Committee of European Banking Supervisors

11 March 2010

Consultation paper on

CEBS's implementation guidelines on Article 106(2)(c) and (d) of Directive 2006/48/EC recast

(CP 38)

Introduction

1. The amendments to the Capital Requirements Directive[1] by Directive 2009/111/EC (referred to as CRD II) relating to the large exposures' (LE) regime – limits and applicable exemptions – necessitated a few very targeted provisions to exempt very short-term exposures related to money transmission or financial instruments clearing, settlement and custody services to clients in order to facilitate the smooth functioning of financial markets and the related infrastructure.

2. Providing guidance on the scope and the eligibility conditions of the exemption provisions in Article 106(2)(c) and (d) CRD II is seen as important for safeguarding a level playing field for all institutions providing money transmission or financial instruments clearing, settlement and custody services to clients, including single-purpose institutions such as (International) Central Securities Depositories [(I)CSDs] and Central Counterparties (CCPs) that are regulated as credit institutions according to national law (thus falling under the LE regime).

3. **CEBS presents its draft proposals for the implementation guidelines on Article 106(2)(c) and (d) CRD II for a public consultation, which will run until 6 May 2010**. Responses should be sent to the following e-mail address: cp38@c-ebs.org. Comments received will be published on CEBS's website unless respondents request otherwise.

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[1] Capital Requirements Directive (CRD) is a technical expression which comprises Directive 2006/48/EC and Directive 2006/49/EC. Please note that general references to "Directive 2006/48/EC" and "Directive 2006/49/EC" or the "CRD" refer to the amended versions of the Directives and references in these Guidelines to a particular Article of the CRD refer to the amended Directives. The amending Directive (Directive 2009/111/EC) was published on 17 November 2009 and can be found under: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0097:0119:EN:PDF.

4. CEBS would particularly welcome market participants' views on the questions set out at the end of the paper.

Executive summary

5. Article 106(2) (c) and (d) of CRD II provides exemptions from large exposures rules for certain short-term exposures arising from the provision of money transmission, correspondent banking, clearing and settlement and custody activities.

6. These guidelines are structured in **two main parts** covering the provisions of (i) Article 106(2) (c) and (ii) Article 106(2) (d).

7. Institutions that provide services related to the provision of money transmission, clearing, settlement and asset servicing of financial instruments or securities financing services deal with very large volumes of inflows and outflows within short timeframes. The cash activities related to these services are highly volatile, making the end of day positions uncertain and creating the possibility for large exposures to arise.

8. The aim of the exemption from the large exposure regime provided by **Article 106(2) (c)** is to facilitate the smooth functioning of financial markets and the related infrastructure.

9. To be eligible for the exemption in Article 106(2) (c) CRD II, exposures shall meet 3 conditions (eligibility criteria): first, the exposure stems from a specific type of transaction (eligible transactions), second, the exposure arises from client activity; and third, the exposure does not last longer than the following business day.

10. As the provision of payment services is a bilateral relationship, **Article 106(2) (d)** provides a further exemption to the large exposure regime for intra-day exposures to institutions providing services related to the provision of money transmission, clearing and settlement and correspondent banking.

11. To be eligible for the exemption in Article 106(2) (d) CRD II, exposures shall meet 3 conditions (eligibility criteria): first, the exposure stems from a specific type of transaction (eligible transactions); second, the exposure is to specific services providers; and third, the exposure is intra-day.

12. These guidelines provide further clarification of the eligibility criteria to be met to qualify exposures for exemption from the large exposure regime under the provisions of Article 106(2) (c) and (d) CRD II.

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I. Background

13. A revised large exposures regime is included in the amended Capital Requirement Directive. The amendments have to be transposed into Member States' national law by 31 October 2010 and to be applied from 31 December 2010.

14. The revised provisions on large exposures comprise specific provisions allowing exemptions from the large exposures regime for very short-term exposures related to targeted services (money transmission, financial instruments clearing and settlement and custody services).

15. This consultation paper responds to the provision in Article 106(2), last sub-paragraph, of CRD II, that CEBS shall elaborate guidelines in order to enhance the convergence of supervisory practices in applying the exemptions in points (c) and (d) of that Article.

II. Objectives and Methodology

16. The objectives of the guidelines are to:

    a) achieve a common understanding among competent authorities across the EU on the implementation and application of the new provisions;

    b) foster their convergent transposition; and

    c) create more transparency for market participants.

17. The guidelines presented in the consultation paper do not aim to be a comprehensive set of rules, but rather to complement the new CRD provisions in Article 106(2) (c) and (d) CRD II, where additional guidance appears necessary or appropriate.

18. Members and Observers from the Consultative Panel were invited to nominate industry experts to provide technical input to CEBS's work. These industry experts were invited to comment on a draft of the guidelines. The experts provided CEBS with their technical input on a number of important aspects and have significantly contributed to the finalisation of the draft guidelines now published for consultation.

