7 December 2007

Second consultation paper on CEBS' technical advice to the European Commission

on the review of the Large Exposures rules

Executive Summary

1. This consultation paper (CP) sets out CEBS' preliminary views on the issues included in Part 2 of the European Commission's (the 'Commission') Second Call for Technical Advice (Nº 7) to CEBS on the review of the large exposures rules[1]. It also includes a summary of CEBS' key findings from Part 1 of its Advice to allow respondents to have a complete understanding of all aspects included in the review of the large exposures rules. Respondents are advised to read this CP together with CEBS' Part 1 Advice[2].

2. CEBS has developed the first part and is developing the second part of its Advice in a manner consistent with the Commission's better regulation agenda. CEBS is doing this by following, as far as time constraints allow, the draft impact assessment guidelines that have been developed by the 3L3 committees[3].

3. Chapter 1 of the present CP provides a summary of CEBS' main findings on the key concepts underpinning the regulation of large exposures as set out in its response to Part 1 of the Call for Advice.

4. In line with the Level 3 Impact Assessment draft guidelines, further information on the set of different policy options considered by CEBS in its Part 1 Advice is also included. In addition, CEBS has also undertaken a high level qualitative assessment of the potential impacts of the various high level policy options that have been considered and the impacts of each policy option compared to the current large exposures regime (please see Annex 1). Further to the information included in the Part 1 Advice, Annex 2 presents a summary of the results of the questionnaire on the cost of the current large exposures regime for the industry.

---

[1] Second Call for Advice from the Commission: http://www.c-ebs.org/documents/large exposures_CfA2.pdf

[2] First part of CEBS' technical advice to the European Commission on the review of the Large Exposures rules: http://www.c-ebs.org/Advice/documents/LE_Part1adviceonlargeexposures.pdf

[3] 'Impact Assessment Guidelines for EU Level 3 Committees' May 2007, http://www.c-ebs.org/Consultation_papers/documents/IA_GL.pdf

5. Chapter 2 sets out CEBS' initial views on the definition of what a large exposure is. CEBS considers it important to clarify the concept of 'connected clients', as it is a core definition in the large exposure rules, with the aim of ensuring a harmonized implementation of the rule among Member States. Recent events have made this need even more important. A high level interpretation of both 'control' and 'interconnectedness' in the context of the LE regime is suggested. Also included are a number of examples of what could be understood as an indication of control as well as of possible financial dependency, and cases when an entity may be included in more than one group of 'connected clients'.

6. CEBS proposes a clear distinction between 'connected clients' (ordinary customers / counterparties that are connected to each other and as a result should be regarded as a single risk) and 'connected parties' (natural persons who are involved with the management of the institution at a senior level or legal persons or partnerships which are closely related to the institution). CEBS believes that is difficult to introduce limits on total exposures to connected parties; good corporate governance and sound credit risk management should provide adequate assurance.

7. In Chapter 3 CEBS provides a full range of arguments to supports its views on the definition of exposure value. Although the issue of the 'calculation of exposure values' was already discussed in its Part 1 Advice, CEBS believes that it could be useful to revisit that discussion and clarify CEBS' thinking on this.

8. CEBS' view is that the proposed "amended limit based back stop regime" should be based on the most accurate exposure values available, and advanced models used internally by institutions can help to calculate exposure values accurately. Internal models approved by supervisors could normally be accepted as the basis for the calculation of exposure values. As a general rule, CEBS considers it appropriate to closely align the requirements for the calculation of exposure value under the large exposures framework with institutions' internal risk management practices and the regulatory measurement systems required under the CRD.

9. Exposure values for on-balance sheet items should be based on relevant accounting standards; this means, in particular, that exposures should be net of accounting provisions and value adjustments. However, there are also arguments to support the view that exposures should be gross of accounting provisions and value adjustments, and views from respondents are specifically sought.

10. CEBS' orientation is to consider a differentiated approach to the calculation of exposure values for off-balance sheet items (other than derivative instruments and securities financing transactions (SFTs)).

11. For institutions that have not obtained permission to use their own estimates of conversion factors for off-balance sheet items, CEBS' initial thinking to ensure a prudent approach is to require such institutions to use the 'worst case scenario' number – that is a 100% conversion factor except for the low risk items included in Annex II of 2006/48/EC, for which a 0% conversion factor will generally be applied. However, as part of its ongoing work, CEBS is considering whether the 100% conversion factor might prove to be too conservative for certain

transactions, while the 0% conversion factor might prove to be too lenient for others. CEBS is to investigate further which specific transactions can be exempted from these flat conversion factors.

12. For institutions that have obtained permission to use their own estimates of conversion factors (advanced IRB institutions), CEBS proposes a small number of principles on the basis of which those institutions may be permitted to use such estimates for large exposures purposes. However, where a 100% conversion factor is applied to an off-balance sheet item, for large exposures purposes, advanced IRB institutions would not be allowed to use their internal estimations.

13. For collective investment undertakings, structured transactions and other arrangements where there is an exposure to underlying assets, CEBS proposes a set of high level principles to ensure that exposures values are calculated in a harmonized way. CEBS believes that this approach would significantly enhance supervisory convergence in the EU without prescribing detailed rules or imposing undue burdens on the banking sector.

14. In Chapter 4, CEBS provides its initial views on the treatment of CRM techniques. CEBS believes that in general the market failure analysis justifies a different treatment in some specific cases and the need for a more conservative approach to large exposure regime than in the solvency regime. CEBS' initial thinking is that the need for certain and timely recovery processes is stronger under a large exposures scenario.

15. Moreover, in the absence of mitigation techniques, for institutions allowed to use IRB approach, LGD will always be 100%, that is, institutions should not be allowed to take into account the amount that will eventually be recovered in the bankruptcy process given the great uncertainty regarding the amount and the need for a timely recovery of the amount due.

16. CEBS evaluates and discusses three alternative approaches, taking into account the potential costs and benefits of each alternative compared with the current regime. Considering prudential concerns and the cost / benefit arguments, the most balanced solution would be to accept the same treatment in the large exposures regime as in the solvency regime but only for those CRM instruments considered liquid enough (where their recovery could be considered as certain and timely). In this case, if an element is eligible under the large exposures framework, its minimum requirements and its effects would be the same as under the solvency rules. However, if an element is not eligible it would not be accepted whatever the institution's approach. CEBS has developed its preferred alternative into concrete proposals to change the current large exposures regime, if that is needed.

17. CEBS' initial thinking is to keep the current rules on netting as well as on financial collateral when institutions use the comprehensive method. Furthermore CEBS recommends following the solvency rules, when institutions use the simple method, instead of applying the conservative haircuts of the current LE rules. As regards physical collateral CEBS believes that, in general, they should not be eligible for large exposures purposes. Nevertheless, it proposes to accept real estate collateral and seek specific views from interested

parties. For real state collateral, it is proposing to follow the simple current large exposures rules, regardless of an institution's approach, instead of using the more complex solvency rules. For unfunded credit protection the same treatment could be accepted for large exposures as for the minimum capital rules.

18. CEBS believes that the development of supervisory guidance to ensure that institutions take into account indirect exposures when addressing 'unforeseen event risk', instead of quantitative rules, is the most appropriate way to deal with this issue. Institutions should be required to evaluate the losses arising from indirect sources as well. It is considered more appropriate to require suitable stress tests rather than design a system of limits.

19. Chapter 5 considers the treatment of trading book exposures. The market failure analysis indicates that unforeseen event risk can affect exposures in both the trading and the banking book. However, the current differences in the treatment of both types of exposures under the large exposures regime could be explained by the different nature of the business included in the two 'books'.

20. CEBS believes that the differentiated treatment of exposures in the trading and banking books could give rise to regulatory arbitrage opportunities due to the fact that two are becoming increasingly blurred. However, CEBS' preliminary view is that the problem of regulatory arbitrage also applies to the capital requirement regime, which lays the basis for the definition of the trading book that is relevant also for the large exposures regime. It is therefore the task of supervisors to determine if the positions in the trading book are really held with a trading intent in line with an institution's trading strategy.

21. In Chapter 6, CEBS considers different options for the treatment of intra-group exposures under the large exposures framework. Considering the market failure analysis, CEBS' preliminary view is that the basic market failure analysis does not apply (on a solo basis) to entities that are part of sub-consolidations in which capital is fungible (i.e. it must be possible for capital held in one legal entity to support losses arising in another) and common risk evaluation, measurement and control procedures are in place, or between branches and their parents.

