6 November 2007

Draft feedback to the public consultation on CEBS' CP14 on the first part of its advice to the European Commission on large exposures

1. In June 2007 CEBS published a consultation paper (CP14) on a number of key aspects of the large exposures regime as part of developing its response to the first part of the European Commission's Call for Advice.[1] The consultation period ended on 15 August 2007. 12 responses were received, all of which are published on the CEBS' website.

2. This paper presents a summary of the key points arising from the consultation and the changes made to address them. It also includes a feedback table which reflects CEBS' detailed views on the public comments.

General comments

3. Respondents broadly agreed with the proposals outlined in CP 14. They think that the large exposure (LE) limits are useful if they operate as a "regulatory backstop" against unforeseen event risk. However, there are some large institutions that consider that the best approach would be to allow institutions themselves to manage this risk following Pillar 2 guidelines on concentration risk. Also, some small institutions proposed that the LE regime should be considered as a basic indicator approach to LE risk under Pillar 2.

4. Further work was requested on a more explicit formulation of the main objective of LE regulation, enhancing the international comparison to consider the practical application of the LE rules and the possible use of exemptions, and further consideration of some of the major counterparty failures which have occurred in recent years including investigating why those have not resulted in firm failures or losses to depositors.

Specific comments

5. On the objectives and purposes of a large exposures regime most respondents accept that there are legitimate supervisory concerns that justify an LE regime - preventing unforeseen event risks that could negatively and significantly impact banks' liquidity or solvency, and limiting the degree to which institutions are exposed to incidents of traumatic loss which are likely to threaten their solvency and which usually relate to single name concentrations. These tail events are not sufficiently covered under Basel II.

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[1] http://www.c-ebs.org/documents/LE_CfA2.pdf

6. All of them support the LE regime if it serves as a backstop against unforeseen event risk. It should be a relatively 'light touch' regime, within which institutions can retain much flexibility to manage risks through their own systems, policies and practices.

7. At the same time, they comment that the paper should also recognise that single name, sectoral and geographic concentration risk should be handled through the Pillar 2 framework.

8. However, some large institutions question the presumption that a LE limit is the appropriate tool to address single name concentration risk. They believe that the Pillar 2 framework is enough because risk management and risk mitigation tools have developed significantly since the introduction of the LE regime and because banks take the management of concentration risk very seriously; their limits are in general tighter than the regulatory limits.

9. All respondents support the proposal that the undiversified idiosyncratic risk should not be considered at this stage in the Pillar 1 process, nor should a Pillar 1 treatment be developed for sectoral and geographic risk, as both issues are adequately dealt with under Pillar 2.

10. The use of a market failure approach was generally welcomed by respondents although some large institutions indicated that they do not agree with the output of the analysis and do not agree that there remains a material degree of market failure with respect to unforeseen event risk and, therefore, that an LE regime is not needed anymore.

11. Some respondents think the analysis should be improved by the inclusion of a differentiated MFA by size or business activity/business models and that the MFA should recognise the improvements in risk management and discipline enhanced by Basel II rules. They also asked for different examples of MFA, as they believe that the examples of failures included in the CP were not relevant to unforeseen event risk (or even implausible) and were instead examples of mis-management and bad governance.

12. A number of respondents said that rating agencies and wholesale counterparties provided an effective level of market discipline, while others believe that the pressure that credit rating agencies may exert is only felt by large banks, if at all.

13. Regarding market discipline imposed by other stakeholders (disclosure), some respondents believe that it is difficult for disclosure requirements to contribute to market discipline in this context since they are updated too infrequently to offer timely information on this issue. Market discipline may be used as a motivating factor in theory but, in this context, it would have little relevance in practice.

14. It was also pointed out that although limits could be an appropriate tool, CP14 provided limited consideration of alternative regulatory tools available in determining the way forward.

15. All respondents consider that the countries chosen to compare with the EU LE regime are the right ones, but they also point out that the comparison should

be deepened in order to truly assess the competitive implications of the LE regime.

