article 109 of Directive 2006/48/CE: "A credit institution's exposure to a client or group of connected clients shall be considered a large exposure where its value is equal or exceeds 10% of its own funds". This definition (does not name and therefore) excludes "connected parties" which are extensively discussed thereafter. "Client or group of connected clients" see issue "Interconnectedness".
- §84: In addition to the general need for clarification, recent events have made this even more important. Until now, the supervisory authorities have focused only on the asset side of the undertakings in question in order to identify whether one undertaking may encounter repayment difficulties because of the financial problems of the other entity. The turmoil in the financial markets following the sub-prime crisis in the US, have shown that two or more undertakings can be financial dependant because they are funded by the same vehicle. For example, in Germany, Rhineland Funding issued CP in order to finance the numerous "Loreley Conduits". As the asset quality of one conduit came into question, Rhineland Funding was unable to issue new CP and provide the necessary funds to all the conduits. Therefore, IKB Bank as the main provider of liquidity facilities had to fund the whole structure. Although the different conduits were not invested in the same assets and were legally independent, it is clear with hindsight that the different conduits constituted a group of connected clients as they formed a single risk. Supervisors may therefore take into account not only the risk that derives from the business and assets of two entities but also from their liability or funding side. Necessary clarification of general interpretation related to connected clients, reflecting recent developments around IKB and its conduits.
  - Includes dependency in funding that requires the reporting within in one group of connected clients, although the different conduits were not invested in the same assets and were legally independent.
  - However, it remains in question if an LE regime is the institution to monitor this kind of risk. Small changes in the structure of those vehicles would evade reporting requirements. Instead, improved disclosure requirements would be a more effective control mechanism.
- §90: CEBS proposes that the subsidiaries of central governments, regional governments or local authorities do not normally need to be grouped together as connected clients. Isn't this requirement generally obsolete if §253ff apply?
- §91: CEBS proposes that dependencies arising purely from geographical proximity or identical sectors are not included as these are considered within the Pillar 2 assessment. Agreed - this is very important to avoid double counting in Economic Capital models.
- §95: CEBS proposes that in principle, an entity should not be included in more than one group of connected clients. There are, however, constellations that require an entity to be included in more than one group of connected clients. Assigning a given customer to more than one customer hierarchy implies the need for a separate grouping of customers for the purpose of Large Exposures than for (regulatory and economic) capital assessments (as otherwise risk would be double counted in the latter). The latter also bears a conflict with the proposed consistent use of the CRD exposure measures as CCF calibrations generally depend on the customer hierarchy chosen. This must be avoided.

Chapter 3. Definition of Exposures Value

- §102 (also §9): <On-balance sheet items> exposures will be net of accounting provisions and value adjustments. It needs to be clarified that this does not relate to general value adjustments but only specific charge-offs (like LLPs).

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[2] Deutsche Bank comments in red.

- §105: For institutions that have not obtained permission to use their own estimates of conversion factors <..>, CEBS considers the possibility of not permitting the use in all cases of the same exposure calculations as are used for credit risk capital requirements purposes. This would otherwise remove yet another incentive to move to the Basel II advanced approaches and introduce manifold manipulation possibilities.
- §113: CEBS <proposes> a small number of principles on the basis of which institutions are permitted to use for large exposures purposes their own exposure calculations which are also used for regulatory capital requirements purposes <...>:
  1. institutions that have obtained permission to use their own estimates of conversion factors to calculate their risk weighted exposure are permitted to use their own exposure value measurements for the purposes of the large exposures rules (but this does not include recognition of risk weighting based on counterparty creditworthiness); Contradiction to some of the statements made in Chapter 4 where use of RWA components other than EAD are discussed.
  2. such exposure values must be demonstrated to the competent authority to be suitable for use in the context of a framework designed to limit the losses of an institution in the event of the unforeseen default of a counterparty; and Potentially superfluous as the Basel II audits should have assessed this prior to granting approval. This would only be necessary in the unlikely case that a bank wishes to use the IMM only for the purpose of LE reporting.
  3. such exposure values must be arrived at consistently with the approach that the institution uses for estimating exposure values in the context of its internal approach to setting maximum limits for exposures to single counterparties (or groups of connected counterparties). See issue "Internal Models Method".

