



EUROPEAN COMMISSION

Internal Market and Services DG

FINANCIAL INSTITUTIONS

Banking and financial conglomerates

04.01.07

0011

Brussels,  
Markt H1/JOD/rf D 29 (2006)

Mme Danièle Nouy  
Chairman  
CEBS  
Tower 42  
25 Old Broad Street  
UK-London EC2N 1HQ

Dear Danièle,

**Call for Technical Advice (No.7) to CEBS on the review of the Large Exposures rules**

I am very pleased to send you the Commission's seventh official call for technical advice from the Committee of European Banking Supervisors (CEBS).

This is the second call for technical advice in relation to the review of the existing rules on large exposures (LE). On behalf of the European Banking Committee (EBC) and the Commission services I would like to thank CEBS and its constituents for the submission of the first pieces of technical advice in relation to this review. The Commission services and the EBC highly value the contribution of CEBS into the review of the existing LE rules. The advice already received represents an important input into the work to date and was instrumental in the recent EBC decision to extend the timeline of the review beyond December 2007 in order to permit a wider-ranging review.

In the letter of December 1st 2005 that accompanied the first request for technical advice on LE, the Commission services indicated that further support from CEBS would be welcome, but that the exact extent and nature of input would be specified at a later date. This Call for Technical Advice represents the further specification of technical advice sought, and includes all the outstanding areas in which the Commission services and the EBC are seeking input. Although this call for advice is more detailed than the previous one, it is hoped that this detail will allow CEBS to focus on the areas of most particular interest to the EBC and the Commission services. In several instances, the specified nature of the technical advice requested has been made in response to the observations and information emerging from the CEBS technical advice already provided.

Although the Commission services and the EBC understand that CEBS may wish to extend the delivery dates as set out in this call for advice, I would like to emphasise the importance of adhering to the submission dates of 30<sup>th</sup> September 2007 and 28<sup>th</sup> February 2008 in order to allow the EBC to maintain its timetable for the review. As we

understand that CEBS has already commenced certain parts of the work, on the basis of indications of the likely content of this call for technical advice, I am confident that CEBS will be able to deliver high quality advice within the timetable.

I am attaching to this letter a copy of our call for advice.

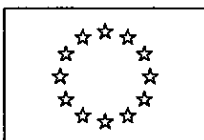
Yours sincerely,



Patrick Pearson  
Head of Unit H1

Contact: Jane O'Doherty, Tel: (32) 2 298 4811 ([jane.o'doherty@ec.europa.eu](mailto:jane.o'doherty@ec.europa.eu))

Enc: Call for Advice



EUROPEAN COMMISSION

Internal Market and Services DG

FINANCIAL INSTITUTIONS

Banking and financial conglomerates

Brussels, 3 January 2007

## **CALL FOR TECHNICAL ADVICE No. 7 FROM THE COMMITTEE OF EUROPEAN BANKING SUPERVISORS (CEBS)**

**Subject: Large Exposures**

### **1. Background**

In recognition of the limited changes to the longstanding rules on Large Exposures (LE) contained within the Capital Requirements Directive<sup>1</sup> (CRD), Article 119 of Directive 2006/48/EC and Article 28(3) of Directive 2006/49/EC require that a report on the functioning of the rules on LE, together with any appropriate proposals, be prepared by 31st December 2007.

In December 2005, the Commission services issued a call for technical advice to CEBS in relation to the review of the existing LE rules.<sup>2</sup> Following the receipt of this technical advice<sup>3</sup> and subsequent discussions within the European Banking Committee (EBC) and its working group on LE, the EBC decided that the review of the existing rules should be extended beyond 31st December 2007. The EBC concluded that this extension would permit a wider-ranging review and would facilitate a regulatory pause whilst the CRD is being implemented, both of which are understood to be the strong wish of both industry and supervisors.

The review of the existing LE rules will be governed by the Better Regulation agenda<sup>4</sup> including the deployment of open, transparent, evidence-based policymaking. It should also be noted that, consistent with better regulation, no decisions have been made in relation to the appropriate outcome of this review.

Although CEBS has already engaged in consultation with stakeholders in relation to this review,<sup>5</sup> the Commission services acknowledge that it may be necessary to engage with industry again in relation to this Call for Technical Advice. Any such consultation should be mindful of the existing regulatory burden facing firms, and keep requests to the minimum necessary to allow for the fulfilment of this Call for Technical Advice.

<sup>1</sup> Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast); and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast).

<sup>2</sup> [http://ec.europa.eu/internal\\_market/bank/docs/calls/051208\\_call\\_for\\_tech\\_advice\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/calls/051208_call_for_tech_advice_en.pdf)

<sup>3</sup> CEBS advice received in response to Call for Advice (No.5) issued November 2005. The technical advice received is available on the CEBS website: <http://www.c-ebs.org/Advice/advice.htm>

<sup>4</sup> COM(2005) 97 – Communication from the Commission to the Council and the European Parliament – 'Better Regulation for Growth and Jobs in the European Union'  
[http://ec.europa.eu/governance/impact/docs/key\\_docs/com\\_2005\\_0097\\_en.pdf](http://ec.europa.eu/governance/impact/docs/key_docs/com_2005_0097_en.pdf)

<sup>5</sup> CEBS 'Questionnaire on the survey of market practices', March 2006: [http://www.c-ebs.org/Advice/LE\\_questionnaire.pdf](http://www.c-ebs.org/Advice/LE_questionnaire.pdf)

At the EBC meeting of November 14<sup>th</sup> 2006, EBC members agreed to a new draft timetable to carry out the review, and to the preparation of this second Call for Technical Advice to CEBS in relation to the review of the existing LE regime. It should be noted that intra day exposures are specifically excluded from the scope of this Call for Technical Advice.