16. On the large exposures limit, all respondents but one supported CEBS' view that there should be no recognition of counterparty creditworthiness in the calculation of exposures. However some respondents believe that there are some specific exceptions to this principle. Other respondents favour a rather simple approach: a simple three tier weighting system: 0% for OECD sovereigns, 20% for OECD banks and 100% for all other exposures.

17. As regards the 800% limit, many respondents prefer to keep it as it is, as it is said that the maintenance of the limit as a general rule could be helpful to provide against poor concentration risk management, or be used as a general guideline for less complex institutions.

18. On the calculation of exposure values for institutions not allowed to use internal models, most respondents support harmonisation of the conversion factors, although half of the respondents say that the new conversion factors should not be higher than the old ones and that a 100% conversion factor may be not appropriate.

19. As regards the internal calculation of exposure values for off-balance sheet items, most respondents welcome the idea of developing a small number of principles on the basis of which institutions would be permitted to use their own exposure calculations (i.e. their own conversion factor estimates for IRB and/or their Internal Model Method for counterparty credit risk) in the LE framework.

20. In general, respondents believe that the determination of exposure values should be as simple and consistent as possible with those established for solvency purposes under Basel II.

21. Most respondents have not given precise answers to the questions included in CP14 regarding liquidity facilities provided to structured finance transactions or n^{th} to default products.

22. The principles put forward for calculation of exposures to CIUs and structured finance transactions were considered by respondents to be too complex. Most respondents would prefer to have a case by case approach to whether economically their exposure is best represented as an exposure to the scheme, or the underlying assets. Some respondents also pointed out that there are many cases in which institutions do not have enough information at their disposal to apply the principles proposed.

Summary of CEBS' response

23. CEBS' view is that there has been broad support for the objectives of a LE regime, as described in the CP. However, CEBS agrees that CP 14 should be modified on the following lines: i) to make it clearer that existing Pillar 2 requirements cover all aspects of concentration risk, including single name concentration risk; ii) to explain that the LE framework and Pillar 2 requirements on concentration risk are different, although related, issues; and iii) to signal that the LE regime will be constructed as a regulatory backstop

ratio to limit the risk of institutions suffering traumatic losses which are likely to threaten their solvency but which also leaves sufficient room for institutions to use their own internal approaches and does not aim to influence banks' internal management of concentration risk.

24. CEBS agrees with most respondents that market failure with respect to unforeseen event risk still remains. However, it is important to keep in mind that the MFA is still a work in progress. CEBS has accepted some of the suggestions received and is to develop further the MFA in the second part of its advice. CEBS has also sought to provide adequate consideration of the various regulatory tools available and to improve the examples provided.

25. CEBS considers that the work conducted so far on the LE regimes in other jurisdictions is enough to conclude that there is broad consistency between the EU LE regime and those in other jurisdictions and that overall the EU regime is not more strict than any other regime, although it is possible to find some particular transactions that are treated more strictly in the EU than elsewhere.

26. CEBS agrees that some exceptions should be allowed to the general conclusion of not considering counterparty creditworthiness in the LE regime. This issue will be analyzed in the second part of CEBS' advice.

27. CEBS believes that the 800% limit has merits in providing a harmonised minimum standard for ensuring granularity of the credit portfolio but wishes to stress that compliance with this limit does not substitute in any way for the requirement to manage concentration risk under Pillar 2.

28. As regards the calculation of exposures values, CEBS considers that a fruitful approach to this question would be to develop a small number of principles on the basis of which institutions would be permitted to use their own exposure calculations used for regulatory capital requirements.

29. For institutions not authorised to use their own estimates CEBS believes that a 100% conversion factor should be retained as a general principle, except for the low risk items for which 0% will be generally applied. However some further exemptions from these flat conversion factors could be accepted. More work is to be done on this in the second part of CEBS' advice.

30. Regarding the treatment of basket products CEBS believe that there is scope to achieve a degree of principles-based agreement which could significantly enhance supervisory convergence in the EU without prescribing detailed rules or imposing undue burdens on the industry.