Chapter 4. Credit Risk Mitigation and Indirect exposures

- §131 (also §15): CEBS believes that there are market failures that justify in specific cases different treatment between the regimes. In the absence of CRM techniques, for the large exposures limits, institutions cannot take into account the amount that eventually will be recovered in the bankruptcy process given the great uncertainty regarding the amount and the need for timely recovery of the amount due. Therefore, in the absence of mitigation techniques, in the case of institutions allowed to use the IRB approach, the LGD will always be 100%. LGDunc=100% preserves CRD Art. 106 (1) (and effectively reduces the regime to monitoring EAD instead of EAD*LGD) but is out of sync with the use of own LGDs (see issue "Risk mitigation").
- §133: Taking into account the above considerations, CEBS' initial view is that there are prudential arguments that can justify a more conservative approach regarding the treatment of protection in the large exposures framework versus the minimum capital framework. See issue "Risk mitigation". The alternatives listed thereafter all have this problem and need to be expanded also to unsecured exposures. Real changes for the better would rather be
  1. to consistently allow own LGDs also for unsecured exposures (similar to Proposal 1 but in conflict with §131), or
  2. abandon the use of LGD but restrict the exposures is subject to the large exposure regime (e.g, by excluding strongly collateralised/protected portions altogether; similar to Proposal 2).
- §142: Regarding ¨on balance sheet netting¨ and ¨master netting agreements¨ CEBS agrees that the risks exposed in the previous section do not apply to them and they can be accepted in the same way as in the capital rules. Potential conflict with principle §113 (3) as this would imply that we have to calculate PFE under regulatory netting as an additional exposure measure for no other reason than LE reporting
- §148: Under the CRD, the recognition of the mitigated effect of real estate collateral does not directly reduce the exposure but is implicit in the reduced risk weight or in the reduced LGD. The calculation of the effects is different depending on the approach used by the institution. CEBS' initial view is that it is not justified to introduce such a differentiated treatment in the large exposures framework. Another argument to go for alternative 2 in §133.
- §§152&153: CEBS' view is that for unfunded credit protection the same treatment as in the minimum capital rules could be accepted. Both guarantees and credit derivatives are permitted to reduce capital requirements under the CRD, and are available under all credit risk approaches. Both types of contract work by substituting a 'promise to pay' from the underlying obligor with another 'promise to pay' from the protection provider. <…>. Good modification that allows active risk management for large loan names.

- §§157&158: CEBS is <...> proposing to follow the minimum capital rules for unfunded credit protection <...>. For institutions permitted to use own estimates of LGD, CEBS initial recommendation is to allow them to use their internal calculation of the effects of the unfunded protection if they can estimate its effects on their exposures separately from other LGD-relevant aspects.
  CEBS has yet do not reach a stance on whether to accept, or not to accept, the treatment of double default in the large exposures regime. This all implies a complex application of varying PDs, and LGDs attributed to borrower and guarantor, respectively. Technical requires an additional Basel II style process with a slightly different rule set.

Chapter 5. Trading Book issues

- §20, §§182&183: CEBS believes that the differentiated treatment of exposures in the trading and banking books could give rise to regulatory arbitrage opportunities due to the fact that two are becoming increasingly blurred. However, CEBS' preliminary view is that the problem of regulatory arbitrage also applies to the capital requirement regime, which lays the basis for the definition of the trading book that is relevant also for the large exposures regime. It is therefore the task of supervisors to determine if the positions in the trading book are really held with a trading intent in line with an institution's trading strategy. Regulatory arbitrage between banking and trading book out of scope - agreed.
- §179: <...> the investment firm meets the additional capital requirement of €520,000 (= excess exposure * 200 % * 8 %). This calculation is difficult to follow.
- §180: Clearly, treating trading book exposures according to the existing banking book regulations will have strong adverse effects on investment firms' ability to provide investment services. An interesting statement in view of the current discussions around incremental default risk which bears some contradiction with
- §185: CEBS initial thinking is that it may be necessary to amend the trading book large exposures regime in the context of the incremental default risk capital charge.

Chapter 6. Intra-group exposures

- §191: CEBS considers that the basic market failure analysis (defined as the risk of a regulated institution incurring traumatic loss as a result of the default of an individual counterparty due to "unforeseen events") does not apply (on a solo basis) to exposures between entities in sub-consolidations that meet the criteria set out above (fungible capital, sub-consolidation level risk control), or between branches and their head offices.
- §24 & §213: CEBS considers it inappropriate to propose that subsidiaries in host Member States be mandatorily exempted from large exposures regulation, because groups may not always support failing subsidiaries (which may be systemic from a host state's perspective) and there may be impediments to the movement of capital and liquidity across national borders in stressed situations.
- §247: CEBS proposes that financial institutions not subject to the CRD should not be subject to large exposures limits on a solo basis but parent institutions should include their exposures on a consolidated basis.

