

EBA/Op/2018/02

14 March 2018

Opinion of the European Banking Authority on measures in accordance with Article 458 of Regulation (EU) No 575/2013

Introduction and legal basis

1. On 13 February 2018, the European Banking Authority (EBA) received notification from the Haut Conseil de Stabilité Financière (HCSF, the French macro-prudential authority) of its intention to apply Article 458(2)(d)(ii) of Regulation (EU) No 575/2013 of the European Parliament and of the Council (the Capital Requirements Regulation – CRR)¹.
2. The notified measure proposes to tighten, for global or other systemically important institutions only, the large-exposure limits applicable to large and highly indebted non-financial corporations (NFCs) resident in France or groups of connected NFCs assessed to be highly indebted and based in France.
3. The EBA's competence to deliver an opinion is based on Article 34(1) of Regulation (EU) No 1093/2010 of the European Parliament and of the Council² and Article 458(4) of the CRR.
4. Article 458 of the CRR requires designated or competent authorities entrusted with the national application of that provision to notify the EBA if the authority identifies changes in the intensity of macro-prudential or systemic risk in the financial system that have the potential to have serious negative consequences for the financial system and for the real economy in a specific Member State and which the authority considers would be better addressed by means of stricter national measures.

¹ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

² Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC.

5. Within one month of receiving the notification, the EBA is required to provide its opinion based on the points in Article 458(2) of the CRR to the Council, the Commission and the Member State concerned.
6. In accordance with Article 14(5) of the Rules of Procedure of the Board of Supervisors³, the Board of Supervisors has adopted this opinion.
7. The EBA notes that the present notification from the HCSF is the first case in which a designated authority has made use of Article 458 of the CRR to set stricter large-exposure limits.

Background to the measure

8. Article 458(2)(d) specifically refers to stricter national measures concerning the level of own funds, requirements for large exposures, public disclosure requirements, the level of the capital conservation buffer, liquidity requirements (as laid down in Part Six of the CRR), risk weights for targeting asset bubbles in the residential property and commercial immovable property sector or intra financial sector exposures.
9. The proposed measure by the HCSF invokes Article 458(2)(d)(ii) of the CRR and would involve the tightening, for global and other systemically important institutions, of large-exposure limits applicable to large and highly indebted NFCs domiciled in France, or groups of connected NFCs, pursuant to the rules set out in Article 395 of the CRR. More specifically, the proposal is to apply the stricter limit to exposures that meet all of the following criteria:
 - i. Exposures as defined in Articles 389 and 390 of the CRR that are larger than or equal to EUR 300 million without taking into account the effect of credit risk mitigation (CRM) techniques and exemptions, in line with Article 9 of Commission Implementing Regulation (EU) No 680/2014⁴.
 - ii. Exposures of global or other systemically important institutions (currently six institutions⁵) at the highest level of consolidation of the banking prudential perimeter.
 - iii. Exposures to NFCs:
 - For NFCs whose ultimate parent is resident in France: exposures to the entire group of connected clients (GCC), as defined in CRR article 4(1)(39), to which the NFC belongs.

³ Decision adopting the Rules of Procedure of the European Banking Authority Board of Supervisors of 27 November 2014 (EBA/DC/2011/001 Rev 4).

⁴ [Commission Implementing Regulation \(EU\) No 680/2014 of 16 April 2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to the CRR.](#)