Annex

Feedback table on CP14: analysis of public responses and suggested amendments

Draft text CP14	Summary of comments received	CEBS' analysis	Amendments N/R : change not required
III. Objectives and purposes of a large exposures regime			
1. Do you agree with our analysis of the prudential objectives of a large exposures regime?	Many respondents believe that CEBS' paper should clarify the main objective of the new regulatory framework more explicitly. They believe that the paper should include a stronger recognition of the existing Pillar 2 requirements. Nevertheless, most of the respondents believe that there are legitimate supervisory concerns that justify an LE regime: preventing unforeseen event risks that could negatively and significantly impact a bank's liquidity or solvency; to limit the degree to which institutions are exposed to incidents of traumatic loss which are likely to threaten their solvency - the materialization of such event risks usually relates to single name concentrations, such as fraud or misrepresentation. They accept	The dividing line for the purposes of the LE regime and the Pillar 2 requirements is that the LE regime shall ensure that no failure of a customer causes a traumatic loss and so threatens the solvency of an institution, while under Pillar 2 institutions shall be able to assess the impact of undiversified idiosyncratic risk and of sectoral and geographic concentrations in their credit portfolio on their internal capital allocation. The market failures that justify the need for prudential regulation also apply to the LE rules as a part of the prudential framework. The minimum capital requirements address these market failures at the portfolio level: Pillar 1 seeks to ensure that firms have a minimum amount of capital to ensure resilience	CEBS has reviewed this section in an attempt to clarify further the main objective of the LE regulatory framework. Please see chapter 1 of the first part of the Advice.

	that these tail events could not be sufficiently covered under Basel II. However, all respondents except one believe that it is crucial to keep clear that the LE regimen is different/not linked to risk concentration management issues, although these two concepts are quite closely related. The LE Framework should not be defined alongside the Pillar 2 requirements because this will effectively require institutions to operate dual frameworks to manage the same risk exposure. One respondent believes that the relationship has to be clarified and that the new regime must not lead to over-regulation of less complex institutions which will not be able to implement more sophisticated systems on top of the LE regime. Most of the respondents do not see potential problems or overlapping between the Pillar 2 requirements on concentration risk and our proposals for regulatory limits for large exposures. The two are complementary regulation. One respondent questioned the presumption that a 25% limit is the appropriate tool to address single name concentration risk. It believes that Pillar 2 is enough and thinks that unforeseen event risk is part of idiosyncratic risk, not a separate risk,	against losses, and Pillar 2 seeks to correct for distortions caused by concentration risk to the portfolio-level assumptions made by Pillar 1, for example accounting for increased unexpected losses arising from geographical, sectoral and single name exposure concentrations. However, it does not account for market failures arising as a result of individual single name exposures: the risk that one large exposure could, regardless of the performance of the rest of the portfolio, trigger the unexpected default of a firm, or cause the firm to experience significant difficulties of the sort that could lead to instability, contagion, and/or the need for central authorities to intervene. This is what CEBS considers "unforeseen event risk". As the large exposure regime has a different purpose from the Pillar 2 requirements, they are not substitutes but complementary. Compliance with the large exposure requirements does not replace appropriate management of concentration risk under Pillar 2. As the few risk models in use which take into account the idiosyncratic risk have not been tested yet, it would be premature to allow institutions to substitute the LE	

	although it recognises that there are idiosyncratic risk events that fall beyond the chosen confidence level for the IRBA which are of legitimate concern to regulators (i.e. material tail events). This respondent rejects the assertion that firms will cease to exercise good governance in times of earnings volatility. It also believes that fraud appears to be the only example of 'unforeseen event risk' cited in the consultation. If the purpose of the regime is to address the risk of fraud, it does not think that a limit regime is necessarily the most appropriate response. For its part, for non-complex institutions, one respondent is not convinced unforeseen event risk can so easily be distinguished from other elements of single event risk (Pillar 2). All the respondents agree that undiversified idiosyncratic risk should not be considered at this stage in the Pillar 1 process, nor should a Pillar 1 treatment be developed for sectoral and geographic risk, as both issues are adequately dealt with under Pillar 2.	regime with their internal models. The risk of fraud as part of operational risk covers only fraud conducted by an employee of the institution. Fraud within a customer is recognised under the credit risk framework.	
IV. Market Failure/ Regulatory Failure Analysis			