22. However, the basic market failure analysis may apply to cross-border intra-group exposures, in particular outside the EEA, because they are not subject to common risk controls and capital is not fungible. There could also be further negative externalities that arise as consequences of the insolvency of a group, because large intra-group exposures could inhibit the timely and efficient resolution of banking groups and harm depositor's interests. This means that there may be a case, depending on the cost-benefit analysis, for regulatory intervention on some specific types of intra-group exposures.

23. CEBS analyses the potential costs of imposing intra-group exposure limits (an undue restriction of group liquidity management, competitive disadvantages between Member States of the EU, competitive disadvantages against third party jurisdictions and the frustration of progress towards a truly single European financial services market) as well as the benefits (reduce unforeseen event risk, European banking groups prevented from failing due to an idiosyncratic event affecting one of their subsidiaries that does not form a part of their core group, and fewer barriers to the efficient resolution of a failed cross-border banking

group). It is recognised that these costs and benefits may be very different across Member States.

24. As regards the scope of application and on the basis of the market failure and high-level cost / benefit analysis, it is CEBS' initial view that large exposures regulation should not apply to subsidiaries that meet the criteria set out in Article 69.1 of the CRD (2006/48/EC), holding companies that meet the criteria of Article 69.2 and parent companies that meet the criteria set out in Article 69.3 of 2006/48/EC (i.e. situated in the same Member State, no impediment to transfer of capital and there are consolidation-level controls). CEBS considers it inappropriate to propose that subsidiaries in host Member States be mandatorily exempted from large exposures regulation, because groups may not always support failing subsidiaries (which may be systemic from a host state's perspective) and there may be impediments to the movement of capital and liquidity across national borders in stressed situations. Nevertheless, input is sought from the industry on the possible way forward regarding the treatment of subsidiaries of an institution based elsewhere in the EEA.

25. For intra-group exposures of creditor entities *located in the same Member State* as debtor entities, CEBS' orientation is that it should be exempted from the limits, provided the conditions in Article 80.7 or 80.8 of CRD are met. However, intra-group exposures to group entities *in a different Member State* may be subject to a different degree of market / regulatory failure than similar domestic intra-group exposures. Because there are strong arguments both for and against imposing limits on intra-group exposures within the EEA, a range of option is proposed: i) Subject all cross-border intra-group exposures in the EEA to large exposures limits without exemptions; ii) the same but with a "safety valve" that gives authorities the discretion to relax or remove intra-group limits in exceptional circumstances; iii) leave it open to national discretion and iv) do not apply limits to intra-group exposures within the EEA. Finally, for intra-group exposures to institutions *in non-EEA jurisdictions*, CEBS considers that the basic market failure analysis applies, particularly where the jurisdiction is non-CRD equivalent and / or where there is strong likelihood that capital would be ring-fenced in a stressed scenario. A range of options is also proposed: i) Impose limits on all intra-group exposures to entities in non-EEA jurisdictions; ii) the same but with a "safety valve" that gives authorities the discretion to relax or remove intra-group limits in exceptional circumstances and iii) leave it open to national discretion.

26. Finally, the chapter discusses the extent to which intragroup exposures should be aggregated and how the intragroup limits should be calibrated. CEBS will use a set of high level principles to help in form a conclusion. Industry's views on the high level principles would be welcome.

27. CEBS believes that the application of a large exposures regime to *investment managers* may be an example of regulatory failure since the regime imposes a burden on investment firms (including a reporting burden) without delivering benefits to consumers. It is not proposed to exempt other investment firms (including those often called "investment banks"). As regards other financial institutions that are not credit institutions, CEBS' initial view is that they should be exempted from large exposure limits on a solo level, although they are

subject to the limits at the consolidated level if they form part of a group subject to the large exposures regime.

28. Chapter 7 deals with the treatment of sovereigns and other public sector entities. CEBS believes that the basic market failure analysis does not apply to certain entities such as sovereigns, international organizations, multilateral development banks, regional governments and local authorities. It is believed that failure of these institutions fall outside the definition of plausible unforeseen event risk that the large exposures regime seeks to cover. However, unforeseen event risk could arise if the currency is not the same than the currency of the bank taking the exposure. Therefore, CEBS' orientation is to propose that exposures described in Art. 113(3), paragraphs (a)-(f) should be exempted from the large exposures limits, as well as some regional governments and local authorities. And this would require the deletion of the current national discretion to fully or partially exempt these exposures from the large exposures limits.

29. In Chapter 8 CEBS discusses alternative proposals for the treatment of interbank exposures based on a differentiated impact analysis of applying the proposed backstop regime to all unsecured interbank exposures. CEBS' initial view is that a market failure could exist with respect to large interbank exposures as such exposures give rise to systemic risk and are associated with moral hazard problems.

30. In some Member States, the cost-benefit analysis suggests that the benefits of correcting this market failure outweigh the cost of any regulatory failure that intervention might introduce, although in other Member States this is not the case. Furthermore, the impact of introducing limits also varies depending on the size of the institution and the type of activity it engages in. CEBS would welcome industry's views on this analysis, the assumptions underlying it and the appropriate parameter estimates to use in calculating the benefits of the limits.

31. At this stage, CEBS has yet to conclude what the most appropriate treatment for interbank large exposures is but aims to do so in presenting its final response to the Commission after taking industry comments into account. CEBS will be considering whether a differentiated approach should be taken to institutions of different sizes and natures. CEBS will consider a full range of policy options, including a reporting-only regime; hard-limits based regimes featuring various degrees of national discretion, and other potential regulatory solutions.

32. Chapter 9 deals with the issue of the regulatory response when limits are breached. CEBS considers the current regime appropriate for breaches in the trading book. However, for the banking book, there are a broad range of practices across Member States regarding the supervisory reaction to a breach of limits. CEBS believes some degree of convergence would be necessary to avoid competitive distortion.

33. CEBS has discussed three possible supervisory reactions to a breach of the limits: i) not allow the breach at all; ii) agreement with supervisors of an adjustment period in order to facilitate the return to a compliant situation, that should be compensated by a requirement of an immediate deduction from own funds of the excess exposure and iii) the breach of the limits can be maintained over a long period of time provided there is a deduction from own funds of the

excess exposure. Finally, the question of when a deduction of the excess from own funds is allowed is (i) should the entire exposure be covered by own funds; or (ii) should only that portion of the exposure that is in excess of the large exposures limit be deducted from own funds. CEBS also agrees that, apart from the special treatment in the trading book, there are other circumstances when a breach of limits can be understandable.

34. In Chapter 10, CEBS gives some consideration to the purposes of reporting on large exposures and reaches the preliminary conclusion that the most important objective is allowing supervisors to be informed in time when concentration risk occurs as well as allowing them to make comparisons between institutions regarding their single name concentration risks. CEBS discusses several possible options: Pillar 3 reporting and disclosure; reporting to supervisory authorities based on financial institutions' internal reports; and reporting to supervisory authorities based on reports defined by the supervisors. CEBS' orientation is to consider the last option to be the most suitable to fulfil the reporting objectives.

35. CEBS recognizes that the review of the large exposures regime is a good opportunity to harmonize the reporting of large exposures within the EU. CEBS' initial thinking on the contents of possible harmonized reporting is included.

36. Chapter 11 sets out CEBS' views on possible rewards for good credit management. It is CEBS' preliminary opinion that the recognition, and reward for, good credit management that is included in the solvency regime is also embedded in the suggested large exposures rules. The incentive for better credit management comes through the calculation of the net exposure value to which the limits are applied. It is also agreed that the market failure analysis does not justify exempting from the large exposures limits to the more sophisticated institutions.

37. CEBS submits its initial views for a public consultation which will run **until 22 February 2008**. Comments should be sent to the following email address: cp16@c-ebs.org. Comments received will be published on CEBS' website unless respondents request otherwise.

38. CEBS' standard consultation period has been slightly shortened due to the tight deadline set up by the Commission. CEBS expects to deliver its final advice by end-March 2008. Due to the short period of time that CEBS has available for developing its Advice after the end of the consultation period, early responses to the CP will be greatly appreciated and late responses will not be considered.

39. When developing its views on Part 1 of the Advice, CEBS has benefited from industry's input gathered from the public consultation on the CP14[4]. **In addition, a public hearing will be organized on the 15 January 2008 at CEBS' premises in London from 9.00 a.m. to 4.00 p.m. to allow interested parties to share their views with CEBS.**

40. CEBS would particularly welcome market participants' views on a number of issues and questions. The proposed questions have been divided into high level or policy questions and more technical questions. Although answers to all

[4]Responses to CP14 are published on CEBS' website: http://www.c-ebs.org/Consultation_papers/CP14_responses.htm

questions would be welcome, CEBS would seek respondents' views on all high level questions and would appreciate receiving further input on the more technical questions if relevant for the respondent. Respondents are also asked to provide feedback on the costs and benefits arising from the CEBS proposals, or their own proposals whenever relevant.

