



27 March 2008

## **Second part of CEBS's technical advice to the European Commission**

### **on the review of the large exposures rules**

#### **Background**

1. The large exposures framework currently applies to all credit institutions and investment firms falling within the scope of Directive 2006/48/EC and Directive 2006/49/EC (both referred to hereafter as the 'CRD') and the cross reference in Article 3(1)b of the latter Directive to Article 4(1)(1) of Directive 2004/39/EC (MiFID). This includes the full range of banks from large systemically important institutions to small cooperative banks and the full range of investment firms from large broker-dealers to small brokers and asset managers.
2. Article 119 of Directive 2006/48/EC and Article 28 of Directive 2006/49/EC, require the European Commission to submit to the European Parliament and to the Council a report on the functioning of the large exposures provisions of the CRD. A review of the large exposures framework is therefore being carried out by the Commission together with the European Banking Committee (EBC).
3. In December 2005, the Commission issued a first Call for Advice to CEBS on the review of the large exposures rules. This requested CEBS to carry out a stock take of current supervisory practices and a consultation on current industry practices. In response to this request, CEBS has provided to the Commission, and published, a Supervisory Stock Take on large exposures<sup>1</sup> and a Report on Industry Practices<sup>2</sup>.

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<sup>1</sup> Final Report – Supervisory Stock Take on Large Exposures, 2 April 2006, [http://www.c-eps.org/Advice/LE\\_report.pdf](http://www.c-eps.org/Advice/LE_report.pdf)

<sup>2</sup> Call for Advice from the European Commission on large exposures – Report on industry practices, 31 August 2006, [http://www.c-eps.org/Advice/LE\\_industryreport.pdf](http://www.c-eps.org/Advice/LE_industryreport.pdf)

4. In January 2007, the Commission issued a second Call for Advice to CEBS<sup>3</sup>. This requested CEBS's Advice on substantive aspects of the large exposures framework. This Advice was called for in two parts.
5. Part 1 of the Call for Advice deals with the objectives and purposes of a large exposures regime - the purpose, the need for and appropriate levels of large exposures limits; whether the large exposures regime can be considered to be achieving its objectives; examination of the 'metrics' for the calculation of exposure values; and consideration of the extent to which the credit quality of the counterparty can or should be recognised.
6. On 15 June 2007 CEBS issued a Consultation Paper on the first part of its Advice ("CP14")<sup>4</sup> After processing the feedback from market participants gathered from the consultation process and also in a 11 July 2007 public hearing<sup>5</sup>, CEBS published Part 1 of its Technical Advice to the Commission on 6 November 2007.<sup>6</sup>
7. Part 2 of the Call for Advice addresses the questions of credit risk mitigation; indirect concentration risk; intra-group exposures and other group-related issues; trading book aspects; reporting requirements; and consistency of definitions. In Part 2 CEBS was also requested to address the questions whether 'one size fits all' or whether a differentiated approach is desirable, for example in respect of more sophisticated and less sophisticated institutions, or having regard to the different types of institutions, particularly those that engage in specialised activities or services. The question whether there is further scope for incentives to reward good credit risk management was also to be considered.
8. On 7 December 2007 CEBS issued a Consultation Paper on the second part of its Advice ("CP16")<sup>7</sup>. CP16 puts forward CEBS's preliminary views on the key aspects included in both Part 1 and Part 2 of the Commission's second Call for Advice. In this way interested parties could have a complete understanding of all the aspects included in the review of the large exposures regime. In addition a public hearing was organized on 15 January 2008 and a broad range of market participants shared their views on CEBS's preliminary proposals.
9. The present Advice provides CEBS's response to the Commission's second Call for Advice with a special focus on the issues called for in the second part. The Advice takes into account the feedback gathered in the dialogue with the industry, e.g. through the consultation processes and in the public hearings.

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<sup>3</sup> Call for Advice (No. 7) to CEBS on the review of the Large Exposures rules, 4 January 2007, [http://www.c-eps.org/documents/LE\\_CfA2.pdf](http://www.c-eps.org/documents/LE_CfA2.pdf)

<sup>4</sup> CEBS Consultation Paper (CP14) On the First Part of its advice to the European Commission on large exposures: [http://www.c-eps.org/Consultation\\_papers/documents/CP14\\_LE\\_150620072.pdf](http://www.c-eps.org/Consultation_papers/documents/CP14_LE_150620072.pdf)

<sup>5</sup> Summary of the 11 July 2007 public hearing: <http://www.c-eps.org/press/18072007.htm>

<sup>6</sup> First part of CEBS' technical advice to the European Commission on the review of the Large Exposures rules: [http://www.c-eps.org/Advice/documents/LE\\_Part1adviceonlargeexposures.pdf](http://www.c-eps.org/Advice/documents/LE_Part1adviceonlargeexposures.pdf)

<sup>7</sup> CEBS Consultation Paper (CP16) on the 2<sup>nd</sup> part of its advice to the Commission: [http://www.c-eps.org/press/documents/LE\\_Part%202\\_07122007.pdf](http://www.c-eps.org/press/documents/LE_Part%202_07122007.pdf)

## Methodology

10. CEBS developed both the first and the second part of its Advice in a manner consistent with the Commission's better regulation agenda. CEBS has done that by following, as far as time constraints allow, the draft impact assessment guidelines that have been developed by the 3L3 committees<sup>8</sup>. The draft guidelines are consistent with the Commission's own Impact Assessment methodology but have been refined to take account of the regulatory objectives of the 3L3 Committees and their existing working practices.
11. Central to the analysis set out in this report is the use of market failure/regulatory failure analysis as a means of identifying problems that a large exposures regime could seek to address, i.e. the purpose of the regime.
12. Cost/benefit analysis (CBA) also forms a key part of the impact assessment process. CEBS has conducted a quantitative analysis of the cost of the current regime. In discussing different policy options, CEBS also included a number of qualitative considerations on the costs and benefits of each one.
13. Effective stakeholder consultation is a central part of the 3L3 impact assessment methodology. Market participants' views have been gathered at various stages of the process (e.g. survey of industry practices, public consultations and public hearings on both parts of the Advice).

## Executive summary

14. The present report provides CEBS's response to the Commission's second Call for Advice with a special focus on the issues called for in the second part. The Advice takes into account the feedback gathered in the dialogue with the industry, e.g. through the consultation processes and public hearings on both parts of the Advice.
15. **Chapter 1** sets out CEBS's understanding of the objectives and purposes of a large exposures regime. CEBS believes that ensuring that risks arising from large exposures to individual counterparties or groups of connected counterparties are kept to an acceptable level follows from the overarching principles of prudential supervision.
16. CEBS believes that a market failure does arise as a result of large single name exposures that give rise to the risk of traumatic losses due to "unforeseen events" and that this market failure is not (fully) addressed by any of Basel II's three pillars. CEBS's view is that there is therefore a remaining risk related to large exposures that justifies regulatory intervention.
17. CEBS discussed a number of different policy options available and has concluded that a limits-based "back-stop" regime is the most appropriate regulatory tool. CEBS has however identified some short-comings in the current regime that

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<sup>8</sup> 'Impact Assessment Guidelines for EU Level 3 Committees' May 2007, [http://www.c-eb.org/Consultation\\_papers/documents/IA\\_GL.pdf](http://www.c-eb.org/Consultation_papers/documents/IA_GL.pdf)

need to be addressed and is proposing an amended limits-based backstop regime.

18. CEBS has reviewed the approach to large exposures in a number of non-EU jurisdictions and although a variety of regimes exists across the world, CEBS has concluded that overall the EU regime is not in general more strict than any other individual regime, although it is possible to find some particular transactions that are treated more strictly in the EU than elsewhere.
19. On the question whether 'one size fits all' is the best approach, CEBS has concluded that the market failure analysis does not justify exempting large/sophisticated institutions from the large exposures limits.
20. CEBS's opinion is that the recognition of, and reward for, good credit management that is included in the solvency regime is also embedded in the proposed large exposures rules.
21. **Chapter 2** analyses the reasons why the calculation of large exposures limits should only be based on the exposure value. The implication of this is that, for IRB banks, PD and LGD should be set at 100% and in general maturity should not be taken into account.
22. CEBS discusses the large exposures limits and concludes that the 25% limit operates as a long back-stop regulatory limit which provides a very wide space within which reliance is placed on institutions to manage single-name concentration risk, alongside other forms of concentration risk, within their own risk management systems. CEBS is of the view that the 800% limit can be kept in European regulation because it provides a simple and harmonised minimum standard to ensure credit portfolio granularity.
23. **Chapter 3** presents CEBS's views on the objective of the rule of 'connected clients', i.e. to identify clients so closely linked by idiosyncratic risk factors that it is prudent to treat them as a single risk and puts forward a proposal to amend Article 4 (45) of Directive 2006/48/EC. CEBS proposes a number of indicators to identify situations of 'control' and also lists some illustrative examples of possible 'financial dependency' where institutions would normally need to group clients. CEBS also proposes to broaden the definition of the rule in order to include the existence of a common source of funding as an indication of connectedness.
24. CEBS is aware of the difficulty of providing precise definitions of the concept of 'connected clients' and 'interconnectedness' and stresses the need for L3 guidelines for further guidance and harmonization.
25. **Chapter 4** presents CEBS's views on the scope of application of the large exposures regime. CEBS believes that the current level of application does not need to be changed - the large exposures framework is required at a consolidated, sub-consolidated and a solo level, including the discretion that supervisors have to waive the latter if the conditions laid down in Article 69 of CRD are met.
26. Based on the market failure analysis, CEBS is proposing to exclude investment firms with "limited licence" and with "limited activity" from the scope of application of the large exposures regime. Financial institutions outside the

scope of the CRD should be also exempted from the large exposures limits on a solo basis but the parent institution should include their exposures on a consolidated basis.

27. **Chapter 5** sets out CEBS's views on the calculation of exposure values. Exposure values for on-balance items should be based on relevant accounting standards, net of accounting provisions and value adjustments. For off-balance sheet CEBS's view is that a 100% conversion factor would be appropriate for all items in Annex II for all firm types (Standardised, Foundation-IRB and Advanced-IRB).
28. For arrangements with exposure to underlying assets CEBS has identified that there is currently considerable variation in the approaches adopted by supervisors and institutions to the determination of whether or not there is an exposure in the context of schemes (tranching or untranching) with underlying assets. To ensure supervisory convergence CEBS is proposing to develop L3 guidelines on the appropriate treatment of various structured instruments.
29. **Chapter 6** presents CEBS's considerations on the treatment of specific portfolios under the large exposures regime. Exposures to sovereigns, international organizations, multilateral development banks, regional governments and local authorities, and other public sector entities, as described in Article 113.3, items (a) - (d) and (f) of the CRD, should be automatically exempted from the Large Exposures limits. Exposures under Article 113.3 (e) could be exempted when certain conditions are met.
30. CEBS has concluded that the basic market failure analysis applies also to interbank exposures and therefore it is more prudent to take robust ex-ante action on interbank contagion risk. CEBS considers that a complementary backstop limit is required. However CEBS recognizes the serious problems of such a rule for small banks and is therefore proposing a regime that incorporates specific provisions to take into consideration potential threats for smaller institutions.
31. CEBS's view is that the different nature of the business included in the banking and trading books justifies the current differentiation of treatment for large exposures purposes. As pointed out by the industry, treating trading book exposures in the same way as banking book positions would have adverse effects on institutions' ability to do business due to increased direct costs in the form of re-structuring transactions, obtaining more collateral, more management time and the opportunity costs of lost business.
32. On the treatment of intra-group exposures CEBS proposes to retain the national discretion of Article 113(2) that is intragroup exposures may be fully or partially exempted from large exposures limits when counterparties are covered by the same or equivalent supervision on a consolidated basis. This discretion should be extended to also apply to exposures that meet the conditions of Article 80.8, which allows exposures to entities within the same institutional protection scheme to be exempted.

33. In this context, CEBS does not consider the 20% limit to be justified, and suggests therefore that Article 111.2 be deleted and replaced with qualitative principles designed to ensure that firms are managing their exposures to entities outside of their consolidated group on an arm's length basis.
34. **Chapter 7** presents CEBS's considerations on the treatment of credit risk mitigation techniques for large exposures purposes. A more conservative approach than in the solvency regime is deemed necessary in order to address the prudential concerns. CEBS proposes to accept the same treatment of CRM techniques for large exposures purposes as for solvency purposes, but only for instruments considered sufficiently liquid.
35. CEBS believes that physical collateral should not be accepted as eligible for large exposures purposes whatever the institution's approach, with the sole exemption of real estate collateral provided that certain prerequisites that ensure timely and certain recovery are achieved.
36. **Chapter 8** provides CEBS's proposal on the appropriate supervisory reaction when breaches on the large exposure limits occur either in the banking or the trading book. For the banking book the most appropriate solution is to allow a temporary breach, allowing the institution an adjustment period to return to a compliant situation, provided the excess is deducted from own funds. CEBS has identified a few specific circumstances when the immediate deduction of the excess from own funds should not be required. For breaches arising from trading book activities, the current regime is appropriate and should be maintained.
37. **Chapter 9** presents CEBS's proposals on the reporting requirements for large exposures purposes. CEBS proposes a harmonized frequency by transforming the current national discretion into a general rule requiring at least quarterly reporting. Furthermore, CEBS is of the opinion that even exposures exempted from the large exposures limits should be reported. CEBS's views on the elements to be reported are also included. However, L3 guidelines should be developed in order to reach a harmonized outcome.

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# Chapter 1. Objectives and purposes of a large exposures regime

## 1.1. The need for a Large Exposures regime

38. CEBS believes that ensuring that risks arising from large exposures to individual counterparties or groups of connected counterparties are kept to an acceptable level is part of the overarching principles of prudential supervision, which are to ensure continuing financial stability, maintain confidence in financial institutions and protect consumers and in particular depositors.
39. CEBS considers that the core aim of a large exposures regime is to protect against the risk of a regulated institution incurring traumatic loss, which could threaten its solvency, as the result of the default of an individual counterparty due to the existence of “unforeseen events”.
40. CEBS believes that the most effective supervisory tool to achieve this aim is a limit-based backstop regime. However, CEBS has identified some shortcomings in the current limit-based regime and believes significant improvements can be made as they are discussed in the current report.

### *What a Large Exposures regime seeks to achieve: MFA/RFA*

41. From a market failure analysis (MFA) perspective the case for regulatory intervention in large exposures is at heart the same as the case for all prudential supervision. There are three basic types of market failure that should be considered in both cases; namely i) negative externalities associated with systemic risk and market confidence; ii) moral hazard and iii) information asymmetry.
42. The new solvency rules (Basel II) address these market failures at the portfolio level: Pillar 1 seeks to ensure that institutions have a minimum amount of capital to ensure resilience against losses. Pillar 2, among other things, 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 aggregate single name exposure concentrations. Pillar 3 seeks to enhance market discipline by ensuring that appropriate portfolio level information is publicly disclosed by institutions.
43. However, it does not account for market failures arising as a result of large exposures to individual counterparties or group of connected counterparties. The risk that one large exposure could, regardless of the performance of the rest of the portfolio, trigger the unexpected default of an institution, or cause the institution to experience significant difficulties of the sort that could lead to instability, contagion, and/or the need for the central authorities to intervene. Counterparties could default unexpectedly due to internal fraud, unforeseen government action (e.g. banning their products), loss of major customers or markets, or an unexpected breakdown in the validity of their business model. This is what CEBS considers the risk of traumatic loss due to “unforeseen events” to mean.