2. Do you agree with the analysis that there remains a material degree of market failure in respect of unforeseen event risk?			
Use of MFA	Respondents generally welcomed the use of a market failure approach for the analysis of the issues. A number of respondents did not agree with the analysis and did not agree that there remains a material degree of market failure with respect to unforeseen event risk. The CEBS consultation practices were described as open and transparent by one respondent.	Respondents welcome the MFA but not the outputs from the work. MFA within the Part One advice is confined to high level analysis regarding the justification, or not, for the regime. In the second part of the advice a more detailed MFA will be provided in order to take into account regulatory failure analysis regarding the different types of institutions / transactions / exposures.	CEBS has redrafted this part in order to be clearer on the MFA and in particular to better explain why CEBS thinks that there remains a material degree of market failure with respect to unforeseen event risk. Please see chapter 1 of the first part of the Advice.
Differentiated approach	A number of respondents were concerned that the LE regime could have disproportionate effects if not evaluated on a more differentiated basis. Specific areas of concern included: exposures to central banks and OECD sovereigns, market for M&A lending.	Analysis is thought to be too general. A deeper analysis is to take place within the work as CEBS considers the issues listed in part 2 of the Call for Advice. For example, in the context of the appropriateness of a "one size fits all" regime CEBS' analysis will seek to identify more precisely where, if at all, a market failure persists by considering issues on a more differentiated basis (for example by firm size, business activity, exposure	To be addressed in the second part of the Advice.

		type).	
Regulatory failure	Some respondents commented on regulatory requirements that were a cause of "friction" and that regulatory practice was not thought to have adapted to current market practices and did not recognise the developments in risk management that had taken place since LE regulation was first introduced. Some respondents said that the treatment of, for example, structured notes or 'basket products' under a future LE regime may lead to a regulatory failure, especially if the (implementation) requirements are not well designed.	Further regulatory failure analysis was thought to be required both in respect of the current regime, and as a factor to be considered when advising on a future regime. The deeper and differentiated analysis within the work to develop Part 2 of the Advice will assist in considering the issues raised.	To be addressed in the second part of the Advice
Regulatory tools / options	A number of respondents proposed and commented on a range of regulatory tools. For example, allowing firms to use their own systems where these are deemed appropriate by supervisors, use of guidelines rather than hard limits, use of independent third party review and reporting frameworks, and LE issues to be entirely within Pillar 2. Some respondents commented that limits may be an appropriate tool.	CEBS agrees that alternative regulatory tools should be considered.	CEBS has included a new section that sets out the alternative tools and their pros and cons as assessed against what CEBS thinks the purpose of a LE regime should be and how they might help address the issues/risks. Please see chapter 2 of the Advice.
Management compensation and incentives	Respondents did not agree that management goals and the social	CEBS agrees that in general that management goals and the social interest should be aligned.	The text has been redrafted to clarify this issue. Please

	interest were not aligned. Some elements of mismanagement might be more properly identified as operational risk	However this is not always true and this is the general justification for prudential regulation. CEBS consider misalignments to be the exception not the rule, but there is still the need for regulation to address this exceptional behaviour which even if exceptional could seriously damage financial stability.	see chapter 1 of the first part of the Advice.
Governance	A number of respondents described corporate governance frameworks which were thought to provide mitigation to the negative externalities noted in CP14.	Corporate governance is about misalignments of internal incentives while we tried to address misalignment between the institution's own goals and social goals.	N/R
Market disciplines imposed by rating agencies	A number of respondents said that rating agencies and wholesale counterparties provide an effective level of market discipline. It was noted that this might be expected to be of more relevance to larger firms. But some other respondents questioned the efficacy of market discipline in general and rating agencies in particular to deal with issues related to large exposures.	Disclosure and market discipline are further analysed.	Please see chapter 2 of the first part of the Advice.
Other stakeholders - information	One respondent noted that information asymmetry characterises financial services and as such is one	CEBS believes that its views on these issues should be clarified.	Please see chapter 2 of the first part of