High Level questions:

Q2. Do you agree with the proposal and suggested interpretation of 'control' and of 'interconnectedness'? Do you find the guidance/examples provided in both cases useful? Please explain your views, provide examples. And where relevant provide feedback on the costs and benefits.

Q5. Do you think that low risk items should receive a 0% conversion factor? Do you believe that there is room to apply conversion factors between 0% and 100 % in a large exposures regime? Which items could in your opinion receive a conversion factor different of 100%, and for which reasons? Please explain your views and provide feedback on the costs and benefits of such an approach.

Q9. Do you agree that for large exposures purposes there can be cases where it is justified to treat mitigation techniques in a different way from the treatment under the minimum capital requirements framework? Please explain your view and provide examples. And where relevant, please provide feed back on the costs and benefits.

Q15. Do you consider that two different sets of large exposures rules for banking and trading book are necessary in order to reflect the different risk in the respective businesses? What could be the costs/benefits of this? Please explain your views and provide as appropriate feedback on the cost and benefits of this.

Q21. What are your views on the proposals/options for the scope of application of the large exposures regime?

Q22. Which treatment do you believe is the most appropriate for intra-group exposures i) to entities within the same Member State; ii) to group entities in different Member States and iii) to group entities in non-EEA jurisdictions ? Please explain your response.

Q26. What are your views on the proposal to remove the national discretion and to automatically exempting exposures to sovereigns and other international organisations (within Art 113.3 (a – f)), as well as some regional governments and local authorities? Please explain your views.

Q31. Given the market failure and costs/benefit analysis set out, what treatment would you consider appropriate for interbank exposures?

Q34. Respondents' views on the approaches to non trading book breaches of the limits would be welcomed. Please explain your views and provide examples and feedback on relevant costs and benefits.

Q37. What is your opinion on CEBS' initial thinking regarding the elements to be reported under the large exposures regime?

Q38. Do you agree with CEBS' views on the recognition of good credit management? Please explain your views.

More technical questions:

Q1. CEBS would welcome respondent's views on the high level impact assessment of the policy options (Please see Annex 1)

Q3. In your view, how should exposure values for on-balance sheet items be calculated, gross or net of accounting provisions and value adjustments? Please provide examples to illustrate your response and feedback on relevant costs and benefits.

Q4. In your opinion, what could be the costs/benefits of applying a 100% conversion factor to the generality of off-balance sheet items?

Q6. In your opinion, how can a large exposure regime address the risk that credit institutions may not be able to exercise their legal right to cancel an undrawn credit facility?

Q7. CEBS would welcome comments on the proposed set of principles. Are they appropriate for allowing Advanced IRB institutions to use their own exposure calculations? Please provide feedback on the costs and benefits that you consider would arise from adopting such an approach.

Q8. In the context of schemes with underlying assets, do you agree that for large exposures purposes it is necessary to determine whether the inherent credit risk stems from the scheme, the underlying assets or both? Do you agree that the proposed principles are appropriate to identify the relevant risk in a large exposures back stop regime? Are there other relevant criteria that you wish CEBS to consider? Please explain your views and where relevant please provide feedback on the costs and benefits.

Q10. Do you agree that the three alternatives set out for the recognition of CRM techniques are the relevant ones? Do you think there are other alternatives CEBS should consider? Please explain your views and provide examples. And where relevant, please provide feed back on the costs and benefits

Q11. Are there costs/benefits that have not been identified? Are the costs/benefits identified correctly assessed? In particular could you provide CEBS with more information on the impact of each of the alternatives on the institutions' and collateral market's behaviour?

Q12. Do you support CEBS' proposal that institutions that use the simple method should follow the minimum capital rules (substitution approach) instead of applying the haircuts included in the current large exposure

rules? Please explain your views and where relevant provide feedback on the costs and benefits.

Q13. Do you agree that physical collateral should not in general be eligible for large exposures purposes? Do you support CEBS' views that residential and commercial real estate should be eligible and that the current large exposures rules should be applied instead of the minimum capital rules? Please explain your views and provide examples. And where relevant, please provide feedback on the costs and benefits.

Q14. Do you agree that the development of a set of principles or guidance to require institutions to take indirect exposures into account when addressing 'unforeseen event risk' is the best way forward? Which principles do you think are relevant? Do you have suggestions for possible principles? Please explain your responses and provide feedback on the costs and benefits where relevant.

Q16. Since the boundary between trading book and banking book exposures is increasingly blurred, do the current large exposures rules create an incentive to book business in trading book (which would otherwise be disallowed in the banking book)? Please explain your views and provide feed back on relevant costs and benefits.

Q17. Instead of the current risk based capital charge for excess exposures in the trading book, would a simple approach that allows any excess in the trading book to be deducted from an institution's capital resources be more appropriate in the context of a limit based back stop regime? Please explain your views. Please provide examples and feedback on relevant costs and benefits.

Q18. Do credit related products such as credit derivatives and structured products in the trading book require special attention and a different treatment from other positions in the trading book? Please explain your views, provide examples.

Q19. Do you have any comments on the market failure analysis on intra-group exposures?

Q20. Could intra-group large exposures limits give rise to other costs and benefits? Please explain your response.

Q23. What are your views on the high level principles to define *intra-group limits*?

Q24. Do you agree with the proposal to invite the Commission to consider exempting investment managers from a future large exposures regime? Please explain your views and provide feedback on the relevant costs and benefits.

Q25. Do you agree with the proposal on the treatment of other financial institutions for large exposures purposes? Please explain your response.

Q27. Please provide feedback on the costs and benefits that you consider would arise from the proposal.

Q28. Is there room for further exemptions? Please explain your views and provide feedback on the costs and benefits that you consider would arise from the further exemptions that you propose.

Q29. Do you consider that large interbank exposures of all maturities are associated with the market failures identified?

Q30. What do you consider to be the implications of the caveats set out above for the conclusions of the cost/benefit analysis? Do you have any other comments on the cost/benefit analysis?

Q32. Would a 25% limit on all interbank exposures unduly affect institutions' ability to manage their liquidity? Should maturity of the exposure continue to play a role? CEBS would find any practical examples useful as aids to its thinking (CEBS would not disclose confidential information).

Q33. If you believe there is a market failure but a hard 25% limit would not be appropriate, what would you consider an appropriate treatment for interbank exposures?

Q35. What are your views on the 3 reporting options? Please explain and provide feedback on the costs/benefits of CEBS' initial views.

Q36. Do you support CEBS' thinking on the purpose and the benefits of regular reporting using predefined reporting templates?

Background

41. The large exposures limits have constituted an integral part of the international prudential framework since 1991 when the Basel Committee published a paper on good practices regarding measuring and controlling large exposures[5]. In 1997, these recommendations were included in the Basel Core Principles, and have been retained with slight amendments in the recent review of the Basel Core Principles that took place in 2006. Five years before the first Basel paper the limits were included in the European prudential framework through the 87/62/EEC Recommendation issued by the Commission. But even before that, a large number of Member States already had large exposures limits as part of their national prudential frameworks.

42. Recently the international prudential framework has been substantially reviewed by the new Basel Accord, which in Europe has been adopted through Directives 2006/48/EC and 2006/49/EC. Given the far reaching character of this change it was deemed necessary to check to what extent other elements of the prudential framework outside the Basel Accord are still justified, and where they are, whether they need some adjustment in order to exist in harmony with the revised rules on capital adequacy.

[5] Basel Committee: MEASURING AND CONTROLLING LARGE CREDIT EXPOSURES (January 1991).

43. 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'). 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.

44. 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).

45. 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[6] and a Report on Industry Practices[7].

46. In January this year the Commission issued a second Call for Advice to CEBS[8]. This requested CEBS' advice on substantive aspects of the large exposures framework. This advice was called for in two parts:

    i) Part 1 of the Advice was requested by end September 2007 - on the objectives and purposes of a large exposures regime; the purpose, 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.

    ii) Part 2 of the Advice was requested by end February 2008 – on 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, and 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 is also to be considered.