⁵ https://acpr.banque-france.fr/sites/default/files/20171201_liste_aeis_0.pdf

- For NFCs whose ultimate parent is not resident in France: the sum of the exposure to any of their subsidiaries that are resident in France, and all their subsidiaries (resident in France or not), as well as exposures to clients that are economically dependent on the identified NFCs. This is a subset of the GCC as defined in CRR article 4(1)(39).
 - NFCs that are not resident in France and are neither a subsidiary nor a parent of a French resident NFC are not within the scope of the proposed measure because the assessment that justifies it rests on an analysis of resident NFCs' indebtedness only.
- iv. The NFC's ultimate parent company fulfils both of the following criteria computed on a consolidated basis⁶:
- The leverage ratio (defined as total financial debt less outstanding liquid assets over total equity) is higher than 100%.
 - The interest coverage ratio (defined as earnings before interest and taxes (EBIT)⁷ over interest expenses) is lower than 3 (i.e. interest expenses are more than one third of EBIT).
10. In the HCSF's reading, the CRR does not rule out or exclude the imposition of macro-prudential measures, which tighten the large exposure limits but only for certain exposures corresponding to certain types of clients or group of connected clients (i.e. the highly indebted NFCs) with a certain geographical dimension (mainly established in France). The HCSF further argues, that such a type-of-exposure and geographical restriction of the scope of the measure, is not only permitted by CRR but also justified on the basis of proportionality.
11. The HCSF proposes that institutions falling in the scope of the notified measure (i.e. identified by the French authorities as global or other systemically important institution according to CRD article 131) will be responsible for appropriately computing the listed financial indicators, based on the information provided by their counterparties.
12. Guidelines and specifications for that computation will be made available to those institutions and to competent authorities in other Member States. Furthermore, the HCSF states that no additional supervisory reporting data will be required of the affected institutions, since the measure does not deviate significantly from the current large-exposure framework set out in the CRR in terms of the way in which large exposures are computed.
13. The calibration of the proposed measure pertains to the two indicators related to the NFC's indebtedness level and to the stricter limit of 5% of eligible capital on the exposure.

⁶ HCSF argues in the notification that both indicators are considered important indicators of corporate financial soundness and refers to the work of International Monetary Fund (IMF) staff on the assessment of corporate vulnerability.

⁷ Given that the focus of the measure is on firms' medium-term vulnerability, the concept of EBIT – rather than EBITDA (earnings before interest, taxes, depreciation and amortization) – is preferred because it makes it possible to assess whether a firm is economically viable. In general, rating agencies and analysts use EBITDA because they have a different perspective and focus more on firms' short-term cash position.

14. To ensure a focus on large corporates (LCs) and avoid additional reporting requirements, the HCSF proposes to consider only exposures with a value (calculated without taking into account CRM techniques and exemptions) that is equal to or above EUR 300 million.
15. Regarding the calibration of thresholds for the two indicators of NFCs' indebtedness, HCSF's simulations are said to indicate that the proposed levels (i.e. a leverage ratio above 100% and an interest coverage ratio below 3) might be sufficient to avoid the building up of excessive risks by the institutions to which this measure would apply. These two indicators on NFCs' activities are, the HCSF argues, widely available from public information; however, if they cannot be computed due to lack of data for a particular NFC, the HCSF proposes that it should be assumed that these thresholds have been met for such entities.
16. As regards the stricter limit of 5% of eligible capital, the HCSF notes that a balance between institutions' resilience and risk prevention had to be reached. In its view, this limit is sufficiently low to work as a backstop to safeguard institutions from excessive risk-taking and, at the same time, it is not too restrictive and not prone to lead to an excessive reduction in exposures to targeted NFCs, potentially forcing undesirable or too aggressive deleveraging.
17. The HCSF conducted an impact analysis to calibrate the 5% of eligible capital limit that is expected to act as a backstop. By calibrating the measure in such way, the HCSF argues, it would ensure that the impact of the measure would be limited and would not result in any significant costs for the real economy. Thus, this is a forward-looking measure, aiming to prevent the build-up of future vulnerabilities.
18. According to the HCSF, the proposed measure is proportionate, as it would strengthen the resilience of the banking sector in case of losses in the NFC sector while not limiting lending to sound NFCs, which could have an adverse effect on the real economy. For this purpose, the measure focuses on large and highly indebted NFCs (less than 10% of the sample of LCs).
19. In addition, it is proposed that the measure be applied only to French systemically important institutions. The HCSF intends, by publicly announcing this measure, to provide a signal to smaller institutions, as well as to institutions from other countries not directly affected by the measure, about the increasing risks posed by the overall indebtedness of some large NFCs and the need to monitor them closely.
20. The HCSF declares that the measure is to be fully applied from 1 July 2018, with no phasing-in period and for a period of at least two years, with the possibility of renewal.
21. The HCSF, with the support of Banque de France and the Autorité de Contrôle Prudentiel et de Résolution (ACPR), will regularly monitor the evolution of risks and the overall implementation and calibration of the measure, as well as the potential effects on institutions that are not in the scope of the measure. Consequently, the stricter large-exposure limit could be revised downwards to 3% if the build-up of institutions' exposures to large and highly indebted NFCs were to persist.