	of the fundamental tenets underpinning regulation more generally. However, it and other respondents did not consider information asymmetries to be relevant as between a firm and key stakeholders (including depositors and wholesale counterparties) as other mitigants were available (e.g. large banks are usually rated). It was noted that there will be Pillar 3 disclosure requirements – but these are not the only drivers of firms' disclosures.		the Advice.
Interim conclusions and request for input	Many respondents noted the MFA was partial in a number of aspects as these are to be included within the Part 2 work. Many respondents were supportive of a regime emerging from the review that took a "light touch" approach which included flexibility for institutions' own approaches.	A more differentiated approach will emerge as a result of the further analysis to take forward the development of CEBS' Part 2 advice.	To be addressed in the second part of the Advice.
Examples	One respondent said that it agreed in part with the view that inadequate and insufficient management was often a cause of, or contributing factor towards, an unforeseen event occurring. A number of respondents thought the examples of failures were not	Examples were not thought to be relevant to unforeseen event risk. CEBS has included more examples to illustrate the point. Although CEBS' view is that an effective LE regime should be forward looking and based on sound market	Please see annex I of the first part of the Advice.

	relevant to unforeseen event risk and instead were examples of mis-management and bad governance. It was suggested the MFA should consider the implications of the significant counterparty collapses that have taken place over the last few years and why these have not resulted in firm failure. The Norwegian case study was not thought to provide evidence that there is a significant market failure (or if there is a failure, would tend to suggest that it is not material) or that there is a threat to regulatory objectives (i.e. market confidence and protection of consumers)	failure analysis, bank failures due to LE have fortunately been historically relatively scarce. It is important to remember that banks' ability to take on these exposures has been limited by the current regime hence the relative scarcity of examples should not lead us to become complacent and ignore the structured market failure analysis. Moreover CEBS thinks that there does not need to be a firm failure for there to be a market failure. A firm failing to address risks appropriately and relying on others can have the effect of passing on negative impacts to others.	
Further evidence that you consider useful for deepening the market failure analysis?	A number of respondents suggested further work be undertaken, including: (i) elements of the MFA should be deepened and considered further and that there should be a differentiation (eg by size, activity); (ii) assessing firms' practice in relation to the significant counterparty failures that have happened over the last few years that have not resulted in firm failure and losses to determine why; (iii) consideration of the policy options available; and (iv) revisiting the MFA in the light of further work on Part 2.	In the second part of the Advice a more detailed MFA will be provided in order to take into account regulatory failure analysis regarding the different types of institutions/ transactions/exposures.	To be addressed in the second part of the Advice.

VII. Other jurisdictions			
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?	Respondents generally welcomed CEBS' consultation paper on "other jurisdictions". Some respondents agreed that the countries chosen are the right ones. Two respondents have not experienced any systematic competitive disadvantage across countries.	CEBS welcomes the support expressed by the industry on the Consultation Paper. The aim of this paper is to promote consistency and convergence and reduce level playing field distortions.	N/R
	Most of the respondents recommend deepening the comparison in order to truly assess the competitive implications of the large exposures regime, including analysing the practical application of the official rules, the use of possible exemptions in third countries, the scope of application and the methods of exposure calculation. Furthermore, different definitions, according to civil law and the practice of supervisors, could distort the outcomes of the analysis. One respondent believes that to ensure that EU firms are not put at a competitive disadvantage CEBS will need to revisit this issue once it has developed final proposals at the conclusion of Part 2 of the Call for Advice.	CEBS shares the industry points and considers that, indeed, there are different large exposures regimes not equally applied worldwide. The work conducted so far on the LE regimes set in other jurisdictions is enough to conclude that there are broad consistencies between the EU LE regime and those in other jurisdictions and that overall the EU regime is not more strict than the regimes in the other jurisdictions even when for some particular transactions it is possible to find a more favourable treatment.	Please see chapter 3.