III. Implementation date

19. CEBS expects its Members to transpose the guidelines into their national legal framework and apply them by 31 December 2010 at the latest.

IV. Article 106(2)(c) CRD II

20. Background: An important part of the payments related to money transmission, clearing, settlement and asset servicing of financial instruments or securities financing services is executed in commercial bank money. Such payments take place around the world, in different time zones, with different market practices, holiday regimes and currencies. The payments take place across a network of commercial banks and involve custodian banks, CCPs, (I)CSDs and their related cash correspondent banks. To ensure that the markets function properly and efficiently, the institutions involved have to manage the time gaps between inflows and outflows on their inter-bank accounts due to client transactions (i.e. movement of large volumes within short timeframes).

21. As the cash activity related to money transmission, clearing and settlement as well as asset servicing of financial instruments or securities financing services is highly volatile and dependent on client behaviour, the incoming funds are not always pre-advised (in pure payment processing, funds are typically never pre-advised), i.e. the end of day positions are uncertain until the end of a business day. Thus, large exposures may unexpectedly arise towards the end of the business day, at a time when further reduction can no longer reasonably be achieved and they are supposed to be resolved by the next business day. Therefore, Article 106(2)(c) CRD II provides for certain very short-term exposures to be exempted from the large exposure regime. The aim is to facilitate the smooth functioning of financial markets and the related infrastructure.

22. Eligibility criteria: To be eligible for the exemption in Article 106(2) (c) CRD II, exposures shall meet all of the following three conditions: A.) the exposure stems from a specific type of transaction; B.) the exposure arises from client activity; and C.) the exposure does not last longer than the following business day.

    A. Transaction type: The exemption has no limitation regarding specific counterparties or entities but does in relation to exposures arising from specific transactions which are eligible. The requirement in Article 106(2) (c) CRD II stipulates the following list of transaction types and exposures arising from those transactions:

        1. provision of money transmission including the execution of payment services, clearing and settlement in any currency and correspondent banking;

        2. financial instruments clearing, settlement and custody services to clients. Custody services include incoming payments of income (e.g. interest or dividend payments), redemption of principal amounts and other payments arising from life-cycle events related to financial instruments. Exempted exposures may arise from exposures to clients, cash correspondents or entities active in the custody services chain (mainly issuers or paying agents);

3. other exposures. CEBS considers that the term "other exposures" covers the following exposures:

    (a) cash collateral given or received in conjunction with transactions under 2, or other financial markets transactions for clients (i.e. cash collateral placed for participation on regulated financial markets or for securities financing transactions); and

    (b) exposures arising on the same day as a consequence of further diversification of exposures covered by the exemption in Article 106(2) (c) CRD II. That is, the scope of the exemption should also cover cases where the institution re-deposits parts of exempted exposures with third party banks or enters into (reverse) repurchase agreements with third party banks, and thereby is not able – due to technical or external time limitations – to diversify the exposures in such a way that the consequent exposures fall below the LE limit. However, in such cases all of the following conditions shall be met:

        i. the original exposure was exempted by Article 106(2) (c) CRD II;

        ii. the diversified exposure(s) result(s) solely from the institution's efforts to reduce its risk vis-à-vis one counterparty by diversifying parts of the original exposure away to one or more other counterparties; and

        iii. the credit quality of any diversified exposure(s) is of the same or higher credit quality than that of the original exposure.

In addition, the above transactions shall only be exempted if they stem from delayed receipts in funding (late incoming payments); Recital 22 of CRD II provides further guidance on the character of the exempted exposures: *"The related exposures include exposures, which might not be foreseeable and are therefore not under the full control of a credit institution, inter alia, balances on inter-bank accounts resulting from client payments, including credited or debited fees and interest, and other payments for client services, as well as collateral given or received."*. This means that exposures are only exempted where the credit institution as a consequence of technical or external time limitations is not in a position to reduce these exposures below the large exposure limit before the end of the business day during which they arise.

B. Client activity: Exposures stemming from transaction types as listed under A. above are only covered by the exemption clause if they arise from client activity. In this context client activity shall comprise both direct and indirect activity, i.e. activity on the initiative of the client but also "indirect" client activity in the form of payments or withdrawals by agents or contracting partners of the client (including the account keeping institution) covering the crediting and debiting of payments, fees and interest, and the provision or withdrawal of cash collateral. Institutions shall be able to demonstrate that exposures they exempt in accordance with Article 106(2) (c) CRD II arose in full from client activity.

C. Short-term (/ overnight): Only exposures that are reduced below the LE limit within the following business day are covered by the exemption in Article 106(2) (c) CRD II, i.e. the reporting institution shall reduce the exposure below the 25% LE limit before the end of the following business day. Otherwise, the exposure is no longer exempted from the LE regime and a breach of the limit shall be reported. However, although the maximum time span for such an exempted exposure lasts until the end of the next business day, CEBS's expectation is that it will be reduced below the 25% limit without delay, i.e. as soon as possible within the next business day.