Opinion on the measure

Economic rationale

22. The HCSF considers that the assessment leading to the proposed measure confirms the acceleration of the financial cycle in France during recent quarters. Although this acceleration goes hand in hand with an improvement in economic conditions, it can overshoot its economic fundamentals and may cause a build-up of risks the materialisation of which could weaken the financial system.
23. With this in mind, the HCSF has identified some risk areas that call for action on the part of the macro-prudential authority. In France, unlike in other large economies in the euro area, credit to NFCs has increased as a proportion of GDP over the past few years. A growth in the outstanding debts of LCs has contributed significantly to the overall trend (LC debt increased by EUR 225 billion from 2010 to 2017 S1, compared with a total increase in the whole spectrum of NFC debt of EUR 410 billion). This growth has been encouraged by low interest rates and allowed financing an increase in cash holdings as well as of external growth.
24. Considering NFCs' heterogeneous nature, some seem more likely to cause risk accumulation, notably leveraged buy-out (LBO) operations and LCs whose indebtedness is already high. The HCSF notes that this heterogeneity has been assessed in particular in relation to an increased sensitivity of NFCs' financial soundness to a hike in interest rates.
25. Hence the HCSF is of the opinion that the current situation calls for the use of a targeted preventive measure, used as a backstop to limit the counterparty risk that banks may face vis-à-vis highly indebted large NFCs, as presented in the HCSF's report, including its diagnosis on the indebtedness of NFCs. The main messages embedded in the analysis include the following:
- Macro-prudential risk related to French NFCs' indebtedness exists and has been highlighted by other institutions and analysts (e.g. the IMF, the European Commission and the European Central Bank). In addition, the HCSF has conducted several meetings and workshops with relevant stakeholders (credit institutions, insurance companies, large NFCs) in order to gather complementary information and to discuss the diagnosis, which was confirmed.
 - LCs represent a significant proportion of NFCs' indebtedness and have contributed to its growth (LCs accounted for more than 42% of corporate debt as of Q2 2017, and between 2011 and 2016 their indebtedness level increased at an average annual rate of 7.5%, compared with 4.9% for all NFCs).
 - LCs' market debt has itself been increasing steadily. From 2010 to 2015, LCs experienced a sharp increase in their debt securities (49%) and a weaker increase in their bank indebtedness (4%).
 - Lower interest rates have mitigated the impact of higher indebtedness on interest expenses. The increase in NFCs' debt is to be viewed in the context of the sharp drop

in interest rates since 2011. The bank credit rate for LCs reached 1% in 2016, and has increased only slightly since (1.3% in Q3 2017). The cost of financing by bonds issuance has followed the same downward trend, falling below the bank credit rate in 2013, and has remained around 0.8% since mid-2016. Given the fall in interest rates, the financial burden of LCs compared with the gross operating surplus decreased from 19% in 2011 to 14% in 2015, but climbed to 16% in 2016. As a consequence, French NFCs could be particularly vulnerable to a rising interest rates environment, since a large part of this debt is at variable rate and needs to be rolled over frequently (unlike, for example, household debt). While a gradual rise in rates during the recovery of activity could potentially be offset by a rising EBIT, a faster rise could be challenging, as the accumulated liquidity buffers might be insufficient.

- An acceleration of investment and a change in cash management practices could be detrimental to the ability of NFCs to meet financial obligations. Despite an increase in French NFCs' investment rate since 2012, the self-financing rate has been decreasing since the end of the 1990s. Moreover, structured debt issuance and LBO transactions, although still at a lower level than 2008, have been showing increasing signs of dynamism (i.e. looser covenants, increasing importance of debt rollover, significant competition) and could be sensitive to a turnaround causing higher default rates. On the cash management front, HCSF's analysis shows that, while NFCs' gross debt over GDP increased significantly from 2008 to Q2 2017, net debt⁸ saw a more muted growth. If cash management practices were weakened in general, or if the debt of NFCs whose net debt is already very high were to continue to rise, risks built up could materialise and LCs' net debt could reach levels capable of threatening the real economy and financial stability.
- Most indebted NFCs show a high goodwill-to-equity ratio, usually sustained by external growth operation for which new debt has often been introduced. Should these goodwill ratios be reversed or revised downwards, NFCs' equity positions and ability to repay debt could deteriorate.