	One respondent envisages drawing a comparison with the treatment of risk concentrations outside the banking and investment business sector.	Agree but CEBS formal remit does not extent to conglomerates.	N/R
	Some respondents pointed out the existence of variations does not help the management and reporting of these issues. One respondent adds that it is apparent that there are quite significant differences in application between EU jurisdictions which cause frictions for members that operate across borders. Some respondents suggest the use of the new findings as a basis for actively working towards harmonisation of large exposures rules beyond the EU.	CEBS agrees with the comment and believes its Consultation Paper will promote convergence in supervisory practices in a field where cross-border differences must be addressed.	N/R
	Some respondents pointed out that large exposures limits may require the syndication of loans in the context of merger and acquisition transactions which can create disadvantages in that business where secrecy is a key element at the origination of transactions. Banks without large exposures regulation can discuss one to one. Clients are reluctant to discuss with banks limited by large exposures regulation since they must include other banks in the process to reach	Even if CEBS agrees with the comment on investment transactions, most of the international investment banks are subject to a large exposure regime. These investment transactions form a risk as long as they remain on the books of the institutions and therefore need to be considered as exposures.	N/R

	the global underwriting capacity, and also in the field of short-term financing of mergers and acquisitions.		
	Some respondents pointed out the exemptions available in the US.	Clarify. There is no large exposures regime per se in the US.	N/R
	The current exposures of derivatives, with no add-ons, have to be taken into account for large exposures purposes.	Derivatives are taken into account for supervisory purposes in determining whether a banking organization has a concentration of exposure to a counterparty. However, derivatives are generally not included in the legal lending limits to single counterparties.	N/R
	The required level of capitalization for large exposures can be met by almost all major banks.	CEBS agrees with the respondents.	N/R
	The US rule appears to apply to single counterparties rather than groups of closely related counterparties and excludes trading book exposures.	CEBS disagrees. The "Combination Rules" (12 CFR 32.5) state that as a general rule, "loans or extensions of credit to one borrower will be attributable to another person and each person will be deemed a borrower, 1) when proceeds of a loan or extension of credit are to be used for the direct benefit of the other person, to the extent of the proceeds so used; or 2) when a common enterprise is deemed to exist between the persons." Common enterprise will be deemed to exist and loans to separate borrowers will be	N/R

		aggregated under several circumstances (e.g., when the expected source of repayment for each loan or extension of credit is the same for each borrower; when loans or extensions of credit are made to borrowers who are related directly or indirectly through common control; when substantial financial interdependence exists between or among the borrowers. The lending limits include trading book exposures as well as banking book exposures.	
	US banks seem not to be obliged to consider all assets in their large exposure reports (e.g. guarantees, off-balance sheet items, derivatives).	Clarify. US banks generally do take into account off-balance sheet items, guarantees and derivatives in their regulatory reporting. In 12 CFR 32.2, which discusses lending limits, you will find language that specifically mentions that loans and extensions of credit include "contractual commitments to advance funds." In the specific context of the legal lending limits, banks need to include in their calculations certain off-balance sheet items or guarantees (e.g., contractual commitments to advance funds), but generally do not need to include derivatives. In paragraph 11 of Annex 2 such an exception relates to correspondent banks only (12 CFR 206.4 and 206.5).	Please see Annex 2, paragraph 11.

	In relation to connected undertakings and affiliated companies, there are non-EU countries applying more favourable large exposure regimes. Japan is more lenient with exposures to affiliated companies (40 % limit instead of 25 %). Therefore, we suggest reviewing the current limit regarding exposures towards connected undertakings of banks, currently being stricter than the general 25% limit.	CEBS considers that the EU large exposure regime is well-balanced. The 40% limit in Japan is an exceptional case, which is a difference with EU. No change of wording.	N/R
VIII. The large exposures limits			
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?	Respondents generally agree with CEBS that counterparty creditworthiness should not be introduced generally in the calculation of exposures, but believe that some exemptions to this rule should be maintained for rather implausible events. One respondent believes that the regulatory framework should focus on dialogue over the management systems under Pillar 2 and, in this framework, it is appropriate to take account of credit worthiness in a large exposures regime. Respondents believe that some exemptions to this rule should be maintained for rather implausible events: for exposures rated AA- or better; for counterparties having better ratings than banks; for	CEBS agrees that some exceptions should be allowed to the general principle of not introducing counterparty creditworthiness into the LE regime. It is considered that there are likely to be cases of extremely high quality counterparties with such distinctive features that the risk of default is so minimal that exemption can be justified. This issue will be carefully analyzed in the second part of the Call for Advice in order to include a list of exemptions as harmonised as possible.	To be addressed in the second part of the Advice.