47. On 15 June 2007 CEBS issued a Consultation Paper on the first part of the Commission's second Call for Advice ("CP14")[9] and on the 6 November 2007 CEBS published Part 1 of its Technical Advice to the Commission.[10]

---

[6] Final Report – Supervisory Stock Take on Large Exposures, 2 April 2006, http://www.c-ebs.org/Advice/LE_report.pdf

[7] Call for Advice from the European Commission on large exposures – Report on industry practices, 31 August 2006, http://www.c-ebs.org/Advice/LE_industryreport.pdf

[8] Call for Advice (No. 7) to CEBS on the review of the Large Exposures rules, 4 January 2007, http://www.c-ebs.org/documents/LE_CfA2.pdf

48. Due to very tight timescales the current CP sets out CEBS' initial views on the issues included in Part 2 of the Commission's Call for Advice and provides an early opportunity for interested parties to provide their views on key aspects of the review of the large exposures rules. The CP also includes a summary of CEBS' key findings from Part 1 of its Advice to allow respondents to have a complete understanding of all the aspects included in this review. Respondents are advised to read the present CP together with CEBS' Part 1 advice.

Methodology

49. CEBS developed the first part and is developing the second part of its advice in a manner consistent with the Commission's better regulation agenda. CEBS is doing this by following, as far as time constraints allow, the draft impact assessment guidelines that have been developed by the 3L3 committees[11]. 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 committees and their existing working practices.

50. Central to CEBS' analysis is the use of market failure/regulatory failure analysis as a means of identifying problems that a large exposures regime could seek to address. The current CP gives some degree of consideration to a high level market failure/regulatory failure analysis for the issues under analysis. In addition, Annex 1 outlines CEBS' high level impact assessment of the policy options set out in Chapter 2 of the first part of its technical advice to the Commission.

51. Cost/benefit analysis (CBA) also forms a key part of the impact assessment process. Annex 2 provides an overview of responses to the CEBS' questionnaire on the cost of the current regime. CEBS wishes to thank all institutions that completed the questionnaire. In discussing policy options within this paper, CEBS also includes materials on cost benefit considerations and would welcome feedback from respondents on the costs and benefits. And, if respondents propose options in addition to those suggested by CEBS, then feedback on the costs and benefits associated with these options would also be welcome. As a result, the CBA element of CEBS considerations should be viewed as "work in progress".

52. Effective stakeholder consultation is a central part of the 3L3 impact assessment methodology. Market participants' views have been gathered at various stages of our process (e.g. survey of industry practices, public consultation on CP14, public hearing on CP14, present public consultation and forthcoming public hearing). CEBS wishes to thank the many institutions and their representatives for their valuable contribution to the debate.

---

[9] CEBS Consultation Paper (CP14) On the First Part of its advice to the European Commission on large exposures: http://www.c-ebs.org/Consultation_papers/documents/CP14_LE_150620072.pdf

[10] First part of CEBS' technical advice to the European Commission on the review of the Large Exposures rules: http://www.c-ebs.org/Advice/documents/LE_Part1adviceonlargeexposures.pdf

[11] 'Impact Assessment Guidelines for EU Level 3 Committees' May 2007, http://www.c-ebs.org/Consultation_papers/documents/IA_GL.pdf

Table of contents

Chapter 1. Summary of CEBS' key findings in Part 1 of its Advice

53. CEBS believes that the first and second parts of its Advice are closely interlinked and that all aspects of the review of the large exposures regime should be considered together. As many respondents to CP 14 have stressed it is necessary to look into some of the detailed aspects of Part 2 in order to understand the full scope of Part 1, and it is not possible to consider some of the issues covered by Part 2 without revisiting some of the issues in Part 1.

54. This chapter provides a summary of CEBS' proposals on the key concepts underpinning the regulation of large exposures set out in its response to Part 1 of the Call for Advice.

55. However, the issue of the "definition of exposure value in a large exposure regime" has been included in Chapter 3 given that CEBS believes that some aspects would benefit from further clarification and discussion.

Objectives and purposes of a large exposures regime

56. 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 which are to ensure continued financial stability, maintain confidence in financial institutions and protect consumers and in particular depositors.

57. 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' view is that there is therefore a remaining risk related to large exposures that could justify further regulatory intervention (e.g. some kind of limits to large exposures).

58. Moreover, CEBS does not believe the large exposure challenge is entirely or primarily 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.

59. From the 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 that any large exposures regime should meet:

    i) ensure that negative externalities arising from large single name exposures are contained to an acceptable level;

    ii) minimise moral hazard arising from the existence of safety nets as it affects the management of large exposures;

    iii) ensure that public authorities have sufficient regulatory tools to monitor, on a on-going basis, the extent to which the overarching principles of prudential supervision are being achieved; and

iv) if intervention is necessary, ensure that is effected using a tool that is appropriate and proportionate for achieving the stated objectives.

Policy options – different regulatory tools

60. The Level 3 Impact Assessment draft guidelines advise policymakers to consider a reasonable number of alternative policies in order to ensure that they are proposing the most appropriate policy. Furthermore, responses to CP14 suggested the need for CEBS to set out the various options, including a Pillar 2 treatment.

61. Therefore CEBS has considered the set of different policy options available:

i) No specific regime: 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: CEBS presents its views on the reasons why it believes that market failures associated with exposures to individual single counterparties cannot be sufficiently addressed under Pillar 2. There may be some reduction in direct costs if the regime is removed. 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 States and uncertainty amongst firms over their permitted maximum exposures may lead them to unduly restrict lending.

iii) Market discipline enforced by Pillar 3 disclosure: CEBS believes that market discipline applies very differently across institutions and that by itself it is not an effective or efficient way to meet the objectives of a large exposures regime. In addition CEBS considers that a Pillar 3 approach would not ensure that market discipline necessarily ensures that firms do not lend more than they should.

iv) Current regime: Although CEBS believes that a limits based regime is the most appropriate regulatory tool; CEBS has identified some shortcomings in the current regime.

v) Amended limit based backstop regime": CEBS considers that the most effective supervisory tool to address the relevant market failures would be a targeted limits based backstop regime. Although CEBS believes significant improvements can be made to the current regime, an EU-wide limit-based backstop regime has the following advantages:

- 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.

62. This analysis does not mean that one regulatory tool rejected as a solution in isolation cannot play a role as a complement to other tools (e.g. disclosure).

High Level Impact Assessment of the policy options identified by CEBS

63. CEBS has undertaken a high level qualitative assessment of the potential impacts of the various high level policy options that have been considered as part of this review. The high level assessment is set out at Annex 1 and considers the impacts for each policy option against the current large exposures regime.

64. The impacts identified are those that would be incremental to the current regime (i.e. the current regime is taken as the baseline against which all of the other options are assessed). For example, in describing the effects of option 1 (removing the existing regime), we set out the 'marginal' - or incremental - effects that may occur when eliminating the formal regulatory requirements of the current regime.

65. The impacts are described in high level qualitative terms and have not been quantified. The high level assessment is not intended to lead to definitive conclusions about the most appropriate policy options.

Q1. CEBS would welcome respondent's views on the high level impact assessment of the policy options (Please see Annex 1).

Other jurisdictions

66. In the first Part of its Advice CEBS provided an overview of the approach to large exposures in a number of non-EU jurisdictions. 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 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.

The large exposures limits

67. On the basis of the analysis it has conducted, 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' opinion is that unforeseen event risks are by their very nature not related to the *a priori* quality of the counterparty (that is, 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).

68. CEBS 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' view that it would be undesirable to increase the limit for high credit quality counterparties.

69. It might be considered that the 25% limit operates as a long backstop 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 way arbitrary this threshold would reflect the supervisor's approximate risk tolerance and in this regard it is analogous to the 8% capital ratio.

70. CEBS believes that the 800% aggregate limit has merits in providing a harmonised minimum standard to ensure granularity of the credit portfolio[12]. It is also perceived as a mechanism for limiting the extent to which losses not covered under Pillar 1 capital requirements are inherent in the portfolio. 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, CEBS stresses that compliance with this limit should not replace in any way the requirement to manage concentration risk under Pillar 2.

Chapter 2. Definition of Large Exposures (connected clients)

71. CEBS proposes to keep the current definition of a large exposure as it is today in article 109 of Directive 2006/48/CE: "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".

72. CEBS considers that, as for the 25% limit, the 10% threshold is in some way arbitrary but it reflects the supervisors' approximate need to be informed of large exposures. However, there are merits in clarifying the definition of "group

[12] CEBS Part 1 advice puts forward the proposal, even though the 800% aggregate limit is not fully justified either by the market failure analysis which is related to the risks arising from large exposures to individual counterparties, nor by the objectives of the large exposures regime as laid down in Part 1 of CEBS advice.

of connected clients" because it is at the heart of the definition of a large exposure.