CRD II refers to "exposures arising from client activities", not to account balances. The balance on an account with a certain counterparty at the end of the day ("aggregate exposure") may be the consequence of various movements from multiple clients during the day, giving rise to "single exposures" as defined above. Therefore, even if the balance on an account on consecutive days ("aggregate exposure") may be above the large exposure limit, this does not automatically imply that it is not covered by the exemption because of condition C. For example, as long as the "single exposure" which led to the account balance at the end of day 1 is reduced during day 2, a new "single exposure" (meeting the conditions above) arising on day 2 is covered by the exemption.

V. Article 106(2)(d) CRD II

23. As the provision of payment services is a bilateral relationship, a further exemption to the LE regime was created for intra-day exposures to institutions providing money transmission services, i.e. in contrast to the exception given in Article 106(2) (c) CRD II, Article 106(2) (d) CRD II deals with exposures vis-à-vis such service providers.

24. Eligibility criteria: To be eligible for the exemption in Article 106(2) (d) CRD II, exposures shall meet all of the three following conditions: A,) the exposure stems from a specific type of transaction; B.) the exposure is to specific services providers; and C.) the exposure is intra-day.

    A. Transaction type: Article 106(2) (d) CRD II provides a list of exposures to be exempted: exposures arising from the provision of money transmission including the execution of payment services, clearing and settlement in any currency and correspondent banking. These exposures are exempted irrespective of the origin of the exposures (i.e. they could be a result of cash movements from financial instrument transactions, payments for purchases, plain cash transfers between accounts etc.) or the means of the payments (cash transfer, cheque clearing, direct debiting, etc.).

    B. Specific service providers: The exemption is limited to institutions providing services listed under A. However, such service providers do not need to be payment institutions as defined by the Payment Service Directive (Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market amending Directives 97/7/EC, 2002/65/EC, 2005/60/EC and 2006/48/EC and repealing Directive 97/5/EC Text with EEA relevance) nor is it necessary that the services listed under A are a major part of the services offered. In any case, the service providers shall be subject to supervision in a Member State or by legislation that is considered to be equivalent to that laid down in Community law.

    C. Short-term (/ intra-day): Only exposures that are reduced below the LE limit within the same business day are covered by the exemption in Article 106(2) (d) CRD II, i.e. the reporting institution shall reduce the exposure below the 25% LE limit before the end of the business day. Otherwise, the exposure is not exempted from the LE regime and a breach of the limit shall be reported. However, although the maximum time span for such an exempted exposure lasts until the end of the business day, CEBS's expectation is that it will be reduced below the 25% limit without delay, i.e. as soon as possible within the business day.

VI. Consultation questions

25. CEBS would appreciate if participants in this consultation, who believe that the present proposals have shortcomings or will be burdensome, would provide suggestions on how these proposals could be amended. Such contributions would give valuable input into how these guidelines can be improved after the consultation. The following questions are of particular interest to CEBS:

Part IV, Article 106(2)(c)

1. **Is the definition of exempted exposures in relation to transaction type clear and do they cover all relevant exposures?**
2. **Is the description of client activity sufficiently clear? Would practical problems related to the identification of client activity arise and, if so, how could they be solved?**
3. **Are the specifications regarding the available time for the reduction of the exempted exposures sufficiently clear?**

Part V, Article 106(2)(d)

4. **Are the definitions of exempted exposures in relation to transaction type clear and do they cover all relevant exposures?**
5. **Is the description of specific service providers sufficiently clear?**
6. **Are the specifications regarding the available time for the reduction of the exempted exposures sufficiently clear?**

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Recital 22:

"[...] In addition, very short-term exposures related to money transmission including the execution of payment services, clearing, settlement and custody services to clients are exempt to facilitate the smooth functioning of financial markets and of the related infrastructure. Those services cover, for example, the execution of cash clearing and settlement and similar activities to facilitate settlement. The related exposures include exposures which might not be foreseeable and are therefore not under the full control of a credit institution, inter alia, balances on inter-bank accounts resulting from client payments, including credited or debited fees and interest, and other payments for client services, as well as collateral given or received."

Article 106(2):

"Exposures shall not include any of the following: [...]

c) in the case of the provision of money transmission including the execution of payment services, clearing and settlement in any currency and correspondent banking or financial instruments clearing, settlement and custody services to clients, delayed receipts in funding and other exposures arising from client activity which do not last longer than the following business day; or

(d) in the case of the provision of money transmission including the execution of payment services, clearing and settlement in any currency and correspondent banking, intra-day exposures to institutions providing those services.

The Committee of European Banking Supervisors shall provide for guidelines in order to enhance the convergence of supervisory practises in applying the exemptions in points (c) and (d).";