	mandatory exposures to central banks; for exposures with very short maturities and first rate credit quality (such as guarantees of M&A transactions of first-class credit quality); netting of the exposures with particularly secure guarantees, such as sovereign guarantees. Some respondents favour a rather simple approach: a three tier 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?	Many respondents prefer to keep it as it is, and for it not to be tightened, because it does not interfere with the concentration management that the largest banks will have to develop anyway within Pillar 2. It is said that the maintenance of the 800% limit as a general rule could be helpful to make provision against poor concentration risk management, or might be used as a general guideline for simpler institutions, although from a methodological point of view, global concentration to single counterparties should be considered in the context of general concentration risk management, i.e. under Pillar 2 only. Responses are divided between the large and complex banks and smaller	CEBS believes that the 800% limit has merits in providing a harmonised minimum standard for ensuring granularity of the credit portfolio. CEBS is of the view that there is merit in having the same rule for all banks. However it must be clear that compliance with this limit does not substitute in any way for the requirement to manage concentration risk under Pillar 2.	Please see subchapter 4.2.

	banks. For the first group the limit is not significant and does not address any additional risks not covered by Pillar II. For smaller banks the limit is in general high but represents an instrument to manage exposures. For the large banks there are no benefits and only compliance costs, although negligible. For the smaller banks it is a system to prevent poor management of concentration risk.		
7. What principles or criteria might be applied for an institution to demonstrate its ability to measure and manage the relevant risks?	Almost all respondents pointed out that the appropriate principles or criteria for managing concentration risk are those set out in the Pillar 2 guidelines issued by CEBS. Some of them added that the principles should consider individual circumstances or whether the bank is large and complex or non-complex and small. The LE regime as a back stop and concentration management satisfying the Pillar 2 requirements appear to be a satisfactory framework for the industry.	CEBS agrees that the appropriate principles that should be applied by an institution to demonstrate its ability to measure and manage concentration risk are those included in the Pillar 2 guidelines already issued by CEBS.	N/R
IX. Calculation of exposure values			
8. Do you consider that the principles outlined with respect	Most respondents are in favour of permitting within the LE-regime the	After further analysis, CEBS agrees with applying in principle the	Please see subchapters 5.2 and

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?	use of the EADs for regulatory purposes. In the case of internally calculated conversion factors, the overall IRB application should be sufficient for permitting its use for the LE regime. Particularly paragraph 195.3 and 195.4(b) are already part of the IRB application. It is not clear how evidence required in paragraph 195.4(a) can be provided. Principle 3 should refer to the firm's concentration risk management system rather than the approach to setting maximum limits. Respondents ask that the principles to be met for exposure and financial derivatives and securities financing transactions be further clarified and elaborated, and also for defining the time horizon and statistical measure for EPE. The "marked to market + add-on" must remain permitted.	internally estimated conversion factor for advanced IRB banks and the Internal Models Method (EPE). The application files for IRB on the one hand and EPE on the other hand should provide the information necessary.	5.3.
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?	Respondents support the harmonisation of the conversion factors, but for half of the respondents the new conversion factors should not be higher than the old ones.	CEBS welcomes the support for the harmonisation of conversion factors.	N/R
10. How are these facilities, transactions etc regarded for	In general, the respondents want to use the Basel II conversion factors	For the low risk items, 0% will be generally applied. CEBS will further	To be addressed in the second part of