44. While an institution may be 'adequately capitalised' at the portfolio level, events can occur which such a model is not (well) designed to capture. Therefore, 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, due to the occurrence of unforeseen events which are outside the parameters of portfolio capital allocation – whether that be regulatory or economic capital allocation.
45. The industry has put forward the view that firms are already well incentivised to manage the risk associated with large exposures within prudent limits. Whilst CEBS accepts that the majority of institutions generally act prudently when managing the risk associated with large exposures, CEBS's view is that prudential regulation is designed to impose minimum standards on institutions and therefore it should be expected that many institutions hold themselves to a higher standard than the regulatory minimum. The real question is whether in practice in the absence of regulation, market failures would be likely to remain due to a smaller number of institutions acting imprudently. CEBS's view is that market failures would remain.
46. Moreover, CEBS does not believe the large exposure challenge is entirely one of credit risk measurement. In extremis, it is clearly imprudent to extend a very large part of an institution's capital to a single counterparty no matter how accurately the risk associated with this exposure may be measured.
47. CEBS's view is that an effective large exposures regime should be forward-looking and based on sound market failure analysis. If bank failures due to large exposures 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 to downplaying the structured market failure analysis.
48. From this high level market failure analysis, and informed by the overarching prudential objectives as they apply to large exposures to individual counterparties, CEBS considers that the following are appropriate detailed objectives for any large exposures regime:
  - ensure any negative externalities arising from large exposures to individual counterparties that threaten the general prudential objectives outlined above are contained to an acceptable level - the externalities may vary in extent and nature between different types of exposure;
  - minimise as far as appropriate moral hazard arising from the existence of safety nets (a "regulatory failure") as it affects the management of large exposures;
  - ensure that public authorities have sufficient regulatory tools to monitor, on an on-going basis, the extent to which the overarching principles of prudential supervision are being achieved; and
  - if intervention is necessary, ensure that it is effected using a tool that is appropriate and proportionate to achieving the stated objectives.

49. In summary, CEBS considers that the core aim of a large exposures regime is to protect against the risk of a regulated institution incurring traumatic loss as the result of the default of an individual counterparty. The high-level market/regulatory failure analysis provides the evidence that there is the need for official intervention to achieve this aim.

## **1.2. Policy options (Impact assessment/CBA)**

50. The high-level market/regulatory failure analysis conducted by CEBS has provided evidence that there is the need for official intervention to ensure regulated institutions are protected against traumatic loss as the result of the default of an individual counterparty due to the existence of “unforeseen events”. The 3 Level 3 Impact Assessment draft guidelines advise policymakers to consider a reasonable number of alternative policies to ensure that the most appropriate policy tool is proposed.
51. CEBS has considered a set of different policy options available and has undertaken a high level qualitative assessment of the potential impacts of the policy options described below:
- i) No specific regime (institutions operating within their own internal practices). CEBS believes this option would not ensure that the risk arising from large exposures to individual counterparties would be kept to an acceptable level. While there may be some reduction in direct costs this must be balanced against the loss of important regulatory information which may reduce the detection of large exposure risks and other important systemic risks. This could result in higher costs overall.
  - ii) Pillar 2 only. CEBS believes that market failures associated with exposures to individual single counterparties cannot be sufficiently addressed only under Pillar 2 for several reasons. Although it is true that there may be some reduction in direct costs if the regime is removed and that it would provide more flexibility for the institutions. However, increased costs (to the regulator and the firms in dealing with supervision) may still arise to the extent that the regulator feels the need to increase supervision in the absence of a regime. There may be increased information requests and different reporting requirements which can impose additional costs. Differences in reporting requirements may make it difficult to compare firms which could lead to an inefficient allocation of supervisory resources and reduce timely detection of large exposure risks. There may be competitive distortions between Member States if Pillar 2 is implemented differently in different Member States and uncertainty amongst firms over their permitted maximum exposures that may lead them to unduly restrict lending. On balance, CEBS believes that a 'Pillar 2 only' approach to large exposures is not sufficient and that other regulatory tools are necessary to meet the stated objectives of an effective large exposures regime.
  - iii) Market discipline enforced by Pillar 3 disclosures. A “Pillar 3” regime for large exposures would require institutions to disclose to the market on a timely basis their large exposures in sufficient detail for market participants to adequately assess and understand the associated risks. CEBS acknowledges some significant challenges in making a Pillar 3 large

exposure regime operational. The nature of some large exposures is transitory often arising from trading or M & A activities. These are likely to be regarded by institutions as highly confidential. Moreover, the transitory nature of these exposures would require a high frequency of disclosure. Moreover, it may be very costly for market participants to analyse these data. In addition, market discipline applies very differently across institutions. Providing these data on a timely and reliable basis may impose significant costs on institutions. On balance, CEBS considers that a Pillar 3 approach alone is not an effective and efficient way of meeting the objectives of a large exposures regime.

iv) A limit-based backstop regime such as the current regime. CEBS considers that a targeted limits-based backstop regime is the most appropriate regulatory tool to address the relevant market failures that have been identified. The arguments in favour of this approach are the following:

- caps negative externalities arising from single name large exposures, irrespective of institutions' risk management practices and oversight;
- delivers certainty to creditors, shareholders and other stakeholders that an institution's exposure to a particular failed or failing counterparty is limited to a particular amount (informational benefit);
- avoids distortion caused by regulatory arbitrage across Member States;
- is simple and easy to understand, and does not require the development, maintenance or oversight of complex models by either institutions or supervisors; and
- avoids undue interference with institutions' day-to-day risk management practices.

52. However, when conducting this analysis, CEBS has identified the following shortcomings of the current regime:

- There is no clear stated underlying rationale. In particular, there may be some market failures that the current regime does not address. National discretions allow an uneven application of the regime across Member States. (CEBS acknowledges that some national discretion may be necessary because not all market failures apply equally across Member States but it is CEBS's intention to propose a reduction of the number of national discretions included in the large exposures regime in order to have a large exposures regime that is as harmonised as possible with the solvency rules.)
- Measurement of exposures in the large exposures regime may not be consistent with the CRD and/or internal practices and may therefore impose an undue burden on institutions.
- There is wide variety in the implementation of the reporting requirements across Member States that may go beyond what is required to conduct the necessary institution specific and systemic risk assessments.

- The interpretation of “group of connected clients”<sup>9</sup> has sometimes been narrowly interpreted to focus on ownership and the asset side of the balance sheet and in any case varies across Member States.
  - There is a possible regulatory failure arising from an extended scope (application of the large exposures regime to fees of investment managers).
53. **Therefore CEBS does not propose to maintain the regime as it currently stands, but proposes a number of improvements. An amended limit-based “backstop” regime is therefore CEBS’s advice.** The specific features of such a regime are set in the following chapters.
54. CEBS explicitly advises the Commission that the focus of the regime should be on individual counterparty risk and therefore CEBS does not make any proposals on geographical, sectoral or granularity risk.

### **1.3. Other jurisdictions**

55. CEBS also reviewed to the extent practicable the approaches to large exposures in a number of non-EU jurisdictions<sup>10</sup>. In general, there are significant similarities between the regimes in operation in these countries; all of them set limits on the maximum amount of exposure to an individual counterparty or group of connected counterparties. However, although a variety of different large exposures regimes exists across the world, CEBS has concluded that overall the current EU regime is not in general stricter than any other individual regime, although it is possible to find some particular transactions that are treated more strictly in the EU than elsewhere.

### **1.4. The same treatment for all types of institutions and the recognition of sound credit risk management.**

56. A key point for consideration has been the ‘one size fits all’ question. The debate naturally follows the differentiated market failure analysis where different types of institution and exposure seem to justify quite different responses.
57. Although advanced institutions may have sophisticated internal models, the risk of traumatic losses due to unforeseen events may not be captured by such models. Given this, CEBS’s view is that the market failure analysis does not justify exempting from the large exposure limits the advanced institutions even when they have sophisticated systems and controls. It has been suggested that institutions that have been authorized to use their own estimates for capital requirements purposes should be given freedom to use their internal practices to set their own internal limits. CEBS encourages such institutions to continue to do so but does not believe that such practices completely address the market failures described, not least because large exposures are not primarily a problem of measurement but one of curtailing extremes.
58. The new solvency rules (Basel II) introduces incentives for good practices through a dual system that provides that only institutions qualified as advanced

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<sup>9</sup> Article 4 (45) of the Dir. 2006/48/EC

<sup>10</sup> US, Canada, Japan, Switzerland and Australia. An overview of the approaches is provided in Annex II of the First Part of CEBS’ Technical Advice to the Commission.

can benefit from a major freedom in calculating the measure of risk. CEBS has considered whether there is merit in analysing to what extent this feature can be translated into the large exposure limits. Those institutions that have been authorized to use their own estimates for capital requirements purposes should be allowed to use them in the calculation of exposure values for large exposures purposes.

59. CEBS's opinion is that the recognition of, and reward for, good credit management that is included in the solvency regime is also embedded in the suggested large exposure rules. The incentive for better credit management comes through the calculation of the exposure value to which the limits are applied by recognising internal estimates in some cases (see Chapter 5 and Chapter 7).
60. CEBS has already stated that the large exposures challenge from a regulatory perspective is not only the measurement of an exposure, as no matter how accurately the exposure is measured, it is clearly imprudent for an institution to extend a very large amount of capital to a single counterparty. Nevertheless, there are cases (e.g. financial derivatives within a netting set or schemes with underlying assets) where there is an additional measurement challenge, and CEBS believes that advanced models used internally by institutions can help to accurately measure the exposure. In these cases, CEBS's view is that the proposed backstop regime should be applied to the most accurate exposure value for which the institution has regulatory approval under the CRD.

## **Chapter 2. The large exposure limits**

### **2.1. Definition of a 'large exposure'**

61. CEBS proposes to keep the current definition of a 'large exposure' as set out in Article 109 of the Directive 2006/48/EC: "A credit institution's exposure to a client or group of connected clients shall be considered a large exposure where its value is equal or exceeds 10% of its own funds".
62. CEBS considers that, although it is somewhat arbitrary, the 10% threshold adequately reflects the supervisors' need to be informed on the large exposures incurred by credit institutions.

### **2.2. Large Exposures limits based on the exposure value**

63. This section analyses the reasons why the calculation of large exposures limits should only be based on the exposure value. The implication of this is that, for IRB institutions, PD and LGD should be set at 100% and in general the maturity should not be taken into account.

#### ***No recognition of credit quality (PD=100%)***

64. CEBS gave careful consideration to the question of the recognition of creditworthiness in the large exposure limits, having regard to the objectives of a large exposures regime explained in Chapter 1 of this report. CEBS is aware

that some credit institutions have suggested that any limits designed to determine the maximum exposure to a single counterparty should incorporate the credit quality of the counterparty.

65. Given that CEBS considers that the aim of the large exposures regime is to protect against the impact of unforeseen events, a key question is whether there is a market failure that justifies setting regulatory limits regardless the quality of the credit counterparty.
66. On the basis of the quantitative analysis set in CP14, CEBS has formed the opinion that the introduction of counterparty credit quality so as to relax or remove the regulatory large exposures limits for highly rated counterparties does not fully address the identified market failures. **CEBS's opinion is that unforeseen event risks are by their very nature not related with the a priori quality of the counterparty** (e.g. the default of counterparty due to fraud, government action, loss of a major customer or market, or breakdown of a business model for an unforeseen reason is usually not reflected in *ex-ante* credit quality assessments).
67. Notwithstanding this, CEBS considers that there could be implausible events or events that would not cause a marginal contribution to the negative externalities already imposed by the default of the counterparty that should be excluded from the large exposures limits (see Section 6.1).

***No recognition of recovery in the bankruptcy process (LGD=100%)***

68. As stated above, the purpose of the large exposures regime is to limit the potential losses associated with the default of a direct counterparty no matter the perceived likelihood of this event. However, the potential losses are not an observable value but an estimation that depends on the amount that reasonably could be recovered by realising collateral/guarantees and through the bankruptcy process.
69. CEBS believes that there are market failures that justify in specific cases different treatments between the regimes. In the absence of credit risk mitigation techniques, for the large exposures limits, institutions cannot take into account the amount that eventually will be recovered in the bankruptcy process given the great uncertainty regarding the amount and the need for timely recovery of the amount due. Therefore, in the absence of mitigation techniques, in the case of institutions allowed to use the IRB approach, the LGD will always be 100%. If institutions use some eligible CRM techniques (funded or unfunded credit protection) their effects should be incorporated as a reduction in the exposure value according to the criteria described in Chapter 7.

***The maturity in large exposures limits***

70. CEBS also discussed whether, and to what extent, maturity of an exposure affects the market failure analysis. Overall, CEBS considers that maturity may not have an important bearing on the market failure analysis because unforeseen events are – by definition – not predictable. Unlike credit risk more generally, where creditors with short-term exposures can respond to a gradual worsening of a counterparty's creditworthiness by reducing their exposures, unforeseen event risks almost by definition arise suddenly and without warning.

71. Therefore, **CEBS's view is that maturity should not be considered for large exposures purposes.**

### **2.3. The 25% limit**

72. Current rules (Article 111 of CRD) set out that "a credit institution may not incur an exposure to a client or group of connected clients the value of which exceeds 25% of its own funds".
73. CEBS's view is that 25% of own funds remains a large amount. It is noted that an exposure equal to 25% of own funds, could equal 50% of Tier 1 capital under the CRD provisions. CEBS believes that the default of a counterparty exposure of this size should be considered in itself close to the threshold of what an institution could sustain without imposing negative externalities on the system. This contributes to CEBS's view that it would be undesirable to increase the limit for high credit quality counterparties.
74. **It might be considered that the 25% limit operates as a long back-stop regulatory limit** which provides a very wide space within which reliance is placed on institutions to manage single-name concentration risk, alongside other forms of concentration risk, within their own risk management systems. Although in some ways arbitrary this threshold would reflect the supervisors' approximate risk tolerance and in this regard it is analogous to the 8% capital ratio.