26. From the above, the HCSF believes that large companies' unsustainable debt levels could generate a substantial negative impact on credit institutions' solvency positions if the credit institutions' exposures to them were to reach high levels. This could in turn have negative consequences for the real economy, through second-round effects induced by banks' reactions (restriction of credit), which might have systemic consequences.

27. Moreover, in view of the importance of cross-border banking groups in France and the degree of openness of the French economy, safeguarding financial stability in France will also have positive effects on financial stability in Europe.

⁸ Net of cash holdings.

Rationale for not using alternative measures

28. The CRR and Directive 2013/36/EU (the Capital Requirements Directive – CRD) offer various options for addressing institutions’ vulnerabilities, and Article 458(2)(c) of the CRR requires the designated authority to explain why a stricter national measure is necessary and why other possible measures (i.e. those pursuant to Articles 124 and 164 of the CRR and Articles 101, 103, 105, 133 and 136 of the CRD) cannot adequately address the macro-prudential or systemic risk identified, taking into account the relative effectiveness of those measures.
29. According to the HCSF, it would be natural to adopt a measure directly related to the corporate debt markets. However, the use of such a measure was deemed infeasible and ineffective, since a significant proportion of large French NFCs issue bonds via foreign markets and because the Autorités des Marchés Financiers (the French financial markets authority) does not have a mandate to limit indebted NFCs’ issuances. For these reasons, the proposed measure is considered appropriate by indirectly addressing the corporate debt market included in the large exposures limit.
30. Regarding Articles 124 and 164 of the CRR on risk weights and loss given default on exposures secured by mortgages on immovable property, the purpose of these provisions is to address risks identified in relation to the real estate sector. Since the HCSF aims to address risks arising from the increasing indebtedness of large French corporates, those provisions are not relevant.
31. As for Articles 101 to 105 of the CRD, the HCSF states that the Single Supervisory Mechanism (SSM) Regulation implies that the competent authority in relation to these articles is the SSM, for all the institutions covered by the proposed measure. These articles pertain to the ongoing review of permission to use internal approaches, the application of supervisory measures to institutions with similar risk profiles and supervisory powers, and the application of specific liquidity requirements. Beyond this governance aspect, the HCSF adds that Articles 101 and 102 of the CRD are of a micro-prudential nature only (not for consideration of macro-prudential aspects) and that the latest review of internal credit risk models did not raise concerns about potential breaches of the CRR (i.e. existing models are indeed based on valid historical data).
32. Concerning CRD articles 103 and 104, the HCSF explains that related measures should be based following the assessment under article 97 of the CRD, through which Pillar 2 measures could be envisaged for similar risks, but notes that the SREP process is mainly a micro-prudential assessment and is not the most appropriate tool to capture macro-prudential concerns. On a bank-by-bank basis, the HCSF did not find risks stemming from the increase in NFC indebtedness, which the HCSF argues being consistent with the preventive nature of the proposed measure based on CRR article 458. In addition, Pillar 2 requirements are seen as less transparent and for which a lack of disclosure exists, which would not allow raising public awareness for the issue related to the growing debt of French NFCs. More generally, the HCSF highlights that the Pillar 2 requirements are currently defined as capital ratio. Increasing this requirement would lead – in a similar fashion as the countercyclical capital buffer (CCyB) and the systemic risk buffers – to increase capital requirements against all exposures while the risk

identified is limited to a specific segment. As a conclusion, the HCSF argues that Pillar 2 measures cannot adequately address the macro-prudential risk identified.

33. With regard to Article 105 of the CRD, its provisions aim to address liquidity risk in relation to, for instance, a specific feature of the business model of the institution, which would not therefore address concerns about the exposures of a bank to increasingly indebted French corporates.
34. Finally, Articles 133 and 136 of the CRD relate to the requirement to maintain a systemic risk buffer and setting CCyB rates. The HCSF underlines that the systemic risk buffer is intended to address long-term non-cyclical risks and applies equally across all segments and sectors, while the CCyB is suited to targeting an overall credit increase and not sector-specific credit growth such as that identified in the assessment leading to the proposed measure.