73. In its Call for Advice the Commission asks CEBS to consider certain definitions: "Interpretation of definitions" that *"there may be scope for greater clarity and consistency in terms of defining what constitutes a credit exposure; who can be considered a counterparty and when counterparties can be said to be connected, if rules are to be meaningful. Industry has expressed concern about various definitions – connected parties in particular – and the difficulties they face in establishing the existence of an economic relationship between clients."*

74. Firstly, CEBS finds it important to make a clear distinction between the terms 'connected clients' and 'connected party/parties'.

75. In general terms, CEBS considers that a "connected party" is one which is connected to the institution itself. CEBS proposes that a <u>connected party</u>

i) is 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 offers 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 of the normal requirements both to 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 a potential that subjective considerations may influence the assessment. And so CEBS suggests that in such situations, it may be appropriate for institutions to introduce an extended credit risk assessment process as a way of addressing the potential risk.

ii) may also be 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.

76. In general terms, CEBS considers that "connected clients" are connected to each other in some way and as a result they should be regarded as a single risk. Connected clients might for example be ordinary customers/counterparties that have no connection other than their business relationship with the institution applying the large exposures rules. However, some seemingly independent counterparties may be connected to each other, for example through their control or financial dependency and as a result constitutes a single risk for the institution.

77. While the definition of connected parties as well as the issue of the possible introduction of limits to the total exposures to these parties might be an issue belonging to the large exposures regime, CEBS orientation is that this is mainly an issue of a 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.

Therefore, CEBS has assumed that the Commission's Call for Advice refers to the need for further clarification of the definition of the group of connected clients.

78. The current large exposures regime applies to exposures to a 'client or group of connected clients'. This is defined in Article 4 (45) of 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".*

Significance and aim of rule

79. CEBS' orientation is that the objective of the rule on connected clients is mainly to identify idiosyncratic credit risk with a very high degree of correlation. It is not intended to cover risks that are similar because the clients operate in the same industry or in the same geographical area as such matters are considered within an institutions Pillar 2 assessment. The correlation stems from either a situation of control or some form of dependency. To have information about connected clients is an integral part of reducing the impact of unforeseen events.

80. The capital requirements imposed on institutions through the CRD are also intended to cover general systematic risk. The large exposures regime is not aimed at covering general systematic risk but unforeseen events that hit a group of connected clients specifically. In the case of connected clients – because of the connection – they are in effect a single risk because their continued existence is linked one to the other. The following are examples of situations that may apply to groups of connected clients.

81. When a group of connected clients is linked together because one controls the other, there is a risk that the management could initiate a transfer of funds from one entity to the other in order to subsidize one of the clients at the expense of the other. In this way, one client's economic problems may eventually cause liquidity problems for the other client as well. The same applies to a case where an agent for a specific product and the agent's only vendor experience a sudden decline in the market for this product. Their joint dependency on the product requires that they are viewed as a group, and the sudden decline in the market could for instance be caused by the introduction of a better substitute into the market.

82. Some institutions report that the connected clients rule has a considerable impact on small and medium sized banks. Frequently, they find that this requirement prevents them from expanding exposures to their largest customers. For large banks, the connected clients rule governs their allocation of customers into the retail market portfolio. Some large banks have, in addition, chosen to apply the large exposure rules voluntarily for their internal management of concentration risk. This is based on the assumption that this regime is well founded and offers protection against unwanted concentration risk.

The need for clarification of the concept of connected clients

83. The Commission points out in its Call for Advice that the industry has expressed a need for clarification of the definition of connected clients.

84. 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 financial dependant 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.

Suggested interpretation of control

- *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.*

85. According to Directive 2006/48/EC, article 4 (9), 'control' means the relationship between a parent undertaking and a subsidiary as defined in Article 1 of Directive 83/349/EEC, or a similar relationship between any natural or legal person and an undertaking. However, this definition is specifically aimed at describing the conditions for requiring a consolidated annual report and the concept of connected clients reaches further.

86. CEBS proposes that 'control' includes the power to govern the financial and operating policies or crucial transactions of an entity[13] so as to obtain benefits from its activities. 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.

87. Control may also exist when the client owns half or less of the voting power of an entity. This can be achieved through a contract entered into with the client or to a provision in its memorandum or articles of association[14], or by virtue of an agreement with other investors. This agreement can be passive. This might be

[13] In this context, a client which is a natural or legal person (- undertaking).
[14] Where the law governing that undertaking permits it to be subject to such contracts or provisions.

the case if the attendance at the general assembly (or equivalent body) is regularly so low that it is predictable that the client will control the general assembly's decisions even with a share of voting rights well below half.

88. 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
- power to co-ordinate the management of an undertaking with that of other undertakings in pursuit of a common objective.

89. CEBS proposes that in situations, where, according to the knowledge of the institution, one client has control over another (e.g. a legal or a natural person has de facto control over a client), then it would be appropriate to carry out a review of the nature of the connection and consider the potential risks this represents. This is provided that the control situation is not just for a transitional period but seems reasonably stable. It is not relevant whether the client for the time being actually does exercise its potential control or not. Accordingly, statements where the client itself imposes limitations on its powers should not be recognised.

90. 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 the central government, regional government or local authority. 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. Accordingly, CEBS proposes that the subsidiaries of central governments, regional governments or local authorities do not normally need to be grouped together as connected clients.

Suggested interpretation of "interconnectedness"

- *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.*

91. 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. A dependency connection between clients may be mutual or only one way. CEBS proposes that dependencies arising purely from geographical proximity or identical sectors are not included as these are considered within the Pillar 2 assessment.

92. As an indication of relationship of dependency between clients, CEBS has listed some examples of possible financial dependency where institutions would need to present strong counter arguments for not grouping clients:

- 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 same;
- exposure to a producer and to vendors that this producer is depending on and which it would take time to substitute;
- exposures to undertakings that have an identical customer base, consisting of a very small number of undertakings and where the potential for finding new customers is limited;
- exposures to undertakings that are financially dependant; and
- exposures to undertakings where the same natural persons are involved in the management/board of both clients.

93. CEBS proposes in 6.5. that it may be appropriate to exempt certain investment manager firms from the large exposures regime. However, if it were to be determined that the large exposures regime continue to apply to them, then CEBS would suggest that asset funds managed by the same investment manager should not as a rule 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).

94. CEBS proposes that an institution should routinely assess whether an exposure to a client is connected to the risk involved with exposures to other clients. 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.

95. CEBS proposes that in principle, an entity should not be included in more than one group of connected clients. There are, however, constellations that require an entity to be included in more than one group of connected clients. This might occur, for example, in the following cases:

- partnerships or incorporated enterprises must be included in the groups of each of their general partners;
- a majority stake (voting rights) in a company might be held by someone on trust for a third person and in this case it could be appropriate to include this company in the group of the trustee/fiduciary as well as in the group on the trustor/transferor; and
- it might be necessary to include an entity in which two persons/companies hold 50:50 participations (joint undertaking, parity) in the groups of these two persons in case they exercise a common influence on the entity.

Q2. Do you agree with the proposal and suggested interpretations of 'control' and of 'interconnectedness' in the context of LE regime? Do you find the guidance/examples provided in both cases useful? Please explain your views, provide examples. And where relevant provide feedback on the costs and benefits.

Chapter 3. Definition of Exposures Value

96. An important issue in the review of the large exposures framework is the calculation of exposure values. In CEBS' 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 fairly wide diversity of approaches.

97. 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.

98. CEBS considers it necessary to modify the exposure calculation requirements under the large exposures framework in order to align them more closely with institutions' internal risk management practices and regulatory measurement systems required under the CRD.

99. CEBS has already stated that the large exposures challenge from a regulatory perspective is not entirely one of measurement in that no matter how accurately the exposure is measured, it is clearly imprudent for an institution to extend a very large part of its capital to a single counterparty. Nevertheless, there are cases (for example, 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' view is that the backstop regime proposed should be applied to the most accurate exposure value available.

100. 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[15]; (3) derivative instruments and securities financing transactions (SFTs); and (4) collective investment undertakings, structured transactions and other arrangements where there is an exposure to underlying assets.

101. It should be noted that it is not the purpose of this section to consider the question of the effect of credit risk mitigation on the calculation of exposure values (except in relation to category (3) where it is appropriate to consider the effects of collateral as an integral aspect of the exposure value calculation).

3.1. On-balance sheet items

102. The CRD does not expressly specify how to calculate exposure values in respect of these items for large exposures purposes. However, 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 provisions and value adjustments. Although at first sight this might be counterintuitive as for impaired loans it increases the large exposure limits and might create an undesirable incentive for institutions to provide a further opportunity to finance within the regulatory large exposures limit the 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[16], as provisions reduce the profits and so reduce own funds.

