

**IBF COMMENTS TO CEBS' CONSULTATION PAPER (CP14)**  
**on the**  
**First Part of its advice to the European Commission on Large Exposures**

1.0 The Irish Banking Federation welcomes the opportunity to comment on CEBS' proposals for the first part of its technical advice to the European Commission on Large Exposures. We support CEBS efforts with regard to assisting the European Commission in their review, and the involvement from industry that CEBS' consultative approach facilitates. The Commission's review remains, in our view, at the very initial stages. Before this project progresses further, it is important that we collectively agree on the objectives and purpose of a large exposure regime and establish whether the current framework is meeting these objectives. It is our view that the current large exposure rules no longer fit with today's risk management capabilities and we welcome CEBS' proposal to replace the current Large Exposures Framework with a relatively 'light touch' regime. We believe that the ultimate objective of this review should be to reach an agreed set of principles to underpin how institutions should manage their unforeseen event risk according to internal processes, under Pillar 2.

Our specific comments to the consultation paper are set out below;

**Section III: Objectives & Purposes of a Large Exposures Regime**

2.0 It is stated in the consultation paper that the concept of Large Exposures fits with the more general concept of concentration risk, and that concentration risk consists of three general aspects; Undiversified Idiosyncratic Risk, Sectoral & Geographic Concentration Risk and Unforeseen Event Risk. While we do not disagree with this conclusion, nor the assertion that "*the central purpose of a large exposures framework is to limit the degree to which institutions are exposed to incidents of traumatic loss, likely to threaten their solvency*", our members are of the view that this objective is now addressed under Pillar 2 of the Capital Requirements Directive. ICAAP Principle 8(c) of CEBS' Guidelines on the Application of the Supervisory Review Process<sup>1</sup> specifically

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<sup>1</sup> "Guidelines on the Application of the Supervisory Review Process under Pillar 2" (25 January 2006); page 23

recommends that all institutions conduct appropriate stress tests. Furthermore, CEBS' Guidance on Stress Testing<sup>2</sup> states that stress testing is "a generic term for describing the various techniques (quantitative and/or qualitative) used by institutions to gauge their vulnerability to exceptional but plausible events". As such, institutions are required to assess their exposure to unforeseen but plausible events under Pillar 2 and manage these risks / attribute capital accordingly. Maintaining the Large Exposures Framework alongside these Pillar 2 requirements will effectively require institutions to operate dual frameworks to manage the same risk exposure.

#### **Section IV: Market Failure / Regulatory Failure Analysis**

- 3.0 Our members do not agree with CEBS' analysis, which concluded that there remains a material degree of market failure in respect of unforeseen event risk. The potential market failures that have been identified could very easily be attributed to poor management or ineffective internal governance. This being said, it cannot be categorically stated that there would be no market failures arising from concentration risk, if the large exposure rules were to be removed. This does not however justify the large exposures regime as necessary.
- 3.1 Our members do agree with CEBS' proposal for a 'light touch' approach, where the regulatory limits would operate as a regulatory backstop creating a wide space within which institutions are expected to manage the risk through their own systems, policies and practices. CEBS have recommended, as part of their Technical Guidance on Concentration Risk<sup>3</sup> that all institutions have appropriate internal processes to identify, manage, monitor and report concentration risk. Furthermore, institutions are recommended to use internal limits, thresholds or similar concepts and have adequate arrangements in place for actively monitoring, managing and mitigating concentration risk against agreed policies and limits. As banks are required to have these internal management processes in place under Pillar 2, we feel CEBS' proposal for a 'light touch' approach would be appropriate on implementation of the Capital Requirements Directive.

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<sup>2</sup> "Technical Aspects of Stress Testing under the Supervisory Review Process – CP12", (14 December 2006); pg. 3, para. 9

<sup>3</sup> "Technical Aspects on the Management of Concentration Risk under the Supervisory Review Process"; (14 December 2006), Concentration 2 pg. 11 & Concentration 3, pg. 12

## **Section VII: Other Jurisdictions**

4.0 Our members agree with CEBS' perception that there are broad consistencies between the EU Large Exposures regime and the rules in other jurisdictions. However, we would like to note that these are likely to be only broad consistencies. Within Europe alone, it has been recognised that there are significant divergences in how the rules have been applied across Europe due to the national discretions contained within the Large Exposures Framework. We would expect that a similar scenario is prevalent outside Europe. While the same concepts may apply in these jurisdictions, there are likely to be differences in how the rules are interpreted and applied.

## **Section VIII: The Large Exposures Limits**

5.0 Our members do agree, in principle, with CEBS' position, such that the credit quality of the counterparty should not be considered when determining the maximum exposure to a single counterparty. However, there are a number of issues we would like to raise in this context. Our first area of concern, relates to the limited scope of collateral that is recognised within the Large Exposures Framework. While some amendments have been made to the original listing contained in the Large Exposures Directive of 1992, we are of the view that this component of the framework requires a significant review. At a very minimum, the list should be extended, with provisions being made to distinguish between the varying quality of collateral posted.

5.1 Our second area of concern is the fact that the issue of double default is completely ignored in the Large Exposures Framework. Where exposures are collateralised or guaranteed, the probability of the institution incurring a major loss as result of default, is further reduced given that both obligor and credit protection provider must default for a loss to be incurred. It is our view that this should be factored into any management framework of unforeseen event risk.

5.2 Lastly, the fact that different risk weightings are applied for large exposure purposes than those applied for credit risk purposes causes confusion. However, rather than attempting to align the two components of the CRD, we are of the view, as noted in Section 3.1 above, that institutions should manage unforeseen event risk through their own systems, policies and practices under Pillar 2.

- 5.3 In terms of the 25% limit placed on single counterparty and connected client exposures, the inflexibility with which this limit is interpreted and applied, can cause difficulties for our members. For example, a group of clients may be deemed connected according to the Large Exposure rules, but from a real-risk perspective, would not pose as an unforeseen event risk to the institution, particularly in cases where it is planned to remove the exposure off-balance sheet within a very short timeframe. Furthermore, the large exposure limits apply at an entity-level, which ignores the real-risk situation where concentration risks are managed at a group level.
- 5.4 It is our view that the 800% limit does not serve any significant purpose and should be removed. On the banking book side, the limit generally does not cause issue for our institutions. However, on the trading book side, the limit can be restrictive due to manner in which exposure values are calculated. Exposures for Over-the-Counter derivatives, for example, are calculated using the potential future credit exposure method. While this approach is appropriate for credit risk purposes, it is not in our view, appropriate for large exposures purposes because it forces institutions to manage their concentration risk on the basis of potential exposure rather than real exposure.

#### **Section IX: Calculation of Exposure Values**

- 6.0 Our members agree with CEBS' suggestion that institutions should be permitted to calculate their exposure values in line with how these values are computed for internal purposes. However, this flexibility should not be restricted to institutions adopting the advanced approaches, but rather applied to all institutions.

#### **Conclusion**

- 7.0 As institutions are required to manage their concentration risk exposure under Pillar 2 of the Capital Requirements Directive, it is no longer necessary to maintain the one-size-fits all approach of the Large Exposures Directive, particularly as one of the core objectives of the Capital Requirements Directive is to better align internal risk management practices with regulatory requirements. We therefore support CEBS



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proposal that a recommendation be made to the European Commission, that a 'light touch' approach be adopted, where the regulatory limits would operate as a regulatory backstop creating a wide space within which institutions are expected to manage this risk through their own systems, policies and practices, under Pillar 2.