Assessment and conclusions

35. Considering the analysis offered by the HCSF, the EBA acknowledges that the objective of limiting indebtedness levels of large and already indebted French NFCs is appropriate with a view to promoting financial stability and preventing future systemic shocks to the French and EU economies.
36. Based on the feedback received from the other EU competent authorities, the potential for the proposed measure to have a negative impact on the Single Market seems limited. Therefore, the EBA does not object to the proposed measure and its pursued objectives but notes the following:
 - i. It is worth noting that the large exposure limit has been tightened to 10% of eligible capital for large corporates domiciled in France following a recommendation of the Commission Bancaire (the forerunner of the ACPR) in 2009, i.e. reducing the prescribed large exposures limit of 25% of eligible capital. The measure now proposed by the HCSF aims at further tightening the current recommendation for a stricter limit.
 - ii. Taking into account further clarifications provided by the French authorities, the EBA understands that the proposed stricter limit applies to exposures to the entire GCC, as defined in CRR article 4(1)(39), in the cases where the NFC's ultimate parent is resident in France (i.e. this includes subsidiaries that are resident in France and outside France). In other cases, the stricter limit will apply to a subset of the GCC (if the non-resident NFC has one subsidiary or affiliate resident in France). Thus defined, the scope of this measure excludes exposures to connected foreign-based entities that are not subsidiaries of a French NFC. The EBA believes that the proposed measure would be more effective as a backstop if it would be applied to the entire GCC, which includes other entities that are in a control and/or economic dependency relationships among themselves and that are connected because they constitute a single risk. Regardless of its residence, the default of a client that is a parent entity could lead to the default of all other connected clients because indeed they constitute a single risk. If the parent entity

is not resident in France, the bank's exposure to the GCC would not have been limited at 5% of eligible capital, as intended by the proposed measure, although the single risk is the same as with a parent entity that is resident in France.

- iii. Information collected via the COREP Large Exposures templates includes details regarding the different counterparties included in the GCC, in particular their residence and sector of activity. In addition, FINREP (Article 9(2)(g) of the Commission Implementing Regulation (EU) No 680/2014⁹) requires institutions to report all exposures above EUR 300 million in the COREP Large Exposures templates. Based on the information provided in the notification, there will be no need to request additional supervisory reporting data. However, to be able to ensure compliance with the stricter limit, the competent authorities would need to assess which exposures would fall within scope of the proposed measure, in particular in the case of groups of NFCs with non-resident parent entities for which only a subset of the GCC would be captured. In these cases, the competent authorities may need to require from the banks additional information regarding certain counterparties. This additional information would allow competent authorities to assess whether certain non-resident counterparties are in fact subsidiaries of the French NFC (and therefore in the scope of the proposed measure) and whether certain counterparties, which are not in a control relationship with the targeted NFCs, are economically dependent on those NFCs (and therefore in the scope of the proposed measure). Regarding the indebtedness indicators, the notification mentions that institutions are responsible for gathering the corporate-specific data necessary to calculate these indicators. However, it is not completely clear to the EBA how authorities will ensure that indicators are computed in a way that is accurate and comparable. It should be noted, however, that when such information cannot be collected by the institution, the HCSF proposes that the two thresholds regarding the NFC activity should be considered as having been met, thus potentially triggering the stricter large exposure limit. The EBA therefore expects the guidance from the French authorities to institutions and other Member States to fully clarify these aspects.
- iv. By imposing a stricter large-exposure limit on global and other systemically important institutions¹⁰, the proposed measure aims to reduce institutions' concentration risk, particularly to riskier and more indebted NFCs. The EBA sees that the proposed measure could be somewhat effective, although it does not currently capture any institution with such an exposure.
- v. While acknowledging that the measure intends also to increase the resilience of large and indebted NFCs, the EBA is of the opinion that this objective is, to some degree, less likely to be achieved. The targeted NFCs might search for alternative funding sources (unregulated entities) and/or spread their bank lending across different institutions,

⁹ [Commission Implementing Regulation \(EU\) No 680/2014 of 16 April 2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to CRR.](#)

¹⁰ In France, six institutions are currently identified as systemically important (global or other), thus effectively falling within the scope of the proposed measure. These institutions account for around 95% of total lending to NFCs.

namely other, smaller institutions in France that might be able to offer advantageous conditions on account of not being directly affected by the proposed measure.