Chapter 7. Sovereigns, international organizations, multilateral development banks and public sector entities

- see issue "Preferential treatment".

Chapter 8. Interbank exposures

- §258: Exposures to institutions regulated by the CRD (which will be referred to in this document as "interbank exposures") are subject to a complex range of national discretions and derogations set out in Directive 2006/48/EC, Articles 113(3)(i), 115(2) and 116. Broadly, and with one or two exceptions, Member States currently exempt, or subject exposures to a 20% weighting of the exposure amount, unsecured interbank exposures of less than one year's maturity.
- §§31&292: At this stage, CEBS has yet to conclude what the most appropriate treatment for interbank large exposures is but aims to do so in presenting its final response to the European Commission, after taking industry comments into account. CEBS will be considering whether a differentiated approach should be taken to institutions of different sizes and natures. CEBS will also consider a full range of policy options, including a reporting-only regime, hard limits based regimes featuring various degrees of national discretion, and other potential regulatory solutions. See issue "Preferential treatment".

Chapter 9. Breach of limits

- §§298ff CEBS has discussed three possible supervisory reactions to a breach of the limits:
  1. Not to accept the breach at all. In that case the required actions to be considered by the institution are, separately or in combination, exposure reduction, the use of credit risk mitigation techniques or an increase of own funds in order to come back within the rule. (The institution would need an increase in capital equivalent to four times the extent of the breach).
  2. Supervisory authorities agree with the institution an adjustment period in order to facilitate institution's return to a compliant situation. As noted above, Art 106 paragraph 3 of the CRD provides for that a breach can be maintained over a certain period of time provided the deduction of the excess from own funds
  3. Breach can be maintained over a longer period of time provided there is deduction of the excess from own funds. In this case, supervisory authorities would require a minimum capital level not lower than the sum of the Pillar 1 and Pillar 2 requirements and coverage of the limit excess in order to accept the breach of the limits for an extended period of time. Besides the own funds coverage of the excess, supervisory authorities would also take into consideration other circumstances such as the total level of own funds, the compliance history of the institution and a rigorous assessment of the internal management and reporting of large exposures.

  Any alternative would be fine with Deutsche Bank as long as it is consistently applied throughout Europe.

Chapter 10. Reporting issues

- §310: CEBS believes that it would be too burdensome for the institutions to provide a full overview of their individual large exposures on a regular basis within their Pillar 3 reporting. Agreed. Not only burdensome, but also highly undesirable w.r.t. to our customers.
- §313: CEBS is of the opinion that the review of the large exposures regime is a good opportunity to consider the purpose of reporting large exposures and where there might be opportunities for harmonisation. Therefore it supports regular reporting with reports defined by the regulators/supervisors. Strictly no appetite for harmonisation efforts like COREP.
- §314: Further, CEBS proposes that the key elements within a large exposures reporting regime might include:
  - reporting of large exposures should be based on gross exposure values Contradiction to the base measure to be used (net; cf. §102)
  - net exposure value as well as CRMs used
  - all intra-group and interbank exposures should be reported regardless of the decision on whether or not to impose limits on those exposures
  - exposures exempted from the imposition of the limits Burdensome as it requires maintenance of the full reporting process.

Chapter 11. Credit risk management

- §321: Large banks by definition are in a better position to diversify their portfolios. Indeed some large banks stated that these limits are not so effective for them as for small banks. They said that they set internal limits stricter than the regulatory limits. Moreover they are usually rated by credit rating agencies and therefore more subject to market discipline.
- §322: However, the results of an analysis conducted by CEBS based on data from large exposures reporting of the five largest banks in each country were that the 25% limit can bite even on large banking groups in a significant number of countries, although it seems that for other countries this limit does not constitute a real constraint.
- §325: CEBS' orientation is that the market failure analysis does not justify exempting from the large exposure limits the advanced institutions even where they have sophisticated systems and controls. CEBS has previously noted, that it considers a large exposures regime to be a back stop limit based regime to address unforeseen event risk.