### **2.4. The 800% limit**

75. The CRD imposes an 800% aggregate limit on large exposures (i.e. the sum of exposures to a client or to a group of connected clients exceeding 10% of its own funds shall not exceed 800% of its own funds).
76. CEBS believes that the 800% limit has merits in providing a harmonised minimum standard for ensuring granularity of the credit portfolio, although it is not fully justified by the market failure analysis which is related to the risk arising from large exposures to individual counterparties.
77. To the extent that an institution's portfolio exhibits a significant degree of 'lumpiness' this means that the idiosyncratic risk of the portfolio has not been diversified away. In such a case the 'Pillar 1' capital requirements may not be sufficient to cover the unexpected loss on the portfolio. Accordingly, the 800% limit might be argued to be a mechanism for limiting the extent to which losses not covered by Pillar 1 capital requirements are inherent in the portfolio. However, it is important to stress that compliance with this limit should not replace in any way the requirement to manage concentration risk under Pillar 2.
78. **On balance, CEBS is of the view that the 800% limit can be kept in European regulation because it provides a simple and harmonised minimum standard to ensure credit portfolio granularity.**



### Chapter 3. Definition of Connected clients

79. The definition of large exposures requires credit institutions to consider their exposures to a "group of connected clients". This concept is defined in Article 4 (45) of the CRD as: "(a) two or more natural or legal persons, who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly, has control over the other or others: or (b) two or more natural or legal persons between whom there is no relationship of control as set out in point (a) but who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, the other or all of the others would be likely to encounter repayment difficulties".
80. CEBS agrees that there is a need to clarify the definition of connected clients, since Member States have interpreted it in different ways. In addition to the general need for clarification, recent events have made this even more important. Until now, the supervisory authorities have focused only on the asset side of the undertakings in question in order to identify whether one undertaking may encounter repayment difficulties because of the financial problems of the other entity. The turmoil in the financial markets following the sub-prime crisis in the US, have shown that two or more undertakings can be financially dependent because they are funded by the same vehicle. For example, in Germany, Rhineland Funding issued CP in order to finance the numerous "Loreley Conduits". As the asset quality of one conduit came into question, Rhineland Funding was unable to issue new CP and provide the necessary funds to all the conduits. Therefore, IKB Bank as the main provider of liquidity facilities had to fund the whole structure. Although the different conduits were not invested in the same assets and were legally independent, it is clear with hindsight that the different conduits constituted a group of connected clients as they formed a single risk. Supervisors may therefore take into account not only the risk that derives from the business and assets of two entities but also from their liability or funding side.
81. **CEBS's view is that the objective of the rule on connected clients is to identify clients so closely linked by idiosyncratic risk factors that it is prudent to treat them as a single risk.** When one client of the institution has an economic connection to another client of the institution to a such degree that the client could face serious difficulties in meeting its commitments if its connected client(s) was affected by a situation of insolvency or of lack of liquidity, this needs to be addressed by treating the exposures to these clients as to a group of connected clients. This rule is intended to address risks arising from unforeseen events, not caused by either sectoral or geographic concentration or general systemic risk. In this sense, the institution should work to identify exposures or liabilities to counterparties that represent one idiosyncratic risk to such a degree that they constitute a single risk.
82. CEBS believes that the definition of connected clients should include connectedness stemming from one of the following type of connection:
- one client has control over the other;

- the clients are interconnected by some form of commercial dependency which cannot easily be substituted; or
  - the clients have a common significant source of funding within the institution, its financial group, its connected party or associate in the form of credit support, potential funding or direct, indirect or reciprocal financial assistance.
83. In order to capture these three dimensions of connectedness – where inclusion of a common source of funding represents a widening of the scope of the rule, **CEBS proposes to change Article 4 (45) of Directive 2006/48/EC** in the following manner:

*“Group of connected clients” means:*

*(a) two or more natural or legal persons, who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly, has control over the other or others: or (b) two or more natural or legal persons between whom there is no relationship of control as set out in point (a) but who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience funding or repayment problems, the other or all of the others would be likely to encounter funding or repayment difficulties.”*

### 3.1. Interpretation of control

84. The definition of control in Article 4 (9) in Directive 2006/48/EC, is specifically aimed at describing the conditions for requiring a consolidated annual report. The concept of connected clients reaches further and needs to be clarified.
85. CEBS proposes that ‘control’ should include the power to govern the financial and operating policies or crucial transactions of an entity<sup>11</sup> so as to obtain benefits from its activities.
86. **CEBS proposes that indicators of control might be seen in cases where the client exercises one or more of these powers:**
- power to decide on crucial transactions such as the transfer of profit or loss;
  - power to govern the financial and operating policies of the entity;
  - power to appoint or remove the majority of directors, the supervisory board, the members of the board of directors or equivalent governing body where control of the entity is exercised by that board or body;
  - power to cast the majority of votes at meetings of the board of directors, general assembly or equivalent governing body where control of the entity is exercised by that board or body; and/or

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<sup>11</sup> In this context, a client which is a natural or legal person (undertaking).

- power to co-ordinate the management of an undertaking with that of other undertakings in pursuit of a common objective.

Control is presumed to exist when the client owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity, unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control. Normally, a client owning 50 % of the shares/ voting power of another client will be able to exercise one or more of these powers. This is even the case when there are two equal partners/ owners who perform this responsibility jointly. Control may also exist under certain circumstances when the client owns less than half of the voting power of an entity.

It should be understood that the control situation is not just for a transitional period but seems reasonably stable. In article 4 (45) the wording "*unless it is shown otherwise*" is used. CEBS proposes to keep it in the definition. It should be interpreted in the sense that if the institution is capable of documenting that what seems to be a control-relation truly is not, then the requirement to group the clients is exempted. Most notably, this would be the case for owners of shares without voting rights. However, it is not relevant whether the client for the time being actually does exercise its potential control or not. Accordingly, voluntary self-imposed limitations on the exercise of control such as legal ring fencing or statements of a similar nature issued by the client itself will not suffice as documentation.

87. CEBS has identified one exemption from the requirement for grouping clients in cases where one client has control over the other, and that concerns subsidiaries where the majority of shares are owned by central governments, regional governments or local authorities. In such cases even though the owner has control over each subsidiary, the risk connected with exposure to one subsidiary is not related to the risk of exposures to other subsidiaries. A failure of one subsidiary, which is a separate legal person, does not necessarily impose a duty on the owner to invest more capital. If the owner still decides to do so, one assumes that this ultimately could be financed by raising revenues.

### **3.2 Interpretation of economic interconnectedness**

88. CEBS proposes that even if the question of control of one client over another is not relevant, an institution should be obliged to consider whether there exists a relationship of dependency or correlation between the clients. If it is more likely than not that the financial problems of one client would cause repayment difficulties for the other, there exists a financial dependency that needs to be addressed. Also, if two counterparties are likely to exploit commitments from the institution (such as guarantees, credit support in structured transactions or non-committed liquidity facilities) at the same time and the underlying cause for this will be similar, these counterparties may be considered as connected clients. A dependency connection between the clients may be mutual or only one way.
89. The target for the definition of interconnectedness is dependencies that the client cannot overcome in a short period of time by taking on practical inconvenience or lower margins or by other easily feasible means. **As an illustration of a relationship of dependency between clients, CEBS has listed some examples of possible financial dependency where**

**institutions would normally need to group clients** (the list is not exhaustive):

- exposure to a commercial property and to the tenant who pays the majority of the rent;
- exposure to the sole producer of a product and to the only buyer of the it;
- exposures to undertakings where the same natural persons are involved in the management/board of both clients;
- where the institution has committed itself to be the existing or potential funder or provider of credit support of more than one conduit or SPV under similar conditions and where it is likely that all of these commitments may materialize into exposures at the same time because they are dependant on the same funder.

90. CEBS is however aware that it is difficult to provide a precise definition of the concept of interconnectedness. With reference to the proposed changes to Article 4 (45), **CEBS also believes that level 3 guidelines regarding the concept of connected clients should be issued.**

### **3.3 Other elements of the definition of connected clients**

91. CEBS considers that it is an integral part of the institution's credit process to identify possible control-relationships and dependencies between clients; this applies especially to clients that have a large exposure or who tend to reach the limit set for inclusion into the market retail portfolio. To have information about connected clients is essential in reducing the impact of unforeseen events. Accordingly, the information required should be available to the institution.
92. In cases of divergence between the opinion of the institution and that of the supervisor, it is the supervisory authority who decides whether a client must be regarded as part of a group of connected clients. The entire exposure of the connected client must be included in the calculation of the exposure regardless of the formal share of ownership.
93. CEBS believes that there will be some situations where there could be a requirement to include an entity in more than one group of connected clients, for example, in the case of an entity in which two persons/companies hold 50:50 participations if they exercise a common influence on the entity.
94. Investments in asset funds managed by the same investment manager need not as a rule to be grouped because each of the funds is an individual legal person and is under supervision. An exception is if the fund in its statutes states that it will on a regular basis invest a given proportion of its funds in another identified fund. Another exemption, to be assessed on a case by case basis, could be when, besides having the same investment managers, the funds in question also have the same Members of the Boards and/or the same name as licensee (i.e. operate under the same name and face the same reputational risk (and often the same policy).

There is however, independently of the connected clients rule, an obligation to assess whether these investments represent a risk both from the scheme and from the underlying assets, (see chapter 5.4).

95. Finally, CEBS wants to point out that the concept of connected clients is applied in two different contexts in Directive 2006/48/EC. Apart from the large exposures part, the definition of connected clients is also applied when categorizing clients into the retail market portfolio (see Article 79 of CRD), therefore **the Commission should study the impact of broadening the definition of connected clients on the treatment of the retail portfolio in the CRD.**

### **3.4. The concept of connected parties.**

96. CEBS also finds it important to make a clear distinction between the terms 'connected clients' and 'connected party/parties'.
97. In general terms, CEBS considers that a "connected party" is one which is connected to the institution itself. That is:
- i) A natural person who is involved with the management of the institution at a senior level, as a member of the board, as an auditor or in some position that allows the building of networks within the institution. The main worry related to connected parties is that loans or other forms of exposures granted to such persons may not be subjected to the normal credit allocation process or may be considered independently from the normal requirements both with regard to the collateral and cash flow that would ordinarily apply to such exposures. CEBS does not propose that loans to such persons are unacceptable. Rather, there is the potential that subjective considerations may influence the assessment and
  - ii) A legal person (or a partnership) which is closely related to the institution in a way that makes it financially dependent on the institution, (see definition of "likely to encounter payment difficulties"). An associate of the institution could also be regarded as a connected party.
98. **CEBS's opinion is that the treatment of connected parties is mainly an issue of good corporate governance and sound credit risk management.** Many of the Member States already have laws in operation aimed at regulating the credit process leading up to credit allocations to connected parties.

## **Chapter 4. Scope of application of the Large Exposures framework**

99. This section defines the scope of the application of the large exposures regime by taking into account the different natures of some specialised institutions.

100. The large exposures framework currently applies to all credit institutions and investment firms falling within the scope of both Directives 2006/48/EC and Directive 2006/49/EC and the cross reference in article 3(1)b of the latter Directive to article 4(1)(1) of Directive 2004/39/EC (MiFID). This includes the full range of banks from large systemically important institutions to small cooperative banks and the full range of investment firms from large broker-dealers to small brokers and asset managers.
101. Moreover, the level of application of the obligations related to the large exposures limits is currently set out in articles 68 to 73 of Directive 2006/48/EC that applies to credit institutions. These articles also apply to investment firms because in Article 2 of Directive 2006/49/EC it is stated that Articles 68 to 73 of Directive 2006/48/EC shall apply *mutatis mutandis* to them, with some specific exceptions.

#### **4.1. Level of application of the large exposure regime**

102. **CEBS believes that no changes are needed to the current level of application: at consolidated, sub-consolidated and solo level.**
103. The large exposures framework should be required **at the consolidated level**; that is on the basis of the consolidated financial situation of the group or of the financial holding company. Institutions shall comply with the large exposures limits on a consolidated basis, when at least one of the following situations applies to them:
- a) they exercise exclusive or joint control over one or more credit institutions or investment firms authorised by the competent authority of a Member State or of another State that is party to the EEA, or exercise significant influence over them;
  - b) they exercise exclusive or joint control over one or more financial institutions;
  - c) they exercise exclusive or joint control or significant influence over one or more institutions governed by the laws of a Member State that is not a party to the EEA and which habitually carry out banking operations; or
  - d) they exercise exclusive or joint control over one or more institutions governed by the laws of a Member State that is not a party to the EEA.
104. Where justified by supervisory objectives, the supervisor could require such institutions included in the scope of consolidation to comply with the large exposure regime **on a sub-consolidated level** if they, or their parent undertaking which is a financial holding company, have a subsidiary that is a credit institution, a financial institution, or an asset management company incorporated in a third country, or hold a participation in such an undertaking; that is, if the conditions set out in Article 73.2 are met.
105. Finally the large exposures regime should also be applied on an individual basis. CEBS also proposes that Member States should have the discretion to waive the requirement to meet the large exposures framework **on an individual level** for any subsidiary of a credit institution (or when the parent undertaking is a financial holding company) if the conditions laid down in Articles 69.1 and 69.2 of Directive 2006/48/EC are met and for a parent credit institution if the conditions laid down in Articles 69.3 and 69.4 are met. That is because CEBS

considers that, on the basis of the market failure and high level cost benefit analysis set out, third party large exposures limits should not apply to subsidiaries that meet the criteria set out in these articles. (i.e. are situated in the same Member State, there is no impediment to the transfer of capital, the parent has declared that it guarantees the commitments entered into by the subsidiary and there are controls at the consolidated level). Although there may be some negative externalities following a group's insolvency, common risk controls, capital fungibility, and a common insolvency framework help ensure that they are kept to a minimum.

106. Institutions considered to be significant subsidiaries of an EU parent undertaking shall apply the large exposures regime on a solo basis or, if relevant, on a sub-consolidated basis. The risk assessment, measurement and control procedures relating to internal controls in credit institutions and investment firms of parent undertakings cover the subsidiary.
107. Finally, CEBS also recommends permitting that the large exposure limits are calculated jointly by the parent credit institution and its subsidiaries whose material exposures or material liabilities are to that parent credit institution when the conditions laid down in Article 70 are fulfilled.
108. **In summary, CEBS proposes that the level of application of the large exposures regime should be based on the same requirements as the level of application in the solvency regime in order to simplify the task and reduce the burden on institutions. Provided that the relevant conditions in Articles 69 or 70 are met, CEBS proposes that supervisors retain discretion to apply the large exposures regime at different levels than the solvency regime in specific cases.** For example, a supervisor could have good reasons for deciding not to apply the large exposures regime to a parent institution, provided that the conditions set out in Article 69.3 are met, and for deciding that, nevertheless, the solvency regime should be applied to that parent institution.

#### 4.2 Investment Firms

109. CEBS believes that the application of the large exposures regime to all types of investment firms could be considered to be a regulatory failure since the regime imposes a burden on specific types of investment firms (including a reporting burden) without delivering benefits to consumers.
110. CEBS has identified investment firms with "limited licence" and with "limited activity" as those firms for which the case for including them within the scope of the large exposure regime has not been made.
111. Market Failure Analysis carried out based on the possible existence of negative externalities and information asymmetry has shown that these types of investment firms do not appear to represent a significant risk of contagion because of the nature of their contracts. Instead, they act as agents for an investor who has delegated portfolio selection and administration to the asset manager. Exposures taken by an investment manager itself (as opposed to exposures incurred on behalf of a client or fund) are generally incidental to its investment management business. They do not tend to have large unsecured

exposures. Their large exposures are often accrued management and performance fees against which they are likely to have recourse to the assets under management (as the result of a client agreement/ contract). (A [full scope] broker dealer's failure could have a more contagious effect as they are able to take positions on their own account.)

112. The costs associated with failures of investment firms are likely to be relatively limited as they are not funded by depositors. The MIFID also requires client assets to be held separately from the firm's assets. Provided that asset managers do not take positions on their own account, interlinkages between firms are likely to be limited and so the collapse of an asset manager would not be expected to impact or have wider implications for consumer protection.
113. Following the identified market failures CEBS proposes that **those investment firms with "limited licence"** as referred to in Article 20(2) of Directive 2006/49/EC, that is those investment firms providing only one or more of the services referred to in points, 1, 2, 4, 5, 7 and 8 of Section A of Annex I of MiFiD<sup>12</sup>, **should be fully exempted from the Large Exposures regime.**
114. **CEBS also proposes a full or partial (discretionary) exemption from the Large Exposures regime for those firms with "limited activity"** referred to in Article 20(3) of Directive 2006/49/EC reflecting that the case for exemption is less clear as this category includes matched principal brokers.
115. It is not proposed to exempt other investment firms (including those often called "investment banks").

#### **4.3. Financial institutions that are not credit institutions**

116. CEBS believes that a clear distinction should be made between financial institutions with deposits or other similar funding ("institutions" in CRD terminology) and other financial institutions that cannot be funded by deposits or similar instruments and do not typically engage in conventional loan-making activities, as is the case with leasing or factoring companies. In these cases there are neither depositors to protect nor a risk of contagion through a crisis of confidence among other institutions' depositors.
117. However, the failure of such institutions could adversely affect parent credit institutions. If these institutions form part of a credit institution's group CEBS considers it necessary to apply the prudential regulation on consolidated basis. That would mean that, for example, the exposures incurred by a fully owned factoring company would not be subject to the large exposures limit at the subsidiary level, but would be subject to large exposures limits at the consolidated level.
118. In view of the above arguments, **CEBS proposes that financial institutions not subject to the CRD should not be subject to large exposures limits**

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<sup>12</sup> Activities listed are: (1) reception and transmission of orders in relation to one or more financial instruments; (2) execution of orders on behalf of clients; (4) portfolio management; (5) investment advice; (7) placing of financial instruments without a firm commitment basis; (8) operation of multilateral trading facilities.



**on a solo basis but that parent institutions should include their exposures on a consolidated basis.**

119. Finally, it is worth mentioning that in some countries these financial institutions (eg. factoring, leasing institutions) are considered credit institutions and therefore they should comply with the large exposures regime on a solo basis. If these institutions belongs to groups who are themselves included in the level of application of the large exposures regime, their exposures should also be considered at a consolidated level. In this case, CEBS believes that flexibility should be provided to supervisors to waive these institutions from meeting the large exposures rules at the subsidiary level.