- vi. In the same vein, while the second objective of this measure is to contain the leverage of the LCs, it is not entirely clear how the HCSF envisages limiting the NFCs' market funding, which is the growing part of the indebtedness of the targeted sector. The EBA acknowledges that large exposure reporting incorporates all balance sheet and off-balance sheet exposures, including market-based finance. However, the notification mentions that a significant proportion of large French NFCs issue bonds on foreign markets while there is currently no power to regulate or limit these transactions. Consequently, the impact of the proposed measure might be somewhat limited.
- vii. The EBA has taken note of the HCSF's reading on the measure's compatibility with the CRR regime, namely that the type-of-exposure and geographical restrictions of a macro-prudential measure is not directly excluded by CRR especially in light of proportionality considerations. The EBA, however, notes that a more restrictive interpretation of Article 458 could be appropriate and, thus, that HCSF could have opted for a different instrument for implementing the measure. Article 458 measures allow modification of the general micro-prudential CRR regime within certain constraints (for example, modifications of risk weights should target asset bubbles only in the residential property and commercial immovable property sectors). Those measures should therefore be closely based on the underlying micro-prudential measure and should not act as a different type of measure. The impact assessment analysis shows that this measure will capture a very limited number of NFCs; indeed, the HCSF considers that the measure is not aimed at counterbalancing a risk already present in the balance sheet of the banks, that could be captured by a Pillar 2 analysis, but instead to prevent future developments that could be damaging from a financial stability perspective.
- viii. Considering this measure to be a preventive backstop, this seems to suggest that the French Authorities could have used Pillar 2 to address the risk in a specific segment or institution (not only in the form of a quantitative requirement as highlighted in the notification but also as a qualitative measure, since the risk has not yet materialised). It is also noted that the use of Pillar 2 can also allow the targeting of individual exposure segments and it is not necessarily set indistinctively against all exposures. Regarding the use of Articles 102, 103 and 104 of the CRD, the HCSF refers to the role of the European Central Bank (ECB) as the competent authority under these articles. However, as stated in Article 458 of the CRR, Member States can refer to the designated competent authority, which may apply the SREP if necessary.
- ix. Additionally, the EBA notes that when arguing in favour of reciprocity for the proposed measure across EU Member States, the HCSF reasons that restricting the stricter measure to French systemically important institutions only would be contrary to the objective of a level playing field across EU's Single Market. Assuming that the request for reciprocity by the French authorities materialises (currently under assessment by the

HCSF), the EBA understands this argument favouring reciprocity but finds it unclear why the HCSF sees this to be the case only for cross border lending provided by systemically important institutions based in other EU Member States. Some of these institutions may be comparable, in size, in predominant business activity and in systemic footprint, to smaller institutions in France not foreseen to be impacted by the proposed measure, which are more likely to be exposed to large and highly indebted French NFCs. The EBA takes note that the HCSF is currently assessing the pros and cons of introducing a materiality threshold which would reduce the impact on small EU institutions. The introduction of a materiality threshold would alleviate such a concern, as smaller institutions in France and abroad would be excluded.

- x. The EBA has taken note that the measure will be applied and monitored by the HCSF - with delegated powers given to the ACPR - in close contact with the SSM for these six banks in case of a breach. Indeed, in France, the HCSF, as the “designated authority”, is in charge of Article 458 of CRR according to the French law.
- xi. The EBA welcomes the intention of the HCSF to closely monitor from a macro-prudential perspective the impact of the proposed measure and to develop additional monitoring tools to assess the evolution of the financial situation of the largest NFCs. Against this background, the EBA encourages a close interaction between macro and micro-prudential Competent Authorities to ensure that all the stockholders involved adequately monitor this measure.

37. This opinion will be published on the EBA’s website.

Done at London, 13 March 2018

Andrea Enria

Chairperson

For the Board of Supervisors