103. There is one exemption to this rule: for on-balance sheet items such as derivatives and other financial instruments, the exposure value is calculated according to the methods laid down in Annex III of the Banking Directive. Annex III provides for a variety of methods: the Mark to Market method, the Standardised Method and the Internal Models Method. It is up to the individual institution to decide which of these methods it wants to apply to calculate the exposure value (for more detail see point 3.3).

Q3. In your view, how do exposure values for on-balance sheet items should be calculated, gross or net of accounting provisions and value adjustments? Please provide examples to illustrate you response and feedback on relevant costs and benefits.

3.2. Off-balance sheet items (other than derivative instruments and securities financing transactions)

104. In determining an appropriate converged approach to the calculation of exposure values one objective is to arrive at exposure value calculations that are fit for the purpose that they are meant to serve. Consistent with this, the method of calculation of exposure values should minimise the additional burden placed on

[15] 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.
[16] Art. 106 1. sub 3 of Directive 2006/48/EC

institutions. In determining the correct exposure value, a distinction will be made between Standardised and Foundation IRB institutions on the one hand and Advanced IRB institutions on the other.

Standardised and Foundation IRB institutions

105. For institutions that have not obtained permission to use their own estimates of conversion factors (or institutions that have obtained permission but for which the supervisor did not accept the use of their own conversion factors for large exposures purposes), CEBS considers the possibility of not permitting the use in all cases of the same exposure calculations as are used for credit risk capital requirements purposes.

106. It is therefore considered advisable to take a prudent approach and require such institutions to use the 'worst case scenario' number – that is a 100% conversion factor except for the low risk items included in Annex II of 2006/48/EC, for which generally a 0% conversion factor will be applied. However, as part of its ongoing work, CEBS is considering if the 100% conversion factor might prove to be too conservative for certain transactions and if the 0% conversion factor might prove to be too lenient for others.

107. 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/CE. However, and subject to national discretion, it is possible 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[17]." and to apply a 50% conversion factor to "the medium/low-risk off-balance sheet items referred to in Annex II".

108. 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.

109. CEBS' initial view is that a 100% conversion factor would be appropriate for medium/low risk items. 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.

110. In particular, with respect to those items included under the medium/low category, one could argue that an institution entering into undrawn credit facilities with an original maturity of up to and including one year which may not be cancelled unconditionally at any time, is in a much better position to assess

[17] Article 113(3)(t) of Directive 2006/48/EC

the risks linked to the transaction as the time horizon over which the transaction will take place is short. Information asymmetries are thus reduced and consequently also the risk linked to such short-term transactions. With respect to documentary credits in which the underlying shipment acts as collateral it has to be noted that these transactions generally have a short maturity. These short maturities, as well as the at least partial protection resulting from the collateral, imply that a 100 % conversion factor would be too conservative. However, it can also be argued that problems may arise in exposures even thought they are of short maturity and that the large exposures regime is intended to provide a "back stop" against unforeseen event risk.

111. 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 do effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness may underestimate the risk involved in this kind of transaction. 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 reputational reasons (e.g. main sponsor of a structured finance transaction, political pressure to participate in a rescue operation).

Advanced IRB institutions

112. Many institutions that are permitted to use their own exposure calculations for regulatory capital requirements purposes appear to take a considered approach to the calculation of exposure values for the purposes of their internal limits. This suggests that there is an opportunity to move away from the situation where institutions are required to calculate three exposure values – one for capital requirements, one for internal limits, and one for the large exposures requirements.

113. CEBS considers that a fruitful approach to this question is to develop a small number of principles on the basis of which institutions are permitted to use for large exposures purposes their own exposure calculations which are also used for regulatory capital requirements purposes, in accordance with Annex VII, part 3, point 9 (e) of Directive 2006/48/EC. CEBS sets out for the purpose of consultation some suggested principles:

> 1) institutions that have obtained permission to use their own estimates of conversion factors to calculate their risk weighted exposure are permitted to use their own exposure value measurements for the purposes of the large exposures rules (but this does not include recognition of risk weighting based on counterparty creditworthiness);
>
> 2) such exposure values must be demonstrated to the competent authority to be suitable for use in the context of a framework designed to limit the losses of an institution in the event of the unforeseen default of a counterparty; and
>
> 3) such exposure values must be arrived at consistently with the approach that the institution uses for estimating exposure values in the context of

its internal approach to setting maximum limits for exposures to single counterparties (or groups of connected counterparties).

114. CEBS proposes that in the exceptional case that the competent authority responsible for the exercise of supervision is, given the above principles, not convinced of the appropriateness of the internally estimated conversion factors for large exposures purposes, the supervisor can require the institution concerned to apply the regulatory conversion factors that are set out in Article 78 or Annex VII, part 3 of Directive 2006/48/EC, as appropriate for large exposures purposes, according to the previous section. However, where a mandatory 100% conversion factor is applied for large exposures purposes, institutions are not allowed to use their internal estimates.

Q4. In your opinion what could be the costs/benefits of applying a 100% conversion factor to the generality of off-balance sheet items?

Q5. Do you think that low risk items should receive a 0% conversion factor? Do you believe that there is room to apply conversions factors between 0% and 100 % in a large exposures regime? Which items could in your opinion receive a conversion factor different of 100%, and for which reasons? Please explain your views and provide feedback on the costs and benefits of such an approach.

Q6. In your opinion how can a large exposure regime address the risk that credit institutions may not be able to exercise their legal right to cancel an undrawn credit facility?

Q7. CEBS would welcome comments on the proposed set of principles. Are they appropriate for allowing Advanced IRB institutions to use their own exposure calculations? Please provide feedback on the costs and benefits that you consider would arise from adopting such an approach.

3.3. Financial derivatives and securities financing transactions

115. 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.

116. Institutions can use for the large exposures regime the exposure values determined within the capital requirements framework. Institutions that have obtained permission to use the Internal Model Method set out in Annex III, Part 6 of the Banking Directive to calculate the exposure value for these transactions, also need to comply with the same principles as the Advanced IRB institutions.

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

117. 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 (tranched or untranched) with underlying assets.

118. 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.

119. 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) 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. 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.

120. However CEBS considers that further work is still necessary on to how to implement the above principles in order to achieve a common understanding within the industry and among supervisors that guarantees as much as possible a level playing field and at the same time ensures that the minimum prudential objectives are reached. The current proposal set out in Annex 3 provides an example of which factors should be taken into account in evaluating the economic substance of a transaction in order to decide whether the risk of incurring a loss from an exposure to a scheme relates to the possibility of default caused by the underlying assets or of the scheme itself, or both.

Q8. In the context of schemes with underlying assets do you agree that for large exposures purposes it is necessary to determine whether the inherent credit risk stems from the scheme, the underlying assets or both? Do you agree that the proposed principles are appropriate to identify the relevant risk in a large exposures backstop regime? Are there other relevant criteria that you wish CEBS to consider? Please explain your views and where relevant please provide feedback on the costs and benefits.

Chapter 4. Credit Risk Mitigation and Indirect exposures

121. In the report on industry practices that CEBS published in August last year it is stated that *¨some respondents flagged that there is a gap between the range of credit risk mitigation techniques developed by part of the industry and the credit risk mitigation techniques eligible for regulatory purposes laid down in the Capital Requirements Directive¨*. However it is not clear if the criticism only refers to the large exposures regime or applies to the CRM treatment laid down in the minimum capital requirements regime.

122. One of the major changes introduced in the new Directive is the further recognition of credit risk mitigation (CRM) in the calculation of the minimum capital requirements. Some of these changes have already been recognised in the CRD for large exposures purposes (see articles 112-114 of CRD). However, some differences still remain in the extent that the two set of rules recognise credit risk mitigation instruments and their effects.

123. This implies that an institution could at present need three different calculations of the credit risk mitigation effects: one for the minimum capital requirements, another for large exposures requirements and ¨potentially¨ a third for internal purposes.

124. CEBS has said in its Part 1 Advice that the purpose of the large exposures regime is to limit the so-called ¨unforeseen event risk¨, that is, to limit the losses for the exposed institution arising from the failure of a single counterparty or group of connected counterparties. In other words, 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 executing collateral/guarantees and through the bankruptcy process.

125. Given the fact that the purpose of the minimum capital rules is to limit the probability of default given some assumptions at the portfolio level, CEBS considers that a relevant question that must be addressed is whether the different purposes of the large exposures regime and the minimum capital regime justify a different treatment of credit risk mitigation techniques.

126. CEBS' orientation is that the estimation of the value of the mitigation technique should not be influenced directly by the fact that the direct exposure defaults, assuming that the direct counterparty and the protection provider are not connected counterparties. This is because an large exposures scenario implies the default of a direct counterparty through idiosyncratic causes.