## **Chapter 5. Calculation of exposure values for large exposures purposes**

120. An important issue in the review of the large exposures framework is the calculation of exposure values. In CEBS's review of industry practices carried out during 2006 it emerged that many institutions – in particular more complex institutions – calculate exposure values for their internal risk management and limits systems in manners that are different to those required for the current large exposures requirements and there appears to be a diversity of approaches.
121. On the other hand, for many smaller and less complex institutions it appears that this is a lesser issue as many of them use the large exposures framework as the basis for their internal risk management.
122. CEBS considers it necessary, where possible, to modify the exposure calculation requirements under the large exposures framework in order to align them more closely with the CRD.
123. CEBS believes that there are cases (for example, financial derivatives within a netting set or schemes with underlying assets) where there is an measurement challenge, and it believes that advanced models used internally by institutions can help to accurately measure the exposure. In these cases, CEBS's view is that the backstop regime proposed should be applied to the most accurate exposure value for which the firm has regulatory permission under the CRD.
124. Four broad categories of exposure are relevant for the purposes of this Advice, namely, (1) on-balance sheet items; (2) off-balance sheet items other than derivative instruments and securities financing transactions (SFTs)<sup>13</sup>; (3) derivative instruments and SFTs; and (4) collective investment undertakings, structured transactions and other arrangements where there is an exposure to underlying assets.

It should be noted that it is not the purpose of this section to consider in detail the question of the effect of credit risk mitigation on the calculation of exposure

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<sup>13</sup> Securities Financing Transactions includes, according to the definition set out in Annex III of Directive 2006/48/EC, repurchase transactions, securities or commodities lending or borrowing transactions, long settlement transactions and margin lending transactions.

values (except in relation to category (3) where the effects of collateral are an integral aspect of the exposure value calculation).

### 5.1 On-balance sheet items

125. In respect of the calculation of exposure values, Article 106 refers back to the items referred to in Article 78 without application of risk-weights, and Article 78 refers to the balance sheet value. Most institutions and supervisors take the view that, **consistent with the CRD requirements for solvency purposes, exposure values for these items should be based on relevant accounting standards, this means in particular that exposures will be net of accounting specific provisions and value adjustments. This should be the case for institutions using both standardised and IRB approaches.** Although at first sight this might be counterintuitive for impaired loans as it increases the large exposure limits and might allow institutions to increase their exposure to a client whose creditworthiness has deteriorated, it is consistent with the general approach that items that are deducted from own funds should not be recognised for large exposure purposes<sup>14</sup>, as provisions reduce the profits and so reduce own funds.
126. For institutions using the IRB approaches, the use of exposure values net of specific provisions and value adjustments for large exposures purposes should be also taken into account in the calculation of the own funds that must be used as the reference point to see if the limits are breached. These institutions should not consider those specific provisions and value adjustments twice, and therefore in the calculation required in Annex VII, part 1, point 36 of the CRD in order to determine the amount to be deducted from own funds if the result is negative (article 57(q)) or the amount to be added to own funds if it is positive (article 63.3) specific provisions and value adjustments should not be taken into account.

### 5.2. Off-balance sheet items

127. CEBS considered two important questions here; firstly, how wide should the scope of application be within the list of off-balance sheet instruments in Annex II of Directive 2006/48/EC, and second, what conversion factor (CCF) should be applied. In discussing these two questions, CEBS was guided very much by the idea of the large exposures regime as a 'backstop' regime.
128. In relation to conversion factors (CCFs), and for capital purposes, the purpose of Directive 2006/48/EC is to calculate the level of capital needed on a portfolio basis and so it is appropriate to consider the probability of a facility being drawn. Consequently under the Standardised approach the exposure value is modified by a factor representing the level of risk.<sup>15</sup> The approach for Foundation-IRB and Advanced-IRB institutions is set out in Annex VII of CRD (see part 3 of this

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<sup>14</sup> Article 106 1. sub 3 of Directive 2006/48/EC

<sup>15</sup> Article 78 of the Directive 2006/48/EC modifies the exposure value of off-balance sheet items by the following percentages; 'Full risk' items such as Guarantees and Acceptances at 100%, 'Medium risk' items such as Undrawn credit facilities with original maturity greater than 1-year at 50%, 'Medium/Low risk items such as Undrawn credit facilities with original maturity under 1-year at 20%, and 'Low risk' items such as 'Undrawn credit facilities that may be cancelled unconditionally at any time' at 0%).

annex VII for Foundation-IRB firms); Advanced-IRB firms are allowed to calculate their own conversion factors for the solvency regime.

129. In the current large exposure regime, a general 100% conversion factor is applied to the off-balance sheet items included in Annex II of Directive 2006/48/EC. However, and subject to national discretion, Article 113( r) and (t) allow Member States to exempt the "low risk off-balance sheet items referred to in Annex II where 'an agreement has been concluded with the client or group of connected clients under which the exposure may be incurred only if it has been ascertained that it will not cause the limits applicable under Article 111 (1) to (3) to be exceeded<sup>16</sup>.'" and to apply a 50% conversion factor to "the medium/low-risk off-balance sheet items referred to in Annex II".
130. CEBS proposes to eliminate these national discretions and instead proposes a harmonised approach. This proposal is in line with the mandate that CEBS has received from the Commission to reduce the number of national discretions as much as possible.
131. **CEBS's view is that a 100% conversion factor would be appropriate for all off-balance sheet items in Annex II for all firm types (Standardised, Foundation-IRB and Advanced-IRB).** Against this idea it is possible to argue that the 50 % conversion factor for medium/low risk items has applied for a long time and dates back (with minor changes) to the Basel Accord of 1988 and is applied by a large majority of Member States (80 % of the Member States at least partly apply the 50 % conversion factor). It also has to be flagged that Directive 2006/48/EC already introduces a more conservative treatment for undrawn credit facilities by imposing a 50% conversion factor on those facilities which are not unconditionally cancellable, compared to the 20 % conversion factor in the capital requirements. **However, consistent with the idea of the large exposures regime being a 'backstop' and not risk-sensitive, CEBS believes it prudent to include all items at 100%.** Even if an institution believes it is very unlikely that an exposure will be drawn, it is still imprudent to enter into an exposure of more than 25% own funds.
132. Chapter 7 deals with credit risk mitigation but CEBS would like to make it clear that it would be perfectly appropriate in principle to apply collateral against a contingent off-balance sheet exposure, provided the collateral (and associated conditions such as enforceability) meet the necessary eligibility requirements.
133. CEBS has been considering whether a 0% conversion factor would be appropriate for low risk items. Against this, it is possible to argue that recent events in the financial markets have shown that a conversion factor of 0 % for undrawn credit facilities which may be cancelled unconditionally at any time without notice, or that provide for automatic cancellation due to deterioration in a borrower's creditworthiness may underestimate the risk involved. Although the contract provides for the legal right to cancel the contract unconditionally, a credit institution may not be able to exercise this right for either for reputational reasons (e.g. main sponsor of a structured finance transaction, political pressure to participate in a rescue operation), or for operational ones (the system for assessing creditworthiness will lag the actual credit position of the counterparty

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<sup>16</sup> Article 113(3)(t) of Directive 2006/48/EC

and such systems will not necessarily be robust in all circumstances). Further, there is a risk that the party granted the facility takes 'false comfort' from it. CEBS acknowledges that a full assessment of the costs associated with 100% CCF has not been possible; the industry feedback has in general been very qualitative on this point; preferring a less strict regime but not providing firm cost estimates.

### **5.3. Financial derivatives and securities financing transactions**

134. For solvency purposes there is a range of ways of calculating exposure values for financial derivatives and securities financing transactions. These include the Mark to Market method, the Standardised Method and the Internal Models Method for financial derivatives, and various volatility adjustment methods, VaR modelling and the Internal Models Method for securities financing transactions.
135. **CEBS recommends that institutions should be allowed to use for the large exposures regime the exposure values determined within the capital requirements framework**, including those institutions that have obtained permission to use the Internal Model Method (IMM) set out in Annex III, Part 6 of the Banking Directive to calculate the exposure values for these transactions.

### **5.4. Collective investment undertakings, structured transactions and other arrangements where there is exposure to underlying assets**

136. CEBS has identified that there is currently considerable variation in the approaches adopted by supervisors and institutions to the determination of whether or not there is an exposure in the context of schemes (tranching or untranching) with underlying assets.
137. CEBS believes that there may be 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 banking sector.
138. After consultation with banks and trade associations in Madrid in October, CEBS suggests that the following proposed requirements may provide a good basis for this principles based approach:
- 1) Supervisors and institutions should identify whether the risk of incurring a loss from exposure to a scheme relates to the possibility of default caused by the underlying assets or of the scheme itself, or both. The institution should determine its exposure accordingly. That means the institution should identify when it is appropriate to look to the scheme itself, to look through the scheme, or both.
  - 2) In determining this assessment, institutions must evaluate the economic substance of the transaction as well as the possibility of 'unforeseen event risk' of various types. Examples of factors that institutions might take into account in determining this assessment include: sources of repayment, including recourse provisions; size, nature, quality and granularity of the underlying credit exposures; tenor; and the sustainability of the cash flows.

139. **CEBS proposes to develop L3 guidelines on the appropriate treatment of various structured instruments.**

## **Chapter 6. Calculation of exposure values for specific portfolios**

140. This section presents CEBS's considerations on the treatment of specific portfolios under the large exposures regime.

### **6.1. Sovereigns, international organizations, multilateral development banks and public sector entities**

141. The main objective of the large exposure regime is that negative externalities arising from large single name exposures are contained to an acceptable level. The basic market failure analysis has been articulated as the risk of a regulated institution incurring a traumatic loss as a result of the default of an individual counterparty due to "unforeseen events". However, where this market failure analysis does not apply then there is no rationale for limiting those exposures.
142. CEBS has already stated that unforeseen event risk is not related to the a priori quality of the counterparty because it only refers to plausible unforeseen event risks. It does not apply to certain entities with different natures and purposes. This is certainly the case for entities such as sovereigns, international organizations, multilateral development banks, regional governments and local authorities, and even other public sector entities in a great number of countries. However, in practice, although there is always the possibility for institutions with these kinds of large exposures to reduce the credit risk in a substantial manner, markets do not reward this risk averse attitude well, leading institutions to follow more common risky business practices.
143. Although there is not a limited and well known list of unforeseen event risks, because of their diverse nature, some entities may not be subject to the same types of unforeseen events as the ones applicable to common bodies regulated by private sector laws. Although other types of unforeseen events can be imagined, these will not plausibly happen to many countries, international organizations, and multilateral development banks. The kind of unforeseen events that could be considered for these entities would have such a huge impact that, no incremental market failure would exist in such cases. For instance, if something so unpredictable happened to make the government of a major developed country default, then, probably, the financial chain of effects could not be stopped by a large exposures regime.
144. Therefore, it is CEBS's view that such events fall outside the definition of the plausible unforeseen event risk that the large exposures regime seeks to cover. The possibility of a sovereign's exposure to idiosyncratic unforeseen event risk mainly depends on the political risk associated with the sovereign. So, in countries with acceptable levels of institutional stability, and where reliable international arrangements are in place, the idiosyncratic event risk can be completely ruled out.

145. **CEBS's proposal is that the exposures described in Article 113(3), items (a) - (d) and (f) should be exempted from the large exposures limits. This would also require the deletion of the current national discretion to fully or partially exempt these exposures from the large exposures limits.**
146. Similarly to the sovereigns indicated, regional governments and local authorities in those jurisdictions can also be ruled out from the large exposures limits. For that it is necessary that the regional governments and local authorities have enough specific revenue raising power or benefit from a specific institutional arrangement to eliminate the risk of default. This would also require the removal of the current national discretion to fully exempt these exposures from the large exposures limits.
147. Exposures described in Article 113(3), item (e), "asset items constituting claims and other exposures to central governments or central banks not mentioned in point (a) which are denominated and, where applicable, funded in the national currencies of the borrowers", should not be automatically exempted from the large exposures limits. In fact, CEBS's initial view, supported by industry feedback, is that, besides transfer risk, events falling under the category of "political risk" and "specific economic risks" can lead these exposures to default.
148. **CEBS believes that exposures under Article 113(3), item (e), can be exempted if the following conditions – based on annex VI, part 1 paragraph 5 of the CRD - are met:** i) exposures to a central government and central bank denominated and funded in the domestic currency of a third country; ii) this third country applies supervisory and regulatory arrangements at least equivalent to those applied in the EU; iii) the competent authorities of this third country assign to these exposures a 0% risk weight for solvency purposes; and iv) the Member State is applying the national discretion that allows the institutions to apply a 0% risk weight for solvency purposes for the reasons mentioned in paragraph 133, the implausibility of these events happening.

## **6.2. Interbank exposures**

### *The CRD treatment of interbank exposures for large exposures purposes*

149. Article 113.3(i) allows Member States to fully or partially exempt from the various large exposures limits exposures that are asset items constituting claims on and other exposures to institutions but not constituting such institutions' own funds (hereafter referred to as "interbank exposures"), with a maturity of one year or less. Article 115.2 allows Member States to assign a risk weighting<sup>17</sup> of 20% to interbank exposures with a maturity of between one and three years, and a 50% risk weighting to interbank exposures represented by tradable debt instruments with a maturity of more than three years. Alternatively, Member States may use the derogation in Article 116 to simply apply a 20% risk weight to all interbank exposures, regardless of maturity. Moreover, Member States may choose to impose more stringent limits than those set out in the Directive (Article 113.1).

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<sup>17</sup> A risk weighting of 20% is the equivalent of a limit of 125% of own funds on exposures subject to a 25% of own funds limit.

The CEBS Supervisory Stock take<sup>18</sup> revealed that, in practice, a wide range of approaches are taken across Member States. For a summary, see Annex [1].

### ***Market failure analysis***

150. CEBS has concluded that the basic market failure analysis – that banks do not fully internalise the risk of unforeseen events resulting in the sudden default of a major single unsecured debtor – applies also to interbank exposures. That is, that unforeseen events arising at major bank counterparties can give rise to negative externalities. This is because CEBS considers that, although it is perhaps less likely that a prudentially regulated institution could unexpectedly default due to an unforeseen event, it remains a plausible scenario. CEBS also considers that additional market failures, associated with systemic risk and moral hazard, also apply to interbank large exposures. CEBS does not agree with some respondents' view that there is no risk associated with short-term interbank exposures: the losses arising from the failure of Bankhaus Herstatt in 1974 demonstrate that even the shortest maturity credit exposures are associated with unforeseen event risk although CEBS recognises that not all unforeseen events develop overnight or with very little warning (eg wholesale counterparties were able to reduce their exposure to Northern Rock over a period of two to three months).
151. BCCI and Barings failed after fraud was uncovered and, more recently, external intervention was required to support Northern Rock<sup>19</sup>, IKB and Sachsen LB after their business models suddenly became, at least temporarily, unviable. The large losses recently made by Societe Generale on its equity derivatives portfolio also demonstrate the potential for banks to make sudden, large and unforeseen losses. Recent studies by Moody's<sup>20</sup> and Fitch<sup>21</sup> demonstrate that, although the average one year default rate of banks and other financial institutions is lower than that of industrial and commercial companies, it remains significant, particularly when account is taken of ex-post measures taken or facilitated by the public authorities to prevent the failure of banks that would otherwise have defaulted.
152. Moreover, banks, by their nature, depend on one another to provide liquidity and other services to each other. This connectedness gives rise to a form of systemic risk, a negative externality: the failure of one bank potentially could adversely affect other banks in the system. If large net interbank credit exposures exist within the system, the scope for onward contagion from the initial failure to other banks is increased.
153. The costs of ex-post intervention, in addition to potentially putting taxpayers' funds at risk, include contributing to moral hazard for banks' creditors. These creditors may weigh up the probability of official intervention in their assessment

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<sup>18</sup> Available on CEBS' website; see in particular Page 2 of [Annex II](#) of the Supervisory Stock take.