## **2. Specific Call for Advice**

This Call for Technical Advice is structured into two parts. The Commission services would ask that CEBS consider within both parts and on an ongoing basis two underlying issues.

Firstly, whether or to what extent the issues identified throughout this Call for Technical Advice could be addressed or improved through enhanced supervisory co-operation and convergence without the need for recourse to legislative measures.

Secondly, whether legislative and supervisory regimes in place in other jurisdictions contain features that should be considered in the EU. The extent to which the international competitiveness of EU firms is, or could be, negatively impacted as a consequence of differences between the rules on LE in the EU and the regimes in place in other jurisdictions should be borne in mind.

### **2.1. Part One**

#### **(a) The purpose of the LE regime**

The CEBS advice on industry practices<sup>6</sup> states that "particularly at larger institutions, there appears to be a gap between the measurement, management, and reporting of concentration risks for internal purposes and the limits and reporting requirements contained in the CRD and national regulations." This observation raises legitimate questions about what the current LE regime seeks to achieve; what risks or regulatory gap(s) the existing regime seeks to address; and why. The Commission services would welcome further technical advice on this issue including a consideration of the purpose of the existing limits, and whether or to what extent they are appropriate at their current levels, or indeed whether the presence of limits is required at all. Consideration may also be given to whether the purpose of the LE regime is the same for all types of firms of varying size and complexity and of different types of specialisation. Following from this, further consideration may be given to whether the current LE regime can be said to be achieving its purpose in respect of all types of firms.

As part of this work, consideration should be given to the extent to which risk concentration issues or large exposures contribute to financial distress. The recitals to the CRD state that "excessive concentration of exposures to a single client or group of connected clients may result in an unacceptable risk of loss. Such a situation can be considered prejudicial to the solvency of a credit institution."<sup>7</sup> As part of a wide-ranging review, whether or to what extent excessive concentration has been the cause of a high level of loss, or serious threats to solvency, could be explored in more detail.

#### **(b) Metrics**

As noted in (a) above, the CEBS advice on industry practices indicates many large institutions, as well as some smaller institutions, set internal limits for single names that differ significantly, in the nature of the metrics, as well as in magnitude, from regulatory requirements.

---

<sup>6</sup> [http://www.c-eps.org/Advice/LE\\_industryreport.pdf](http://www.c-eps.org/Advice/LE_industryreport.pdf); Para 39 (c)

<sup>7</sup> Recital 48; Directive 2006/48/EC

It should be noted that the CRD has already introduced a number of changes which "modernise" the metrics used in the LE regime. For example, exposures related to derivatives contracts as set out in Annex IV of Directive 2006/48/EC can be calculated using any of the methods in Annex III of that Directive, including the Internal Models Method (Annex III, Part 6). Nonetheless, the Commission services consider that the method of calculation of the metrics used as part of the LE regime should also be examined as part of the review.

The scope and detail of this technical advice shall be left to the discretion of CEBS, but should include issues such as the actual notion of exposure, and - for example - whether this should be closer to the CRD notion of "exposure value"; the recognition of Credit Risk Mitigation (CRM) techniques; and the extent to which credit quality can or should be recognised. Ultimately, the metrics used to measure large exposures need to be clear, understandable for all concerned and capable of being produced without excessive burden on firms. This work will form an important foundation for further work on CRM, under Part 2 of the technical advice.

## 2.2. Part Two

In the second part of the technical advice, the Commission services would like CEBS to consider a range of issues as set out below. In providing advice, CEBS should consider how the areas highlighted could most appropriately be captured within a LE regime assuming a broad scope (so not limiting the assessment to single name risk, and including concepts such as geographical and sectoral risk).

### (a) Credit risk management

The EBC previously agreed that recognition of, and possible reward for, good credit risk management is an issue on which further thinking ought to be done. This issue is linked to the question of incentives for firms within any LE regime, and CEBS should provide technical advice on the extent to which such incentives are necessary and/or desirable.

### (b) Credit risk mitigation (CRM)

The CEBS advice on industry practices indicates that many respondents reported that CRM is integral to determining exposure amounts for their internal risk management purposes, with the level of sophistication of CRM techniques varying according to the size of the institution. CEBS could firstly consider whether a LE regime could or should fully recognise all of the CRM techniques permissible under the CRD for credit risk purposes.