127. As far as the large exposures rules recognise the protection as a reduction of the net exposure value, they seek to prevent an institution from entering into a net exposure representing more than 25% of capital. Therefore, there is a risk that losses in the case of default of the direct counterparty could be greater than 25% of capital if the amount recovered from the protection turns out to be lower than expected. This could seriously undermine the solvency of the institution.

128. For example, if a bank has a gross direct exposure that represents 50% in terms of capital collateralised with shares that imply a reduction in terms of net exposure of a half, then if the direct exposure fails and the value of the shares protecting this exposure is enough to recover 25% of capital from the failed direct exposure then the final losses recorded by the institution will be 25% in terms of capital. However if the value of the collateral turns to be lower than 25% then the losses recorded by the institution would be higher than 25% in terms of capital, seriously threatening the solvency of the institution.

129. As a result, CEBS' initial view is that under the large exposures scenario it is especially crucial that the recovery of these amounts is <u>certain</u> so to avoid

traumatic losses. Any mistake in the valuation of the collateral could have more dramatic implications than under the scenario assumed for minimum capital purposes.

130. The recovery should also be timely. There are liquidity arguments that can justify a different treatment of some types of protection. Under the large exposures scenario (for a bank that suffers a sudden loss of 25% of capital because of the default of a counterparty) it would be more urgent to realise the collateral than in other circumstances. That is because 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. It could also be that the accurate exposure value we need to look 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 for which a higher haircut could be justified under the large exposures rules than under the minimum capital rules.

131. CEBS believes that there are market failures that justify in specific cases different treatment between the regimes. In the absence of CRM 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 and unfunded protection) it could be justified in some cases to deviate from the minimum capital treatment due to the specific need for certain and timely recovery.

132. For example, if the gross exposure to a single counterparty represents more than the 25% in terms of capital, e.g. because it is fully collateralised, and this counterparty defaults, then the collateral will replace the direct exposure in the institution's balance sheet. In this case, no losses should be recorded assuming that the collateral value is enough to cover the direct exposure loss. However, if the collateral is financial assets not exempted from the large exposures regime, the collateral that has become a direct exposure could exceed the large exposures limits. In this case, the institution must realize the excess of these assets immediately to comply with the large exposures rules and to avoid being exposed to the unforeseen event risk associated with this counterparty. If the collateral is very illiquid it is likely that the recoverable amount could be well below that expected in other circumstances when there is not so urgent a need to sell it. That is not the case for the collateral admissible under the capital rules and therefore this would not be a reason for deviation with this type of collateral. Moreover, if the collateral is represented by physical assets, there is in principle no need to sell it given that in this case, the collateral would not be subject to regulatory limits. However, as far as the mismatch between the collateral maturity and the direct exposure maturity was significant, then the institution would face a liquidity problem. The institution could face a situation in which a very illiquid physical asset represents more than 25% of its capital, and it needs to sell this illiquid asset to fulfil its commitments. Again, in these circumstances it is likely that the recoverable amount will be lower than expected in other circumstances when it is not so urgent to sell it.

Q9. Do you agree that for large exposures purposes there can be cases where it is justified to treat mitigation techniques in a different way from the treatment under the minimum capital requirements framework? Please explain your view and provide examples. And where relevant, please provide feed back on the costs and benefits.

Alternative proposals

133. Taking into account the above considerations, CEBS' initial view is that there are prudential arguments that can justify a more conservative approach regarding the treatment of protection in the large exposures framework versus the minimum capital framework. CEBS' opinion is that the market failure analysis justifies some deviations from the capital rules.

134. 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. 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.

135. Proposal 1) To accept the same protection treatment in both the large exposures and the minimum capital frameworks (eligibility, minimum requirements and effects).

BENEFITS:

- New business opportunities may materialize if less conservative protection limits are set for large exposures.

- Regulation would interfere less in the collateral market. Therefore, collateral prices would be based to a greater extent on market forces. This would limit the possibility that regulation would impose undue constraints on market developments.

COSTS:

- Direct costs: reduced supervision and monitoring costs given that only one calculation is needed for both regimes to comply with the rules. The amended large exposures regime would be less conservative than the current large exposures regime. The probability of an institution suffering traumatic losses as a consequence of an unforeseen event risk would be greater than now and possibly unacceptable from a prudential perspective (understanding this to mean a higher probability for systemic crisis).

- Compliance costs: reduced compliance costs for financial institutions given that only one calculation is needed for both regimes to comply with the rules.

- Indirect costs (changes in quality and/or quantity): reduced opportunity costs for institutions given that they could enter in a broader range of operations than under the current regime.

136. Proposal 2) To accept the same treatment in the large exposures framework as in the minimum capital framework only for those CRM instruments considered liquid enough. In this case, if an element is eligible under the large exposures framework, its minimum requirements and its effects would be the same as under the capital rules. However, if an element is not eligible, it would not be accepted whatever the institution's approach.

BENEFITS:

- New business opportunities may materialize if less conservative protection limits regarding liquid assets are set for large exposures.

COSTS:

- Direct costs: reduced supervision and monitoring costs given that only one calculation is needed for both regimes to comply with the rules (slightly less than in the first option). The large exposures regime would be slightly less conservative than the current large exposures regime. Then the probability of an institution suffering traumatic losses as a consequence of an unforeseen event risk would be greater than now but more acceptable from a prudential perspective.

- Compliance costs: reduced compliance costs for financial institutions given that only one calculation is needed for both regimes to comply with the rules (slightly less than in the first option). Reduced implementation costs because this regime would imply few changes from the current regime.

- Indirect costs (changes in quality and/or quantity): it would imply a more invasive approach to the collateral market with a higher risk of unduly constraining financial innovation in this area.

137. Proposal 3) to accept the same eligibility list as in the CRD but adopt a more conservative calculation of the protection effects. For example, with a stricter interpretation in several places e.g. timely realisation, sufficiently reliable, undue correlation, and in particular in the calculation of the effect (haircuts, volatility adjustments, level of collateralization required…).

BENEFITS:

- The large exposures regime would be more much conservative than the current regime so providing more stability for the financial system.

COSTS:

- Direct costs: increased supervision and monitoring costs given that different calculations are needed for both regimes to comply with the rules.

- Compliance costs: increased compliance costs for financial institutions given that different calculations are needed for each regime to comply with the rules.

- Indirect costs: (Changes in quality and/or quantity): increased opportunity costs in terms of less business opportunities (Reduced efficiency of

competition?) There could be a need for more collateral therefore affecting the collateral market and perhaps causing a shortage of some forms of collateral. Regulation would interfere more in the collateral market: distortions of collateral prices. There exists the possibility that regulation imposes unduly constraints on market developments.

138. In view of the above considerations on the costs/benefits of the proposals, CEBS initial thinking is that the second alternative is the most balanced solution between the prudential concerns and the cost/benefit arguments.

Q10. Do you agree that the three alternatives set out for the recognition of CRM techniques are the relevant ones? Do you think there are other alternatives CEBS should consider? Please explain your views and provide examples. And where relevant, please provide feedback on the costs and benefits.

Q11. Are there costs/benefits that have not been identified? Are the costs/benefits identified correctly assessed? In particular could you provide CEBS with more information on the impact of each of the alternatives on the institutions' and collateral market's behaviour?

Concrete proposals on CRM techniques

139. In this part of the Advice, CEBS sets out for consultation its preferred alternative (for liquid assets the minimum capital requirements treatment should be used and less liquid assets should not be eligible whatever the institution's approach) so as to make a concrete recommendation in terms of changing the current large exposures regime, if that is needed.

140. 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, so this alternative would imply retaining this article as it is.

141. In the following paragraphs CEBS discusses its orientations on a range of CRM techniques, stressing where some deviations from the CRD rules are proposed.

Netting agreements

142. Regarding ¨on balance sheet netting¨ and ¨master netting agreements¨ CEBS agrees that the risks exposed in the previous section do not apply to them and 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' initial proposal is explicitly to accept the same treatment as in the capital rules.

Financial collateral

143. CEBS' preliminary 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. Therefore, the eligibility criteria depends on the method used by the institution (comprehensive or simple method) and on the use of the advanced IRB approach.