<sup>19</sup> At a UK parliamentary hearing on 16 October 2007, a Northern Rock Board member described the sudden drying up of the ABCP market that led to the bank requiring emergency liquidity assistance as an event that was "unforeseen" and "not thought plausible" in the context of stress testing. Northern Rock is a good example of an unforeseen event arising over a number of months but well under a year: some banks started to reduce their exposures to Northern Rock around three months or so before the bank would have failed had the UK authorities not have intervened.

<sup>20</sup> *Corporate Default and Recovery Rates, 1920-2006* (revised version of 27 June 2007), Moody's (2007)

<sup>21</sup> *Fitch Bank Failures Study 1990 – 2003*, Fitch Ratings (2005)

of counterparty credit risk, leading them to manage their interbank exposures less prudently than they otherwise would. This gives rise to allocative inefficiencies, as implicitly supported banks obtain funds on better terms than those banks and non-banks without state support. This might in turn lead large banks' prudential liquidity requirements to be understated, as counterparties may be more willing to extend longer term credit than they would in the absence of implicit support. Secondly, it is self-reinforcing because larger interbank exposures increase the authorities' incentives to intervene in a crisis, which could itself induce even larger interbank exposures. This is particularly problematic when the structure of the banking market is more concentrated.

154. In practice, in mid to late 2007 and into 2008, some European banks became generally less willing to lend to one another particularly at longer maturities and interbank spreads rose. This may be a result of liquidity hoarding, or because of genuine concerns about the credit quality of individual counterparties. This suggests that banks may have at least partially internalised the externalities discussed above in this unusual period of stress. Nonetheless, prior to the recent period of market turbulence interbank spreads had been persistently low (sometimes the unsecured rate dropped below the secured rate), and institutions continue to hold very large interbank exposures. Furthermore, data collated by CEBS on interbank exposures, a recent BIS Working Paper and the IMF's FSAP reports all indicate that interbank exposures could pose material systemic risk.

#### ***Cost / benefit analysis***

155. The benefits of imposing limits on interbank exposures would be found in reduced exposure to unforeseen *event* risks; reduced systemic risk and hence potentially less need for the authorities to intervene to prevent a systemic crisis, and reduced moral hazard, resulting in a shift of the systemic risk burden from taxpayers to banks themselves. This would produce better incentives for banks to diversify their funding sources in day-to-day operations, contingency funding plans and/or to increase their stocks of liquid assets.
156. The costs of imposing interbank limits *would be* associated with their potential impact on banks' liquidity management, particularly in stressed circumstances, increased operating costs – for some, smaller, banks at least – associated with dealing with a wider range of counterparties, and the costs associated with increased use of secured, rather than unsecured, markets (where such substitution is a feasible option). Banks whose liquidity management is *structurally* reliant on a small number of bank counterparties, that is, where there is a long-standing and persistent<sup>22</sup> large net exposure in one direction, would be most affected by a backstop limits regime. Banks in this position may need to adjust their liquidity management practices to comply with a backstop limit.
157. These identified costs would fall primarily, but not exclusively, on smaller banks rather than larger banks, as many smaller banks rely on being able to place large deposits with a limited range of high quality, typically but not exclusively, domestic, banks. Limits could restrict interbank liquidity in stressed circumstances if banks do not strengthen their contingency funding plans. For some small banks, interbank assets constitute the majority of their assets by value as they engage in little or no lending to the real economy. Depending on

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<sup>22</sup> But not necessarily long maturity: exposures could be rolled over at short maturities.



the calibration of the large exposures limit and therefore the extent to which they were obliged to diversify or take collateral (to the extent that this is possible) against their interbank exposures, the smallest banks may be unable to obtain an economically sustainable spread on placements in interbank markets (or, in the worst case, may be unable to place funds at all) because wholesale counterparties demand a premium for dealing in what are, to them, very small amounts. Small banks that were obliged to diversify their bank counterparties may also suffer an increase in portfolio credit and liquidity risks, as the credit and liquidity profile of their interbank assets could be weakened.

158. For example, feedback provided by UK small banks and building societies suggests it is very difficult for a bank to place an amount smaller than £10-25mn in the unsecured interbank market, and secured markets are simply not available to many smaller banks. However, this problem may be at least partially mitigated by the fact that the introduction of interbank limits could prompt a structural shift in the interbank market and a reduction in the premium for accepting small placements of funds.

159. Small banks' day-to-day operations may also be disrupted by interbank limits. For example, some banks rely on being able to place short term large exposures with their clearing banks to make or receive payments on behalf of clients.

***CEBS proposal for the treatment of interbank exposures in the Large Exposures framework***

160. As identified in the market failure analysis large interbank exposures give rise to systemic risk that must be dealt with either by ex-ante measures or by official intervention to prevent bank failures ex-post. CEBS favours the ex-ante approach as the burden on taxpayers is lower and market functioning more efficient than it is with the alternative, ex-post approach. CEBS has found that the costs and benefits of imposing limits on unsecured exposures would vary significantly between banks and Member States. A correctly calibrated system of limits could make a positive net contribution to the reduction of systemic risk. However, imposing meaningful limits on smaller banks could impose high costs upon them: it would probably cause some of them to go out of business. CEBS suggests that a way to contain systemic risk whilst preserving small banks would be to exempt exposures below a particular value.

161. CEBS considers that risk-weighting exposures would not be conducive to achieving the stated objectives of the regime. It is important to ensure that the ex-ante measure meets the objectives of the large exposures regime: **for a backstop to be effective, it must be calibrated to insulate the lending bank from the unforeseen failure of its counterparty.** The current system explicitly includes national discretion to risk weight exposures at 20% and/or 50%. CEBS considers that, from a technical point of view, this is unsatisfactory because such risk weights do not contain the impact of unforeseen event risk: banks that have between 100% and 250% of Tier 1 capital<sup>23</sup> exposed to a failed counterparty would almost certainly fail if they did not receive external support.

162. As regards the treatment of short-term maturities, CEBS acknowledges that exposures of longer maturities are associated with more unforeseen event risk than exposures of shorter maturities. Nevertheless, in order to construct a robust ex-ante regime that protects against failures that arise with little or no

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<sup>23</sup> A 25% of Tier 1 + 2 capital limit implies a minimum 50% of Tier 1 limit. Risk weighting at 50% effectively increases this limit to 100%, risk weighting at 20% increases it to 250%.

prior warning, **CEBS considers it generally inappropriate to make blanket exemptions for short maturity (however defined) exposures in a backstop regime** as there is a trade-off between exempting exposures of progressively longer maturities and achieving resilience against a wider range of unforeseen events affecting banks. The trade-off is particularly steep for potentially systemic banks.

163. As regards a special treatment for smaller banks, all else being equal, the exposure of a large bank to another large bank is associated with more systemic risk than an exposure of a small bank to a large bank, because in the former case it is more likely that a default would, absent intervention, trigger a systemic crisis. However, systemic risk is also posed by exposures of multiple small banks to the same large bank(s). Data collected by CEBS and industry feedback suggests that many small European banks are exposed to the same larger banks.
164. Industry feedback strongly suggests that many small banks require very large (as a percentage of their own funds) exposures to large banks in order to conduct their day-to-day business. This is particularly the case for small banks whose business involves limited lending to the real economy or is focused on making or receiving relatively high-value payments on behalf of clients. Unlike larger banks, small banks are unable to collateralise their interbank exposures and, in many cases, only a limited range of high quality counterparties are available to them, and many cannot access central bank facilities. In some member states, smaller banks have formed networks which use a central or regional entity to manage their liquidity and access interbank markets. Industry feedback suggests that bundling members' deposits in one central entity that provides access to financial markets is very often essential to achieve competitive conditions.
165. Therefore, the impact of a simple "percentage of own funds" limit on such small banks would be disproportionately high. Industry feedback indicates that an all-maturities limit calibrated at 25% own funds would put some small banks out of business. Moreover, because of differences in market structure and bank activities between different Member States, the impact is likely to vary significantly between Member States. **Therefore CEBS considers it appropriate to make some provision for smaller banks.**
166. Industry feedback also stresses the potential for tighter interbank limits to adversely affect larger banks' liquidity risk. CEBS recognises that, in certain stressed circumstances, this could be the case (although CEBS would expect that banks with robust contingency funding plans would not be reliant on a limited number of counterparties to provide very large amounts of liquidity). Banks would have to hold larger stocks of liquid assets to counteract this risk, which would be costly for them. However, this would represent a shift in the burden of systemic risk from the taxpayer to the banks (and, indirectly, their customers) because there would be less need for ex-post official intervention.
167. On the basis of its market failure and cost-benefit analysis and the industry feedback received on CP16, CEBS makes the following proposal:
  - **Subject all interbank exposures to a limit of 25% of own funds or a specified value in € (or other Member State currency equivalent) terms, whichever is the higher.**

- This value should be calibrated to only benefit banks whose failure would not, plausibly, cause a systemic crisis to ensure that systemically important banks are subject to a 25% limit. CEBS suggests that €150mn might be a reasonable starting point, but further work would be needed to ensure that this does not allow potentially systemic banks to have interbank exposures greater than 25% of own funds.
- **If 25% own funds is less than the value discussed above (eg €150mn), then the portion of the exposure between 25% of own funds and €150mn must be of a maturity of less than 3 months.** This protects against slower burn unforeseen events, whilst avoiding disproportionately restrictive limits on medium sized banks who may not have access to deep and liquid interbank markets to manage their liquidity
- **The exception to this is if 25% of own funds is less than a second, lower threshold.** In this case any portion of any exposure above the second threshold must be of less than 3 months' maturity. Exposures up to the second threshold may be of any maturity. This proposal is included to allow the smallest banks to continue to function. A tentative value for the second threshold would be €50mn (UK banks and building societies indicated that minimum deal sizes entertained by large banks are between £10-25mn). Again further calibration work is needed to ensure that this threshold only benefits those banks that need it in order to conduct business.
- Supervisors could downwardly but not upwardly<sup>24</sup> adjust the thresholds at their discretion to allow for differences in the absolute size of Member States' banking systems.
- The thresholds would need to be periodically adjusted for inflation and/or changes in market structure.
- CEBS proposes to delete Article 113.3(n) because it considers that the above treatment of interbank exposures would allow small network member banks to continue to bundle deposits with a central or regional entity for cash-clearing purposes.

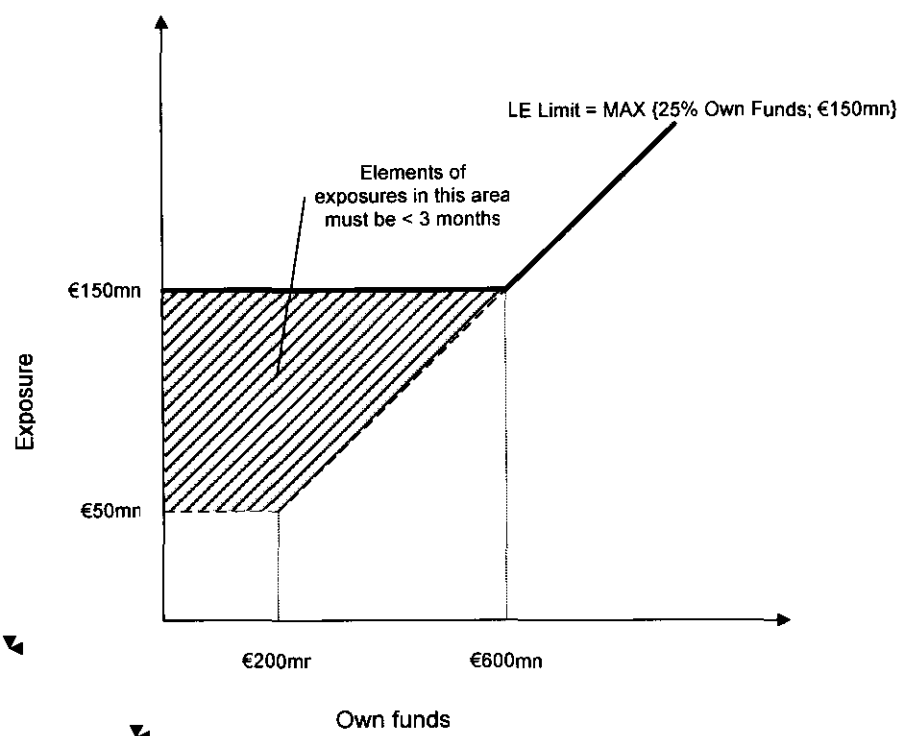
It should be noted that the above proposal is not unanimously shared by all CEBS members<sup>25</sup>, since few Member States support keeping at this stage the current regime and, in particular, to keep the national discretion set out in Article 113.3(i) that allows Member States to fully or partially exempt from the large exposures limits interbank exposures with a maturity of one year or less. Although supportive on the results of the market failure analysis they emphasize the cost-benefit analysis and, in particular, that due to the current money market situation it is not the appropriate time to propose a change in the regulatory regime of interbank exposures, mainly because given time constrains it has not been possible for CEBS to make a full quantitative assessment of the costs associated with its proposal.

168. The proposal, using the suggested threshold values discussed above, is summarised diagrammatically below.

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<sup>24</sup> Allowing upward adjustment would introduce competitive problems within the EEA.

<sup>25</sup> This refers in particular to the supervisory authorities from the Czech Republic, Austria, Germany and Luxembourg, while the last three countries requested for an explicit reference on the final text of the advice..



### 6.3. Treatment of Settlement risk exposures currently scoped out of the regime by Article 106.2

169. CEBS considers that, despite innovations such as CLS Bank, settlement risk arising from fx transactions remains a significant concern. In order to prompt improvements in the measurement and management of these risks, CEBS recommends that such exposures be subject to some reporting requirements and subsequently subject to a review regarding full inclusion within scope. The widespread use of Delivery versus Payments (DvP) systems has, by and large, eliminated routine securities settlement risk. CEBS concludes that there is no strong evidence of market failure and suggests that such exposures remain out of scope.
170. Article 106.2 provides for the exclusion from the large exposures limits and reporting regimes of all exposures arising from foreign exchange transactions incurred in the normal course of settlement during the 48 hours after payment and exposures associated with securities transactions incurred within 5 days of the ordinary course of settlement.

#### **Foreign exchange settlement exposures**

171. Foreign exchange settlement<sup>26</sup> exposures are volatile and potentially large: a recent Committee on Payment and Settlement Systems (CPSS) report<sup>27</sup> suggested that many institutions may have, on peak days, bilateral fx

<sup>26</sup> In this context "fx settlement exposures" means the exposure to loss of principal owing to a default of counterparty between the point of irrevocability of the outgoing payment and final settlement of the incoming payment. It should not be taken to mean the risk that there the relevant fx rate shifts unfavourably between striking and completing the deal, or broader exposures to foreign exchange rate risks.

<sup>27</sup> Progress in reducing foreign exchange settlement risk, Consultative report, CPSS (2007). <http://www.bis.org/publ/cpss81.htm>

settlement exposures that represent a significant proportion of their own capital (an estimated 16% of institutions would have exposures greater than 10% of capital on a peak day). CEBS therefore considers the large exposures treatment of such exposures to be an important issue.