Whilst the range of CRM techniques is broad, industry has particularly identified collateral, and the treatment of credit derivatives, as an area where they consider the regulatory treatment to be overly conservative. Where smaller firms use CRM techniques, the CEBS advice indicates that these firms tend to use only the collateral outlined in the LE regulatory regime. With a particular focus on collateral, and in order to ensure that the risk mitigating effects of collateral are adequately recognised, CEBS should also consider specifically whether the list of eligible collateral should be reviewed. Such consideration should be with a view to considering whether an expansion of acceptable assets or additional flexibility in relation to the treatment of collateral would be appropriate or desirable.<sup>8</sup> CEBS should also consider the extent to which any further recognition of CRM techniques could create the potential for further risk concentration, and how such concerns could be addressed.

---

<sup>8</sup> Again, it should be noted that the CRD already introduces a number of changes which increase the recognition of CRM techniques within the LE regime. Article 112 and Article 114(1) and (2) of Directive 2006/48/EC have introduced a broader recognition of the effects of CRM, particularly for the more sophisticated firms.

(c) Indirect concentration risk

The CEBS advice on industry practices indicates that the treatment of indirect concentration risk (single-name or other concentration risk arising from indirect exposures to the issuers of collateral or the providers of unfunded credit protection) varies widely across institutions. Where firms take indirect risk into account, some treat indirect concentrations in the same way as direct exposures, including the setting of limits for the guarantor in the same way as for the obligor. Indirect concentration risk is not explicitly addressed within the LE rules (although Article 110(3) of Directive 2006/48/EC allows Member States to require firms to monitor indirect concentration risk), but it is an area that should be considered under the review.

(d) Intra-group exposures

The CEBS advice on industry practices indicates that there is a general sense from financial groups that intra-group exposure limits are unduly constraining, given that risk management is conducted at the group level. One of the options in the existing legislation allows for the exemption of certain intra-group exposures, and the CEBS advice on supervisory practices indicates that a majority of Member States allow these exposures to be fully exempt from the LE limits if they are covered by their supervision on a consolidated basis.

CEBS should consider the issues and risks related to any alternative treatment of intra-group exposures, giving due consideration to the impact of intra-group dynamics within firms that have actually faced significant financial stress or instability. Due consideration should also be given to the option for zero percent risk weighting in Directive 2006/48/EC of intra-group exposures for credit risk capital requirements, and whether or to what extent this option should be considered in the context of the review of the LE regime.

(e) Other group issues

CEBS should also consider issues related to the scope of application of the LE rules. Large firms have indicated that the current rules unduly restrict business at an entity level. Consequently, further consideration should be given to the appropriate level of application of an LE regime, being mindful not just of regulatory burdens but also of level playing field issues between larger and smaller firms.

(f) Assessing the feasibility of a "one size fits all" approach

One of the areas that advice would be welcome on is whether a one size fits all approach is appropriate in the area of LE. One possibility that could be addressed is whether a differentiated approach could be feasible. For example, the feasibility and appropriateness of having a different set of rules applicable to, on the one hand, less sophisticated institutions and on the other hand, more sophisticated firms could be considered. Any consideration of differentiation of approaches should be based on the same principles as the approaches for credit risk, market risk and operational risk under the CRD. That is, all approaches should in principle be open to any firm which is prepared to make the necessary investments and which can satisfy the relevant operational requirements to qualify for use of an approach. And there should be a system of incentives to encourage firms to move from simpler to more sophisticated methods of risk management. There would be no possibility of certain approaches being automatically "ruled out" for certain firms.

In relation to this area, CEBS should also consider the appropriateness of the LE regulatory framework to all types of firms, particularly those that engage in specialised activities or services.

(g) Assessing the appropriateness of the existing rules for the trading book

The typically shorter term nature of trading exposures, and the greater inherent 'tradability' of such exposures, may suggest that for the trading book a different approach in relation to LE should be considered.

(h) Reporting

As noted earlier, industry has indicated that there is frequently a clear mismatch between the counterparty names identified as LE to the supervisor and those discussed by the relevant Credit/Risk committee within the firm. While the purpose and needs of regulatory reporting may differ from those of the institutions themselves, CEBS should consider the extent to which supervisory reporting requirements could be more closely aligned to those of the risk functions of the institutions.

A further aspect of reporting relates to the differing frequency and extent of reporting of LE to supervisors across Member States. CEBS should consider the extent to which supervisors value different reporting formats or information and the extent to which firms consider the reports they submit as being representative of the LE risks they are exposed to.

(i) Interpretations of definitions

The CEBS advice on industry practices has highlighted that industry considers that there are divergent supervisory interpretations of certain provisions and definitions within the existing regime. For example, there may be scope for greater clarity and consistency in terms of defining what constitutes a credit exposure; who can be considered a counterparty and when counterparties can be said to be connected, if rules are to be meaningful. Industry has expressed concern about various definitions - connected parties in particular - and the difficulties they face in establishing the existence of an economic relationship between clients. The Commission services would welcome CEBS advice on this area, particularly in terms of how more legal certainty and consistency could be applied to the definitions used within the LE regime.

**Timing**

The Commission services request the submission of this technical advice in two stages:

- Part A, as set out above to be submitted by September 30th 2007; and
- Part B, as set out above, to be submitted by February 28<sup>th</sup> 2008.