internal limits-setting purposes? What conversion factors do you consider appropriate?	whether they are based on regulatory assumptions or internally estimated. A 100% conversion factor is not desirable. Some respondents would like to use the current LE conversion factors for off-balance sheet items.	investigate which other transactions can be exempted from these flat conversion factors.	the Advice.
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) nth-to-default products. How do you calculate exposure values for such products for internal purposes?	Some respondents report that further analysis is needed. Other respondents refer to some of the principles proposed for the CIU and structured finance transactions (212(a) and 213). Due the large variety of products, a respondent pleaded that the treatment for structured products should be left to the institution, based on its internal risk management practices. With regard to baskets, some respondents recommend a differentiation according to the number of transactions (e.g. when the size of the individual transaction is low, they should not be included in the LE regime). According to one respondent, liquidity facilities should be included at 20%.	After a workshop with the industry, CEBS will further analyse the input from the industry to investigate the treatment of these products.	To be addressed in the second part of the Advice.
12. Do you consider the suggested principles set out in Section IX.III appropriate for application to institutions'	Most industry respondents agree that in some cases a look through approach is advisable in order to assess whether there is a material	Although we agree that in most cases these structures by their very nature should not mean a substantial single counterparty risk has arisen from the	Amendments are included with the aim of keeping the principles simple

exposures to collective investment schemes and/or structured finance transactions?	counterparty risk in such types of schemes and to take it into account in order to know the total exposure to the counterparty. A few respondents think that a look through approach is not appropriate at all for these types of structures given the purpose of these structures is precisely to modify the underlying risk. There are respondents that agree that some principles-based agreement amongst the supervisors in the determination of exposures to arrangements with underlying assets should be achieved. Although they disagree in the way CEBS has developed these principles in CP14. In particular ISDA, LIBA & BBA consider that while the two first principles established in CP14 are real principles (although there is room for improving them), the third and fourth principles are nor real principles but rules given their prescriptive nature. In consequence they proposed to delete them. They also proposed to change §212.(a) into" institutions should identify whether the risk of incurring a loss relates predominantly to the default of the underlying assets or to the scheme itself, or both. In determining this assessment, firms must evaluate the economic substance of the transaction.¨ In general, looking at the underlying assets is perceived as being	underlying portfolio we are still of the opinion that this possibility cannot be completely ruled out. As a respondent has pointed out most of these structures are meant to modify the underlying risk in such a way that the counterparty risk is completely mitigated (through diversification of the underlying portfolio, derivatives, guarantees, etc). However it cannot be excluded that there are structures in which risk is materially driven by a counterparty risk. Besides, in the absence of such a principle institutions could design and use these products to circumvent LE rules. As many of the respondents highlight collective investment units are by definition well diversified products. We agree that for CIU´s required by European or other equivalent regulation to be well diversified there is no need to look through. However the principle should be retained to prevent other types of funds not subject to such rules being automatically considered well diversified without any guarantee that it is the case. Therefore we still consider that a principle should be included in the LE regime to require institutions to take into account any material counterparty risk than can arise from these products when calculating the	and flexible enough. Please see subchapter 5.4. To be further addressed in the second part of the Advice

	impractical, complex and too burdensome. They also explain that often the institution does not have enough information to apply the principles in CP14. Most respondents are strongly against the threshold included in principle 2 to define materiality. They consider this approach impracticable, burdensome and irrelevant for the purpose. They are of the opinion that an institution should have the option of regarding the structure as the borrower or to consider the underlying on a case by case basis. They suggest that it is crucial to consider the granularity of the product in order to determine the possibility of being materially exposed to any counterparty risk. Moreover, given the individual character of structured transactions an open and flexible approach is requested.	LE limits. Supervisors should expect that institutions are able to identify such a material counterparty risk and take it properly into account in their risk management. We agree with the institutions on the difficulty of designing appropriate rules regarding the complexity and heterogeneity of such products. Therefore we reaffirm our idea, already expressed in CP14, that a principles based approach is the most sensible way forward to address this issue as it is in line with the better regulation philosophy. The complexity and heterogeneity of these products, as well as the rapid innovation in this field strongly argue in favour of such an approach. Flexible and simple principles were included. However we still think that further work is necessary on to how to implement the principles in order to achieve a common understanding among industry and among supervisors that guarantees as far as possible a level playing field while at the same time insuring that the minimum prudential objectives are reached. Notwithstanding this, we agree with some industry respondents than more work is needed to achieve this goal.	