172. Although CLS and other innovations have reduced the proportion of foreign exchange trades settled using correspondent banking methods (i.e. subject to settlement risk), the absolute value of such trades remains high: total obligations of approximately \$1.2tn per day in 2006. The report also suggests that, on average, such trades give rise to settlement risk for more than 24 hours but less than 48 hours. The 1974 Herstatt case demonstrated empirically the threat that settlement risk may pose to the financial system is real.
173. The report notes that many fx settlement exposures are not well controlled (to quote the report, “only 34% of the surveyed institutions could be said to fully control their traditional fx settlement exposures”<sup>28</sup>), and many institutions lacked a “coherent set of risk-measurements”<sup>29</sup> across individual business units. The report concluded that much remains to be done to contain settlement risk. The CPSS suggested that “all institutions should take immediate action to avoid underestimating the risk they incur” and that “[central banks should] work with supervisors to explore options that could ensure on an ongoing basis that banks apply appropriate risk management procedures to their FX settlement exposures”<sup>30</sup>. Many respondents to the survey that CPSS conducted to inform their report agreed that some form of external pressure, such as regulatory pressure, might be needed for them to make further improvements to their management of fx settlement exposures<sup>31</sup>. Thus, there is evidence of a market failure.
174. Therefore a case could be made for bring these exposures into the regime. Subjecting such bilateral settlement exposures to large exposures limits would bring costs, as well as benefits. Although banks would have to invest in better risk measurement systems, such investment would be costly, and – particularly if the interbank regime were to be made more stringent – bilateral settlement limits could result in a reduction in fx activity with consequent adverse implications for the liquidity and efficiency of markets more generally. **A compromise could be to bring fx settlement exposures in to the reporting regime** – thereby obliging firms to update their risk measurement systems – but, for an initial period at least, leave exposures for which it is not possible to eliminate settlement risk (unusual currency pairs, or same day trades for example) outside the limits regime, and subject this arrangement to a review to be undertaken a number of years after the reporting requirements are brought in.
175. Such a proposal would require appropriate industry consultation – it was not covered in CP16. Furthermore, it would be necessary to explore what form of reporting would be most appropriate. It is not obvious that a three monthly snapshot is the most effective way to monitor fx settlement risk (although the reporting requirement would oblige banks to invest in technology that enables them to monitor and measure the exposures on an ongoing basis). It may be more appropriate, for example, to require banks to report the peak value of

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<sup>28</sup> Page 8 of CPSS Report.

<sup>29</sup> Page 10

<sup>30</sup> Page 12

<sup>31</sup> Page 11

bilateral fx settlement exposures over the three month period. CEBS stresses that any move towards a reporting regime for fx settlement would be a complement to, and not a substitute for, enhanced dialogue between firms and supervisors regarding fx settlement risk.

#### ***Securities transactions settlement exposures***

176. In general, EU countries have implemented the CPSS's-IOSCO recommendations<sup>32</sup> for securities settlement systems and the settlement of securities transactions occurs on a Delivery versus Payment<sup>33</sup> basis. These systems are widely used by banks. Most major third party jurisdictions also employ DvP systems<sup>34</sup>. This eliminates day-to-day settlement risk arising from securities settlement. As a result, CEBS considers that no market failure arises as settlement risk occurs only in the event of operational problems. **Therefore CEBS considers that Article 106.2 (b) should remain in the Directive as the costs of measuring any remaining settlement risk are very likely to outweigh the minimal benefits.**
177. However, it is also possible that some credit exposures could arise as a result of this activity between credit institutions. Although they are normally of a very short maturity (from intraday to 5 days maturity), CEBS believes that it is important to clarify that these exposures should be treated as any other interbank exposure.

#### **6.4. Trading Book**

178. In its Call for Technical Advice (No. 7) on the review of the large exposure rules the Commission asked CEBS to assess the appropriateness of the existing rules for the trading book. The Commission points out that 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 to large exposure should be considered.
179. From the market failure analysis, CEBS's view is that unforeseen event risk could affect exposures in the trading book as well as those in the banking book. Therefore, the associated market failure argument does apply mutatis mutandis to trading book exposures and CEBS believes that these exposures should continue to be within a large exposures regime.
180. The current trading book large exposures regime, however, is distinctive in that it combines the 25 % limit with a series of exemptions for trading book positions alongside higher limits and excess capital charges. In some ways, this provides institutions with flexibility to exceed the 25 % limit. The conceptual distinction between the banking book and trading book was introduced in Directive 93/6/EEC. As investment firms and credit institutions are engaged in direct competition with one another, it was considered desirable to achieve equality in the treatment of credit institutions and investment firms by developing common standards for their trading activities. For this reason it was necessary to introduce the concept of a 'trading book' comprising positions in securities and

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<sup>32</sup> *Recommendations for securities settlement systems*, CPSS (November 2001), Recommendation 7 (page 14).

<sup>33</sup> According to a survey by ECB's Securities Working Group, 2007 (not published).

<sup>34</sup> See *Statistics on payment and settlement systems in selected countries*, Figures for 2005, CPSS (2007), page 219.

other financial instruments which are held for trading purposes and are subject mainly to market risks and exposures relating to certain financial services provided to customers.

181. **The need for a distinction was confirmed by market participants in the industry consultation conducted by CEBS. The distinction is generally justified on the basis of the shorter time horizons for taking positions and the active risk management that apply in the trading book which reduces the problem of information asymmetry.**
182. In addition, the arguments on negative externalities associated with systemic risk and market confidence as well as moral hazard are not as strong for investment firms as for credit institutions as investment firms do not take deposits. Current regulation moreover ensures that the banking business of a bank is sufficiently protected from risk deriving from its trading activities, as any excess in the trading book is only possible if the banking book limits are respected and the capital for the trading activities is not used to meet the capital requirements for the banking activities.
183. The large exposures regime of Directive 2006/49/EC applies only to institutions with a substantial trading book business (Article 18.2 of Directive 2006/49/EC). So only those institutions that calculate the capital requirements for their trading book business in accordance with Directive 2006/49/EC have to monitor and control their large exposures subject to the amendments laid down in Articles 29 to 32 of Directive 2006/49/EC. Other institutions have to treat their trading book positions as banking book positions and apply the provisions of Directive 2006/48/EC only.
184. The large exposure limits for the trading book are based on the net exposure. Basing the large exposure limit on the net position assumes that market participants fulfil their contracts, so that the default risk (not the market risk that is captured under capital requirements) is hedged. The tradability of financial instruments however is not taken into account, as liquidity in the market would dry up immediately if the issuer of the financial instrument fails. Basing the large exposure limit for the trading book on the net exposure may give incentives to book banking book positions in the trading book as such a position then could be offset by a long put option, even if this put option is far out-of-the-money.
185. It is therefore the task of the supervisor to determine whether all positions in the trading book are really held with a trading intent in line with the institution's trading strategy. This is even more important given that the differences between the two books are likely to be blurred. However, the problem of regulatory arbitrage also applies to the capital requirements regime which lays the basis for the definition of the trading book that is used for the large exposures regime.
186. Exposures from underwriting are weighted with respect to the period of time that they are in the books of the institution (i. e. 0 % for the first day, 100 % from the fifth day on). This is based on the assumption that the issuer of new financial instruments will not fail in the very short term. In the calculation of the large exposure limit institutions also have to take account of settlement risk and free deliveries. The recognition of these risks in the trading book is necessary as

the trading intent for a particular instrument may no longer exist when the market price of this instrument has changed in the meantime. This risk can be neglected in the banking book where the profits do not derive from short term price movements.

187. The competent authorities may authorise the limits laid down in the Directive 2006/48/EC to be exceeded if the exposure in the banking book to the client or group of clients in question does not exceed the limits laid down in this Directive, so that the excess arises entirely in the trading book. This recognises that trading positions are held only over a short period and that credit risk/unforeseen event risk connected with these positions over this short period can be assessed and managed more accurately.
188. In case of an excess the institution has to meet an additional capital requirement on the amount of the excess in respect of the 25 % (or 20 %) limit laid down in Directive 2006/48/EC. This additional capital requirement – a departure from the general approach of a limit based back stop regime - calculated in accordance with Annex VI of Directive 2006/49/EC, reflects the risk inherent in the financial instrument that causes the excess over the limit. This additional capital requirement ensures that the institution can only enter into a limited number of trades that exceed the general 25 % threshold.
189. The excess is of course not unlimited. Where 10 days or less has elapsed since the excess occurred, the trading book exposure to the client or group of connected clients in question shall not exceed 500 % of the institution's available free capital. Any excesses that have persisted for more than 10 days must not, in aggregate, exceed 600% of the institution's available free capital. The aggregate limit for trading book positions exceeding the overall limit is based only on those positions that have exceeded the limits for more than ten days. In cases where the limits have been exceeded, the amount of the excess and the name of the client concerned must be reported to the competent authority.
190. Competent authorities may permit institutions which are allowed to use the alternative determination of own funds under Article 13.2 of Directive 2006/49/EC to use that determination for the large exposure limits for trading book positions provided that the institutions concerned are required to meet all the obligations under the large exposure rules in Directive 2006/48/EC.
191. These alternative elements are the institution's net trading-book profits and subordinated loan capital. The competent authorities may permit such subordinated loan capital up to 250 % of the original own funds left to meet the capital requirements calculated in accordance with Directive 2006/49/EC. Short-term subordinated debt instruments are included in the calculation of the limits for the overall large exposure limits as the exposures that they cover also have a short term character. However, the opportunities for a bank in the trading book depend on the use of capital in the banking book, since a reduction of capital requirements for the banking book positions extends the amount available for trading book activities, as the recognition of alternative (tier 3) capital is linked to free core capital.



192. In order to conduct an impact assessment CEBS has evaluated two options: either to keep the current regime as it is or to apply the banking book rules to trading book positions.
193. Applying the banking book rules to trading book positions would certainly simplify the large exposures regime and avoid the problem of regulatory arbitrage, having in mind that the differences between the two books are increasingly blurred, as it is claimed that the composition of trading books has changed substantially and includes more credit related products such as credit derivatives and complex products such as hedge funds and structured products.
194. The application of the banking book regime would on the other hand lead to higher capital requirements for investment firms and banks, if they provide their service on the same scale, and thus would be likely to make the provision of financial services more costly. The new incremental default risk capital charge for trading book positions will additionally reduce the incentives for booking positions in the trading book and thus the possibility for regulatory arbitrage. The application of the banking book regime to the trading book would finally, and in particular, not recognise the differences in the short term horizon of the position taking and the additional qualitative requirements for its management.
195. To conclude CEBS believes that the current large exposure regime is in many aspects different to the proposed limit based back-stop regime. It provides the institutions with generous but still firm large exposure limits. The higher limits are based on (i) the assumption that due to the short term horizon of the position taking institutions are able to assess the likelihood of default more reliably than in the banking book and therefore would restrain themselves from positions in doubtful issuers and (ii) the higher qualitative requirements for the management of trading book positions. Additionally, it limits institutions' ability to exceed the general large exposure thresholds by additional capital charges. On the other hand the limits are significantly more generous than those on the banking book (five times the free capital available versus the 25% limit, and no recognition of underwriting commitments on the first day).
196. Alignment of the banking and trading book regimes, however, would significantly affect the industry (requiring either additional capital or a reduction in risk-taking) and thus could make the provision of financial services more costly. Further, this effect may fall disproportionately on investment firms.
197. In the consultation process the industry was unable to provide quantitative data to allow CEBS to conduct an in-depth CBA of the two options. However, it pointed out that it shares the view that treating trading book exposures the same way as banking book positions would have adverse effects on its ability to do business due to increased direct costs in the form of re-structuring transactions, obtaining more collateral, more management time and the opportunity costs of lost business. Additionally, firms would be limited in their ability to provide immediate liquidity to many markets.
198. As there is no historical/anecdotal evidence so far that the current regime has led to the failure of an institution, a quantitative CBA on the impact of a change was not feasible and the vast majority of supervisory authorities has not identified a need for a review of the large exposure regime for the trading book

**CEBS cannot recommend at this point a change to the current regime, i.e. an alignment of the regimes for the banking and the trading books.**

## **6.5. Intra-group exposures**

### ***CRD treatment of intra-group exposures for large exposures purposes***

199. A limit of 20% own funds currently applies to intra-group exposures (Article 111.2). Note that this limit in effect is an aggregate limit on all intra-group exposures. Member States may choose to exempt intra-group exposures from the 20% limit if they provide for specific monitoring of intra-group exposures by other methods (although, all else being equal, the 25% and 800% limits would still apply). They are also given discretion to fully or partially exempt intra-group exposures from the 25% and 800% limits, provided that the debtor and creditor entities form part of the same consolidated group and that the consolidated group is subject to CRD or equivalent supervision (Article 113.2). Member States may choose to impose more stringent limits than those set out in the Directive (Article 113.1).
200. The CEBS Supervisory Stock take<sup>35</sup> revealed that, in practice, a wide range of approaches are taken across Member States.

### ***CRD treatment of intra-group exposures for capital requirements purposes***

201. Institutions are generally required to treat intra-group exposures in the same way as exposures to unconnected third parties. However, Member States have the discretion<sup>36</sup> to exempt exposures to group companies engaged in financial services and subject to prudential supervision provided that they are included in the same consolidation as the creditor on a full basis, subject to the same risk controls, are in the same Member State as the creditor and there is no practical or legal impediment to the transfer of capital or repayment of liabilities between the two entities (Article 80.7). They may also exempt exposures to members of the same institutional protection scheme, provided certain conditions are met (Article 80.8).

### ***Market failure analysis***

202. CEBS has concluded that the basic market failure analysis (the risk of unexpected default of major counterparties giving rise to negative externalities, which is not adequately captured in the capital requirements regime) applies to exposures to group companies where there are material practical or legal impediments to the transfer of capital, where there is doubt that the group would elect to support the debtor entity should the latter encounter solvency problems or where the debtor entity is not subject to an equivalent level of prudential supervision as the creditor entity on a solo basis (eg. it is a non-financial undertaking or is a bank in a third country whose prudential regulation is not CRD-equivalent). This is because there remains the potential for the failure of the debtor entity to endanger the solvency of the creditor via the intra-group exposure. The large exposure, in other words, could marginally increase the probability of default of the creditor entity and of the whole group in the

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<sup>35</sup> Available on CEBS' website; see in particular Page 2 of [Annex II](#).

<sup>36</sup> Article 89.1(e) allows IRB firms to apply a Standardised Approach treatment to intra-group exposures, or exposures of the same institutional protection scheme.

same way as a third party exposure does. Industry feedback supports these conclusions.

203. When these conditions do not hold, CEBS considers that the market failure does not apply. In such a case, the group has (through its solvency support commitment) already fully internalised the risk of potential losses of the debtor entity up to the level of its consolidated capital and the transfer of resources from one entity to another does not make a marginal contribution to the probability of the default of the creditor entity or of the group as a whole.
204. CEBS notes that in practice this market failure **applies in varying strengths across the EU**. For example, in countries where there is a large subsidiarised foreign banking presence (e.g. many of the countries that acceded to the EU in 2004) exposures of subsidiaries to their parents could present a systemic risk to the banking system of these countries (e.g. due to the potential for the parent to be suddenly made insolvent by fraud). However, if some subsidiaries were themselves to encounter difficulties they may not always benefit from full capital support from their foreign parents. This could place a potentially unfair burden, therefore, on subsidiary countries' taxpayers. In other Member States, for example the Benelux countries, the market failure may be less strong because incentives for groups to support subsidiaries in these countries may be stronger, and impediments to the flow of capital weaker.
205. Intra-group exposures could also give rise to **negative externalities that arise as consequences of group insolvency**, or inhibit co-ordination to support a group on the brink of failure. That is, even though they may not add materially to the PD of the group or any particular entity within it, they impose costs that are not internalised by group shareholders. The fundamental problem underlying these externalities is that external creditors' legal claims are on entities within groups, not on groups themselves, even if in the normal course of business groups are run on an integrated basis. Depending on one's perspective, these could be described as market or regulatory failures. The externalities are primarily associated with the frustration of the timely, efficient and equitable resolution of a failed banking group. We set out the problems in more detail below.
206. First, (uninformed) depositors' interests, and those of the taxpayers who underwrite deposit guarantee schemes, may be prejudiced by exposures of deposit-taking entities to non-deposit taking entities as they would as a group effectively rank alongside the unsecured wholesale creditors of the non-deposit taking entity. Furthermore any rules designed to provide depositors with preferential claims could be subverted.
207. Second, intra-group exposures in cross-border groups could unfairly prejudice the interests of one country's depositors (and taxpayers) over another because the debtor country liquidators / authorities may ring-fence the loaned assets to pay off debtor country depositors in priority to creditor country depositors<sup>37</sup>. This could inhibit international co-operation in the resolution of a failed bank and undermine the basis of national deposit guarantee schemes.
208. Third, partly because of the potential for ring-fencing discussed above, intra-group exposures may make official co-operation to intervene to prevent a group

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<sup>37</sup> Goodhart provides a more detailed explanation of the problem in *Multiple Regulators and Resolutions*, pp253-273 in Evanoff & Kaufman, (2004), *Systemic Financial Crises: Resolving Large Bank Insolvencies*.

from failing more difficult. In the absence of robust, agreed mechanisms for deciding which country provides (for example) emergency liquidity support to a bank with significant operations in a number of countries, the need to agree to ad-hoc co-operative solution could significantly delay, or *in-extremis*, prevent the provision of any such support. This could result in the unnecessary failure of a solvent but temporarily illiquid banking group.

209. Fourth, large intra-group exposures could make otherwise sound legal entities more difficult to sell as going concerns because any potential buyer would become liable for the exposures to the rest of the failed group and so be partly liable for the claims of the other, weaker, entities' creditors.
210. Fifth, in the case of cross-border groups, large intra-group exposures could potentially aggravate the already significant problems caused by the existence of different legal jurisdictions with separate insolvency laws, procedures and liquidators: the EU Winding Up Directive does not apply to groups, but only to individual legal entities. These added complications could give rise to additional legal uncertainty that could inhibit the timely and efficient resolution of a banking group.
211. Finally, there is a risk that – in an unusual, stressed situation – a banking group could be faced with perverse incentives to create large intra-group exposures by transferring all of the “bad assets” into a “bad bank”, and then letting that bank fail and the local deposit insurance scheme and unsecured creditors bear losses beyond the “bad bank’s” own funds, instead of using group resources to absorb losses. However, national corporate governance laws may serve to prevent this from happening and supervisory monitoring and understanding of intra-group large exposures should mitigate this risk.
212. Many of these market / regulatory failures could contribute to the disorderly failure of an international banking group, which could – as the Basel Committee’s 2001 *Report from the taskforce on the winding down of large and complex financial institutions* noted – impose significant direct and indirect systemic costs, including adverse market reactions to similarly situated LCFIs, a freezing up of markets and gridlock in payment systems. This is particularly important as the number of cross-border banks operating in the EU is large and growing<sup>38</sup>.

#### ***Cost / benefit analysis***

213. CEBS has considered the high-level costs and benefits of imposing a limits-based regime on all intra-group exposures. However, due to the unavailability of the relevant quantitative data, it was not possible for CEBS to conduct a quantitative cost / benefit analysis exercise in this particular case. Therefore the discussion of costs and benefits below is in general terms, without (unless specified) being based on a specific calibration of a system of limits.

#### **Benefits of imposing limits on large exposures**

214. The benefits of an intra-group large exposures regime are found in the mitigation of the two groups of market failures discussed above. Their strength depends on whether capital is fungible, the extent to which groups can credibly

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<sup>38</sup> Thomas Padoa-Schioppa estimated in 2004 that there were 40 banking groups with operations in at least six EU countries; there have since been a number of actual and attempted major cross-border bank acquisitions, mergers and ventures.

pre-commit to supporting a particular entity and whether all counterparties in the group share the same risk characteristics. They are likely to be strongest when the counterparty is an unrelated non-financial unregulated group company that does not benefit from a group capital guarantee.

215. Intra-group exposures limits could **prompt banks to take ex-ante action to make their contingency funding plans more robust** and / or hold greater stocks of liquid assets at group and entity levels, making them less dependent upon uncommitted intra-group liquidity and, in the case of banks operating with cross-border subsidiaries, less dependent upon host authorities to provide emergency liquidity assistance to subsidiaries that the group itself may be unwilling to assist but which are important to the stability of the banking systems in which they operate. They could also lead to an ex-ante moderation in groups' risk-taking behaviour.
216. CEBS suggests that if **national borders** are a barrier to the prompt transfer of capital or repayment of liabilities, limiting intra-group exposures would provide a benefit in terms of protecting parts of a diverse group from problems arising in others. On one hand, the marginal benefit of intra-group exposure limits may be weaker if there is likely to be reputational or brand contagion arising from the failure of a group entity, which could cause difficulties for the wider group with or without the intra-group large exposures. On the other hand, a transparent system of intra-group limits could reduce indirect contagion as wholesale counterparties would know that the rest of the group's credit exposure to the stricken entity is limited. CEBS considers that the relative strengths of these offsetting factors will vary considerably from case to case.
217. The benefits are likely to be weakest, but still potentially significant, **within the same legal jurisdiction**. Within a single legal jurisdiction, it is more likely that competing claims can be co-ordinated by a single lead liquidator for all of the entities within the group. The problems associated with burden-sharing do not arise, as the same deposit guarantee scheme and / or taxpayers will share the burden of compensating depositors / providing emergency liquidity assistance. The benefits will be weaker still in countries with no depositor-preference laws and where corporate law exists to protect against the "bad bank" problem described above. However, large intra-group exposures could still frustrate the quick sale of an otherwise sound entity<sup>39</sup> and could, depending on the liquidation procedure used, prejudice the interests of (some) depositors.
218. The benefits will be stronger for intra-group exposures **between jurisdictions** where no robust ex-ante loss sharing arrangements are in place and a co-ordination failure – between liquidators, courts, groups of creditors, or financial sector authorities – is a strong possibility. They will be strongest when the intra-group exposures are to entities in regimes that apply a "separate entity" approach to resolution (eg the US). Such regimes will ring-fence all local assets for the benefit of local depositors, before making assets available to a lead liquidator in the group's home country.

#### Costs of imposing limits

219. The potential costs of intra-group exposure limits arise from potential efficiency losses for banks, and therefore the wider economy, and from potential risks to

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<sup>39</sup> This was identified in the Basel Committee's 2001 *Report from the taskforce on the winding down of large and complex financial institutions* as an obstacle to restructuring the exposures of an LCFI.

stability that they may raise. They are both associated with the capacity of banking groups to manage risk and liquidity on an integrated and centralised basis. Intra-group limits could also affect the way in which groups choose to structure themselves.

220. **Efficiency costs** could arise as a result of banks being unable to present a single “face” to the market when raising wholesale funds, being compelled to run multiple liquidity and risk management operations or being unable to employ funds raised in one part of the group to fund business in another of the group. They would particularly affect smaller entities which depend on their parents for low-cost funding in order to compete with larger firms.
221. Depending on their calibration, intra-group limits could make it necessary to raise funds in multiple entities or jurisdictions and they would also be less able to opportunistically raise wholesale funding wherever it happens to be cheapest at any particular point in time. This means the price they are able to obtain may be less competitive. From an economy-wide perspective, all else being equal, **this would make markets less efficient.**
222. Needing to raise funds and hold risky assets in multiple jurisdictions restricts the extent to which groups can centralise their liquidity and risk management operations. They would therefore need to bear the additional fixed costs of running multiple operations in different parts of the group. This could mean that they are less able to obtain a group-level perspective of the risks within the group. This could lead to **less efficient risk decisions.**
223. Intra-group limits would, however calibrated, ultimately place a restriction on the capacity of the group to use funding raised in one entity to fund risk-taking behaviour in another part of the group. This means that the group would be obliged, to some extent, to raise funds in the entity which is taking the risks. This implies an efficiency cost if it the group’s best source of, for example, retail funding is divorced from its most profitable lending activity.
224. **Stability costs** could arise from intra-group limits if segmentation of liquidity and risk management across the group were to prevent groups from obtaining an overview of their group risk profile, **making them more vulnerable to shocks**, or if groups were prevented from supporting illiquid but otherwise sound subsidiaries in stressed circumstances.
225. Running multiple risk and liquidity management operations across the group could contribute to vulnerabilities to liquidity and other risks at the group level if (and only if) groups were unable, as result, to gain a group-level perspective on the risks being run.
226. Even if intra-group limits were not binding on a day-to-day basis, they could become binding in stressed circumstances<sup>40</sup>. In this case, they could prevent liquidity from flowing from parts of the group with surplus liquidity to (otherwise sound, and solvent) parts of the group suffering liquidity strain. This could, *in extremis*, **lead to the unnecessary failure** (or costly intervention of host authorities to prevent failure) of group entities.

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<sup>40</sup> Whether they would become binding would depend crucially on a) continued compliance with local prudential liquidity standards in all parts of the group, b) ability of the group to provide liquidity support given that most or all other parts of the group may be suffering simultaneous liquidity strain, c) the possibility that some jurisdiction may impose ex-post restrictions on cross-border transfers and d) the willingness of the group to provide liquidity support to stricken entities.

227. If they were to be binding in stressed circumstances, all else being equal and compared to a situation where there were no intra-group limits, there would be increased dependence on the interbank markets. Intra-group restrictions therefore potentially interact with any restrictions placed on interbank exposures. This could result in additional banking system capital being required to retain the same level of business and robustness to shocks.
228. **Impact on group structures and capital guarantees.** The imposition of intra-group exposure limits could affect the way in which groups structure themselves (eg the choice of whether to use branches or subsidiaries), and the extent to which groups that use subsidiaries provide cross-bank capital guarantees. The net benefit / costs of these changes is ambiguous.
229. A group for whom intra-group limits would impose high costs might choose, in response, to structure itself using branches (eg the *Societas Europaea*) instead if the relevant competent authorities were to permit it to do so. It would then only have to comply with most prudential regulations on a consolidated basis and so be less constrained in its liquidity and risk management. It might have to bear higher tax costs (eg groups operating in Member States with low flat-rate taxes would no longer be able to benefit from them) and could be perceived as more “distant” from host markets, which could be damaging to its business. However, there would be no post-insolvency co-ordination failures (at least between jurisdictions subject to the Winding Up Directive).
230. If it chose not to move to a branch structure for tax or other reasons, the group could become less integrated as a result of the limits, meaning that it may become less willing to support stricken entities within the group. This could be a problem for countries where subsidiaries are systemic from a national perspective. Alternatively, it could become more integrated in order to meet the conditions set out for exemption of intra-group exposures, for example the group may put in place cross-group capital guarantees. In this case, capital support is more likely to be forthcoming to stricken entities, but on the downside the scope for poorly managed or supervised subsidiaries to bring down the entire group is increased.
231. This cost/benefit analysis suggests that removing the national discretion that exempts intragroup exposures from large exposures is not appropriate because of the significant differences in the impact of limiting intragroup exposures on the functioning of Member States’ banking systems.

***CEBS proposal for the treatment of intragroup exposures in the Large Exposures framework***

232. Article 113(2) states that intragroup exposures may be fully or partially exempted from large exposures limits when counterparties are covered by the same or equivalent supervision on a consolidated basis. Articles 80.7 and 80.8 set out (more restricted) conditions for Member States to exempt exposures to group and institutional protection scheme members respectively from minimum capital requirements. CEBS believes that it is, generally, desirable to harmonise requirements and remove national discretions wherever appropriate. However, in this particular case, **CEBS has concluded that it is appropriate to retain the national discretion set out in Article 113.2, and that this discretion**

**should be extended to also apply to exposures that meet the conditions of Article 80.8<sup>41</sup>.**

233. CEBS considers that where the supervisor of the creditor entity judges that capital is fungible, that groups can credibly pre-commit to supporting a particular entity and that all counterparties in the group share the same risk characteristics ; or where exposures are not within the same legal jurisdiction but there are robust loss sharing and other arrangements for dealing with a stricken or failed cross-border banking group), any costs of imposing limits on large exposures are likely to exceed the benefits. Benefits are low because there is no credit risk – capital is fungible, the entity is an integral part of the group and is subject to appropriate prudential requirements; and there are no cross-border co-ordination concerns – and marginal costs of limits are relatively high because it is in such circumstances that there are likely to be the fewest other impediments (eg risk-weighted capital requirements) to centralised liquidity and risk management.
234. CEBS has concluded that intragroup exposures that are not exempted from the limits should be aligned as far as is appropriate with the treatment of third party exposures. This includes exposures to unregulated group entities (eg industrial or commercial companies), and exposures to group entities where the presence of minority interests, in the opinion of the competent supervisory authority places a material potential barrier to the transfer of own funds or repayment of liabilities. This is because intragroup exposures that are not exempted are generally associated with the same risks as exposures to third parties. Similarly, the rules on connected counterparties, as currently set out in Article 4 (45), should also be applied to intragroup large exposures. That is, unless it can be proven that two group counterparties do not constitute a single (unforeseen event) risk, despite their common ownership or relationship of control, exposures to them must be aggregated.
235. On this basis **CEBS does not consider the 20% limit to be justified**, instead the general 25% limit should also be applied to intragroup exposures. Therefore CEBS suggests that Article 111.2 be deleted and replaced with **qualitative principles designed to ensure that firms are managing their exposures to entities outside of their consolidated group on an arm’s length basis.**

## **Chapter 7. Credit Risk Mitigation and indirect exposures**

### **7.1 Eligibility and treatment of specific CRM techniques in Large Exposures**

236. CEBS has reached the conclusion that the market failure analysis justifies a more conservative treatment of the credit risk mitigation techniques than for the solvency purposes.
237. CEBS’s view is that under the large exposures scenario that would imply solvency/liquidity stress in the institution itself as a consequence of the default

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<sup>41</sup> Article 80.8 allows exposures to entities within the same institutional protection scheme to be exempted. CEBS considers that, for the purposes of the large exposures regime, these exposures are equivalent to intragroup exposures.



of a large exposure it is especially crucial that the recovery of these amounts should be certain and timely. Any mistake in the valuation of the collateral could have more dramatic implications than under the scenario assumed for minimum capital purposes. On the other hand, under an large exposures scenario it would be more urgent to realise the collateral than in other circumstances as it could be more difficult for the bank to obtain external funds, so the need to obtain liquidity, e.g. by the realisation of the collateral, could be more acute than in other circumstances. Then the accurate exposure value that needs to be looked at is not necessarily the same value as for minimum capital purposes because the horizon for the assessment is not the same in both cases. This would particularly affect the most illiquid mitigation instruments.

238. CEBS has discussed three alternative approaches taking into account the potential costs and benefits of each alternative, including following the same treatment for both frameworks, compared with the current regime<sup>42</sup> (see CP16). In view of the cost/benefits analysis of these proposals, **CEBS agreed that the most balanced solution between the prudential concerns and the cost/benefit arguments is to accept the same treatment of credit risk mitigation techniques, but only for those CRM instruments considered liquid enough.** The loss in terms of a greater likelihood of financial instability is more than offset by the administrative burden and constraints imposed on market developments.
239. Once an element is eligible as credit protection under the large exposures rules, it is subject to compliance with the minimum requirements sets out in the CRD, as already stated in Article 112 of the CRD.
240. In the following paragraphs CEBS presents its proposals on a range of CRM techniques, stressing where some deviations from the CRD rules are proposed.

#### *Netting agreements*

241. Regarding “on balance sheet netting” and “master netting agreements” **CEBS agrees that they can be accepted in the same way as in the capital rules.** This is already so in Article 113.4 for on-balance sheet netting. For master netting agreements there is room for different interpretations under the current drafting so CEBS’s initial proposal is to accept explicitly the same treatment as in the capital rules.

#### *Financial collateral*

242. **CEBS’s view is that the financial collateral eligible under the large exposures framework should be the same as for minimum capital purposes,** with the conditions set out in annex VIII of the CRD for non advanced IRB banks. Therefore, the eligibility criteria depend on the method used by the institution (comprehensive or simple method) and on the use of the advanced IRB approach.
243. CEBS proposes to follow the same rules as set out in annex VIII, part 3 of the CRD. That means no change for institutions that follow the comprehensive method, as it is already included in Article 114.1 of the CRD. As regards those

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<sup>42</sup> It is important to be aware that the current large exposures framework set out in Section 5 of the CRD already establishes a different treatment for CRM than that in the capital rules.

institutions permitted to use their own estimates of LGD, CEBS recommends maintaining the current rules set out in Article 114.2. Institutions can use their internal calculations of the effects of financial collateral if they can estimate its effects on their exposures separately from other LGD-relevant aspects. Moreover, their own internal estimates of the effects of financial collateral should be made on a basis consistent with the approach adopted in the calculation of the capital requirements.

244. CEBS opinion is that the haircuts applied for solvency purposes are conservative enough also for large exposures purposes. The scenario addressed by the large exposures limits is a situation in which the institution is itself under solvency/liquidity stress because it has experienced the default of a counterparty that represents a large amount in terms of capital. CEBS's opinion is that it is very unlikely that this scenario implies higher haircuts than the ones that must be addressed for solvency purposes (e.g. stress in the collateral market).
245. However CEBS's recommendation is that this scenario should also be taken into account in the calculations of the volatility adjustments, in particular in cases where the institution could affect the market price by having a large market share.
246. For institutions that use the simple method under the CRD, CEBS knows that in order to make it consistent with the treatment provided in the CRD for solvency purposes, the substitution approach under Article 117.1.b should also be recommended for large exposures purposes.

#### *Physical collateral*

247. With respect to physical collateral CEBS believes that for the reasons explained above, physical collateral should in general not be accepted as eligible for large exposures purposes whatever the institution's approach. However, the need to be more conservative will depend on the nature of the collateral, in particular its degree of liquidity. In general, physical collateral is less liquid than financial collateral; however it could be that certain types of physical collateral have a market liquid enough to obtain enough accurate volatility estimations.
248. **CEBS's view is that real estate collateral, including leasing transactions under which the lessor retains full ownership of the property leased, could be eligible under the large exposures framework** provided that certain prerequisites are fulfilled and the haircuts are applied not to a volatile market price but to a stable valuation. These prerequisites are that the building is not under construction but finished and that the use of the property is not restricted to certain very specific uses. (This will be always the case for residential real estate but cannot be always the case for commercial real estate). CEBS thinks that in this case the valuation is conservative enough to keep the prudential concerns to an acceptable level.
249. CEBS's advice is to deviate from the minimum capital requirements rules and maintain the current large exposures rules; allowing Member States discretion to recognize commercial and residential real estate. However, for commercial real estate CEBS suggests that if the current national discretion to allow a 50% risk weight under the minimum capital rules remains in place, the Commission

considers deleting the national discretion set out in Article 113.3(q) and aligning with the minimum capital rules in this respect.

250. For residential real estate, the mitigation effect can be recognised up to 50% of the value of the residential property concerned, if the loan is secured to the satisfaction of the competent authorities. For commercial real estate, the mitigation effect can be recognised up to 50% of the value of the commercial property concerned, only if it receives a 50% risk weight under the minimum capital rules.
251. CEBS's view is that given the lower liquidity of these markets and the lack of standardization, the uncertainty surrounding the estimations (both, from the institutions' and from the supervisors' viewpoints) justifies a simpler and more conservative approach than for solvency purposes. This approach would be simple and would allow the same treatment regardless of the approach used by the institutions, including those institutions permitted to use their internal calculations of LGD that will not be recognised for these particular purposes.
252. **For other physical collateral CEBS's recommendation is that it should not be recognised for large exposures purposes whatever the institution's approach** in view of the great uncertainty surrounding its valuation given the lower liquidity of these markets.
253. For covered bonds recognised under the minimum capital requirements rule, CEBS's view is not to change the current exemption that allows Member States to fully or partially exempt these instruments from the large exposures rules. Therefore, CEBS proposes to maintain the national discretion of 113.3.(l).

#### *Unfunded credit protection*

254. **CEBS's view is that for unfunded credit protection the eligibility of protection providers should also be the same as for minimum capital purposes and the same minimum requirements should be fulfilled according to annex VIII part 1 and 2 of the CRD, CEBS proposes that the same treatment as in the minimum capital rules should be followed.** Under the solvency regime unfunded credit protection is generally reflected using a 'substitution' approach. Under the current large exposures regime, and as a national discretion, Member States may also allow a "substitution" approach.
255. CEBS's proposal is to eliminate the national discretion and allow institutions to treat the exposure as having been incurred to the guarantor rather than to the client in all Member States. However this should be permitted only when the guarantee has the same or better credit quality that the unsecured exposure to the counterparty. This should be required to avoid the possibility that an exposure could be exempted from the large exposures limits it is guaranteed by a guarantor of lower credit quality.
256. Both guarantees and credit derivatives are permitted to reduce capital requirements under the CRD, and are available under all credit risk approaches. Both types of contract work by substituting a 'promise to pay' from the underlying obligor with another 'promise to pay' from the protection provider. Provided the guarantor and the underlying obligor are not connected clients and

that the commitment remain the same (same scheduled payments and conditions) there are no reasons to consider that the certain and timely recovery would be more difficult than in the situations addressed for capital purposes.

257. The substitution approach implies that the institution can choose to assign the exposure to the direct creditor, without taking into account the guarantee for large exposures purposes, or to assign the exposure to the guarantor, assuming the default of the direct creditor. Both choices are in line with the purposes of large exposures regime. As far as recognition of the double default argument in order to reduce these exposures for large exposures purposes is concerned, CEBS's strong view is that this is not consistent with the principle of giving no regard to creditworthiness.

## 7.2. Indirect exposures

258. CEBS proposes that an institution should also take steps to mitigate the idiosyncratic unforeseen event risk embodied in indirect exposures. CEBS's view is that there are good reasons to require institutions to address this risk. However, **quantitative rules may not be a practical option for addressing indirect risk; it is more appropriate to introduce a requirement for appropriate stress tests together with adequate information requirements rather than designing a system of limits.**
259. If an institution is exposed to a counterparty both directly and indirectly (because it provides the collateral for another exposure) the 25% limit must be applied to the sum of the loss coming from the direct exposure to this counterparty (that is the net exposure value) and the estimated losses derived from the fact that this counterparty is securing a transaction that in the event of the default of this counterparty would become unsecured, at least until it is replaced by another one<sup>43</sup>. The institution should recognise the change in its risk profile until the protection is replaced; redefine its exposures values, etc.
260. However, CEBS thinks that it is too complex to calculate the impact on an institution of the default of a particular protection instrument. Supervisors should establish a principle that requires institutions to take into account their indirect exposures when addressing the unforeseen event risk. That is, they should also try to evaluate the losses stemming from indirect sources.

## Chapter 8. Breach of limits

261. This section deals with the issue of the regulatory response when limits are breached and includes CEBS's proposals regarding supervisory reactions for the banking and the trading book.

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<sup>43</sup> Of course, indirect concentration can be a problem if exposures protected with the same instrument default at the same time and at that time the collateral value is less than expected. For this to happen the exposures and the collateral would be exposed to a systematic risk that materialised. Although this situation is potentially very dangerous it is not the type of problem we can prevent with the limits on individual counterparties. We need more sophisticated tools (that take into account correlations) to prevent such a risk.

## 8.1. Breaches in the Banking Book

262. CEBS has observed that there is a broad range of practices across Member States regarding the reaction of supervisory authorities to the breach of large exposures limits on the banking book. Therefore CEBS deems it necessary to obtain convergence on this aspect to avoid competitive distortion.
263. The first point where CEBS sees a possible convergence of procedures is the one related to the breach of limits when the excess is caused by specific and extraordinary circumstances such as an affiliation between previously unconnected counterparties or an affiliation between the institution itself and another. Only under these circumstances CEBS thinks the breach of limits is understandable and can be tolerated, provided the excess is deducted from own funds. In addition, there should be no possibility of increasing the value of these exposures and a maximum time frame should be set to bring the exposures into compliance with the limits.
264. Therefore CEBS's view is that breach of limits should not be accepted, except under very specific and justified circumstances such as the ones considered above. Other cases where some flexibility can be considered are those related to a decrease in own funds triggering non-compliance with the large exposures limits. When this happens, it is not adequate compulsorily to increase the deductions from own funds since this could aggravate substantially the recovery chances of the troubled institution.
265. However, due to the backstop nature of the regime, the immediate common response whenever a breach occurs should be an additional requirement for own funds. Applied in a rigorous way, this would lead to the requirement of an own funds increase equal to four times the excess over the limit (excess of the limit/25%). However, in practice, supervisory authorities require an immediate deduction of the excess from own funds, allowing the institution to restore compliance within an agreed time frame.
266. After considering all possible options for dealing with a breach of the limit, **CEBS believes that the most appropriate solution is to allow a temporary breach, only when specific and extraordinary circumstances occur, provided the excess is deducted from own funds, giving the institution an adjustment period to return to a compliant situation.** It should be made clear to the institution that during the adjustment period further increases in these exposures are not allowed.
267. CEBS sees the need to clarify in Directive 2006/48/EC the requirement to deduct from own funds the excess over the 25% limit, as well as the role of the existing provisions contained in Articles 106 and 136 regarding breaches.

## 8.2. Breaches in the Trading Book

268. **It is considered that, because of the nature of the trading book activities, the current regime for breaches in the trading book is appropriate.**
269. Therefore, when limits are exceeded due to an excess entirely arising from the trading book, competent authorities may allow the overexposure, provided that:

- the institution reports quarterly all cases where the limits laid down in Article 111(1) and (2) of Directive 2006/48/EC have been exceeded during the previous three months;
  - the institution meets an additional capital requirement on the excess calculated in accordance with Annex VI of Directive 2006/48/EC;
  - the exposure to the client or group of connected clients in question is limited to 500% of the institution's own funds where 10 days have lapsed since the excess occurred; and
  - the total of the excesses cannot surpass, in aggregate, 600% of the institution's own funds when they have persisted for more than 10 days.
270. When the breach of the trading book limits is not authorised by the competent authorities, or the conditions above are not met, then the banking book breach procedures are applicable.

## Chapter 9. Reporting

271. Reporting requirements for large exposures laid down in Article 110 of the CRD contain a few national discretions.
272. Based on the objective of the reduction of national discretions, **CEBS proposes to delete the national discretion under Article 110.1 (a) and to transform the national discretion under Article 110.1 (b) into a general rule, i.e. reporting of all large exposures at least four times a year.**
273. **Furthermore, CEBS is of the opinion, that exposures exempted from the LE limits should not be left outside the reporting requirement.** CEBS believes that it is important for supervisors to be properly informed of all large exposures of the institutions. Therefore CEBS proposes to delete paragraph 2 of Article 110.
274. According to paragraph 3 of Article 110, Member States may require credit institutions to analyse their exposures to collateral issuers for possible concentrations and where appropriate to take action or report any significant findings to their competent authority. With acknowledgement that the content of this paragraph was not covered in the CP16, CEBS would like to suggest the national discretion be transformed into a general rule with the addition of the requirement for credit institutions to analyse their exposures to protection providers in general, i.e. including guarantors.
275. CEBS has considered various possible options for reporting that could best meet the objectives laid down and is of the opinion that **reporting based on reports defined by the supervisors is the appropriate approach.** Reports defined by the supervisors would allow them to analyze the large exposures of the institutions on a horizontal basis and to make comparisons between different institutions. Furthermore, the definitions/risk metrics used in the reports of

different institutions would be identical<sup>44</sup>, and the internal processing of all data received by the supervisors would be facilitated.

276. CEBS believes further that the reporting burden for the cross-border institutions could be diminished by installing **harmonized reporting at the European level**. CEBS recognizes that harmonization can only be successful if an identical template with common definitions for the information requested, together with harmonized reporting frequency and remittance dates, can be agreed among the supervisors of the Member States. **CEBS believes that further L3 guidelines will be necessary in order to reach the desired outcome.**
277. CEBS has given some consideration to the elements which need to be reported within a regime for large exposures and proposes the following:
- All exposures to a client or group of connected clients equal to 10 % and over of the own funds/consolidated own funds of the reporting institution
    - despite the fact that the exposure after applying credit risk mitigation technique (CRM) would possibly be under 10 %;
    - including exposures partially or fully exempted from the limits <sup>45</sup>;
    - and
    - including the composition of the group of connected clients.
  - Exposures should be reported net of value adjustments;
  - Exposure value before and after applying CRM techniques should be reported, as well as the relevant CRM technique applied. (However it should be noted, that reporting exposure values before applying CRM for derivative instruments and securities financing transactions might prove to be too burdensome for the institutions to deliver).
278. In addition to the regular prudential reporting, the immediate reporting of breaches of the backstop limit would be necessary. Institutions should be obliged to notify their supervisor as soon as they become aware of a breach of the limit, defining the size of the exposure and the cause of the breach together with their plans to rectify the situation.
279. CEBS wants to point out that even though reporting would be based on gross values in terms of CRM, the calculation of the backstop limits would, naturally, be based on net values, where CRM and possible full or partial exemption has been taken into account.
280. CEBS has come to the conclusion that the reporting requirements should also include reporting the 20 largest exposures on a consolidated basis. That is because the 10% threshold in the definition of large exposures is considered to be high from the risk management point of view and especially when larger institutions are concerned, the reporting of large exposures consists of only few clients or groups of connected clients.
281. Extending the reporting to the 20 largest exposures will give the supervisors useful information on the risk profile of the institution. CEBS would like to point out however, that there are Member States where the information in question is

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<sup>44</sup> That would not be the case if the internal reports of institutions were used.

<sup>45</sup> E.g. intra-group exposures, interbank exposures, exposures from sovereigns.

available for the supervisors through other channels e.g. credit registers. In those cases the reporting of the 20 largest exposures should not be requested.

282. CEBS has also considered whether indirect exposures should be included in the framework of regular reporting. This information, although valuable, was considered to be too burdensome both for institutions to report and authorities to supervise. However when the substitution principle of the CRM is used by the institution, the reporting of the exposure of the client/group of connected clients should include this indirect exposure as well.
283. Finally, CEBS has contemplated whether breaches of the backstop limit should be included in the disclosure requirements of Pillar 3, and has decided not to suggest disclosure.



## Annex 1

### Effective risk-weight applied to exposures to OECD credit institutions or investment firms by maturity and country

	Less than 1 year	Between 1 year and 3 years	Over 3 years
Austria	0	20	20 (credit inst) / 100 (inv firm)
Belgium	20 (inv grade / not rated) / 100	20 (inv grade / not rated) / 100	20 (inv grade / not rated) / 100
Bulgaria	0	20	50 (bonds only)
Cyprus	0 / 100	20 (inv grade) / 100	50 (inv grade) / 100
Czech Republic	20 / 100	20 / 100	20 / 100
Denmark	0 / 20	0 / 20	0 / 20
Estonia	20 / 100	20 / 100	20 / 100
Finland	0	20	100
France	0 / 20	20	20 / 50 / 100
Germany	0	20	50 / 100
Greece	0 / 20	20 / 100	20 / 100
Hungary	0	20	50 / 100
Iceland	0	100	100
Ireland	0	20	50 / 100
Italy	0	20	50
Latvia	0 / 20	20 / 100	20 / 100
Liechtenstein	0	20	50 / 100
Lithuania	?	100	100
Luxembourg	0	20	50 / 100
Malta	0	20	50 / 100
Netherlands	0 / 20	20 / 50	50 / 100
Norway	20 / 100	20 / 100	20 / 100
Poland	0 (credit inst) / ? (inv firm)	20 (credit inst) / ? (inv firm)	50 / 100 (credit inst) / ? (inv fm)
Portugal	0	20	50 / 100
Romania	20 / 20	20 / 20	50 / 50 (debt instr. only)
Slovakia	20	20	20
Slovenia	0	20	50 / 100
Spain	50	100	100
Sweden	0 / 20	0 / 20	20 / 50 / 100
United Kingdom	0	100	100