144. For the calculation of the effects of the mitigation, 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. However this would imply a change compared with the current large exposures rules for institutions that use the simple method. In following the minimum capital rules, we allow firms using this method to reduce their exposure, requiring these firms to treat secured exposures as exposures to the issuer of the collateral (substitution approach). This compares with the current regime that allows Member States either to fully or partially exempt collateral in the form of securities provided that certain requirements are fulfilled such as very conservative haircuts (an excess of 100% for debt collateral and 150% for shares) (article 113.3 (o)) or to treat the exposure as having been incurred to the third party rather than to the client if the same requirements are fulfilled (art. 117.1.b). CEBS' proposal is to remove the first possibility and keep the substitution approach, but not as a discretion.

145. As regards those institutions permitted to use their own estimates of LGD, CEBS would recommend 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.

Physical collateral

146. CEBS believes, for the reasons explained above, that physical collateral should not be eligible for large exposures purposes. However, given that the current large exposures regime already recognises some physical assets as collateral, CEBS has carefully considered whether the impact on institutions of removing this collateral from the large exposures eligibility list would be disproportionate in terms of the prudential objectives.

147. For real estate collateral, including leasing transactions under which the lessor retains full ownership of the property leased, CEBS' view is that it is unlikely that a large exposure could arise from these transactions, so there is not much gain from a prudential perspective in not accepting these elements as eligible protection. Therefore, CEBS' initial thinking is that these elements could be eligible under the large exposures framework.

148. CEBS has analysed whether it would be acceptable to use the same treatment for these elements as for minimum capital purposes. Under the CRD, the recognition of the mitigated effect of real estate collateral does not directly reduce the exposure but is implicit in the reduced risk weight or in the reduced LGD. The calculation of the effects is different depending on the approach used by the institution. CEBS' initial view is that it is not justified to introduce such a differentiated treatment in the large exposures framework. Therefore, it is proposed to deviate from the minimum capital requirements rules and maintain the current large exposures rules, but deleting the national discretion, set out in article 113.3.p, 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) and in article

113.3.q, 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).

149. 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.

150. For covered bonds recognised under the minimum capital requirements rules, CEBS' initial view is that there is no reason to deviate from the current rule that exempts these instruments from the large exposures rules.

151. For the rest of the physical collateral elements given that they are not in the large exposures regime, CEBS' strong recommendation is not to include them in the eligible list no matter what the bank's approach.

Unfunded credit protection (guarantees and credit derivatives)

152. CEBS' view is that for unfunded credit protection the same treatment as in the minimum capital rules could be accepted.

153. 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. Under the CRD's capital regime unfunded credit protection is generally reflected using a 'substitution' approach. However, there are some differences depending on the approach taken.

154. Under the SA and IRB approaches the value of unfunded credit protection (G) shall be the amount that the protection provider has undertaken to pay in the event of the default or non-payment of the borrower or on the occurrence of other specified credit events.

155. Under the IRB advanced approach, either the PD or LGD is altered (or both), provided that the 'substitution' principle is not exceeded. When determining the appropriate LGD for 'substitution', factors such as other collateral and the precise nature of the agreement need to be taken into account.

156. Under the current large exposures regime, and as a national discretion, Member States may treat the exposure as having been incurred to the guarantor rather than to the client.

157. CEBS is, therefore, proposing to follow the minimum capital rules for unfunded credit protection and replace the current national discretion. For institutions permitted to use own estimates of LGD, CEBS initial recommendation is to allow them to use their internal calculation of the effects of the unfunded protection if they can estimate its effects on their exposures separately from other LGD-relevant aspects.

158. Some exposures are eligible for the 'double default' treatment, where the risk weight may be lower than that which would apply to either the obligor or the

protection provider. CEBS has yet do not reach a stance on whether to accept, or not to accept, the treatment of double default in the large exposures regime.

Q12. Do you support CEBS' proposal that institutions that use the simple method should follow the minimum capital rules (substitution approach) instead of applying the haircuts included in the current large exposure rules? Please explain your views and where relevant provide feedback on the costs and benefits.

Q13. Do you agree that physical collateral should not in general be eligible for large exposures purposes? Do you support CEBS' views that residential and commercial real estate should be eligible and that the current large exposures rules should be applied instead of the minimum capital rules? Please explain your views and provide examples. And where relevant, please provide feedback on the costs and benefits.

Indirect exposures

159. CEBS proposes that an institution should also take steps to mitigate the idiosyncratic unforeseen event risk embodied in indirect exposures. 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[18].

160. The impact of the default of a direct exposure is the net exposure value, which is quite easy to calculate. However, for indirect exposures it is not so straightforward to calculate the impact of the default, which is the estimated loss derived from the default of the collateral. What would be the impact on an institution in case of the default of a particular protection instrument? The institution should recognise the change in its risk profile until the protection is replaced; redefine its exposures values, etc.

161. It is then very difficult to think of a rule, but at least 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 steaming from indirect sources.

162. CEBS' orientation that there are good reasons to require institutions to address this risk. However CEBS thinks that quantitative rules are not a practical option to address indirect risk; it is more appropriate to introduce a requirement for appropriate stress tests rather than designing a system of limits.

[18] 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.

163. This is already mentioned in some places in the Directive in the following terms: ¨Credit institutions shall employ robust procedures and processes to control risks arising from the use of collateral - including risks of failed or reduced credit protection, valuation risks, risks associated with the termination of the credit protection, concentration risk arising from the use of collateral and the interaction with the credit institution's overall risk profile¨. The question is then if this is enough or whether CEBS should develop these high level principles in greater depth.

Q14. Do you agree that the development of a set of principles or guidance to require institutions to take indirect exposures into account when addressing 'unforeseen event risk' is the best way forward? Which principles do you think are relevant? Do you have suggestions for possible principles? Please explain your responses and provide feedback on the costs and benefits where relevant.

Chapter 5. Trading Book issues

164. In its Call for Technical Advice (No. 7) on the review of the Large Exposure rules the Commission asks 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 in relation to large exposure should be considered.

165. From the market failure analysis, CEBS' view is that unforeseen event risk could affect exposures in the trading book as well as those in the banking book. The current trading book large exposures regime is distinctive in that it combines the 25 % limit with a series of exemptions for trading book positions alongside excess capital charges. In some ways, this provides institutions with flexibility to exceed the 25 % limit. This is justified on the basis of the shorter time horizons for taking positions and active risk management that apply in the trading book. 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.

166. The large exposures regime of the Capital Adequacy Directive (Directive 2006/49/EC) applies only to institutions with a substantial trading book business (Art. 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 in accordance with the Banking Directive (Directive 2006/48/EC), 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.

Differences

167. The large exposure limits for trading books 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. As exposures from underwriting are weighted with respect to the period of time that they are in the books of the institution, the large exposures regime assumes that the issuer of new financial instruments will not fail in the very short term.

168. 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 prices of this instrument have changed in the meantime. This risk can be neglected in the banking book where the profits do not derive from short term price movements.

169. The competent authorities may authorise the limits laid down in the Directive 2006/48/EC to be exceeded if the exposure on 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.

170. In the case of an excess the institution has to meet an additional capital requirement on the excess in respect of the 25 %/20 % limits laid down in Directive 2006/48/EC. This additional capital requirement, 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.

171. 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.

172. 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 each case in which the limits have been exceeded the amount of the excess and the name of the client concerned must be reported to the competent authority. 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.

173. The competent authorities may permit institutions which are allowed to use the alternative determination of own funds under Art. 13 (2) of Directive 2006/49/EC to use that determination for the purposes of the large exposure limits for trading book positions provided that the institutions concerned are required to meet all of the obligations under the large exposure rules in Directive 2006/48/EC, in respect of the exposures which arise in their banking books by using own funds as defined in the Directive 2006/48/EC.

174. These alternative elements are an 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.

175. 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, as a reduction of the capital requirements for the banking book extends the amount available for trading book activities as the recognition of alternative (tier 3) capital is linked to free core capital.

Motivation for maintaining different sets of rules

176. The differences between the large exposure rules for banking book and trading book can be explained by the different nature of the business in the two books. The conceptual distinction between the banking book and trading book was introduced in Directive 93/6/EEC. According to the recital to Directive 93/6/EEC, in a common financial market, institutions, whether they are investment firms or credit institutions, engage in direct competition with one another.

177. It is therefore considered desirable to achieve equality in the treatment of credit institutions and investment firms. It was regarded as necessary to develop common standards for market risks incurred by credit institutions and provide a complementary framework for the supervision of the risks incurred by institutions, in particular market risks, and more especially position risks, counterparty/settlement risks and foreign exchange risks.

178. For this reason it was necessary to introduce the concept of a 'trading book' comprising positions in securities and 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. This was confirmed by market participants in the industry consultation conducted by CEBS in response to the first Call for Advice on large exposures (Report to the Commission on 31 August 2006).

179. Applying the banking book rules to trading book positions in order to simplify the large exposures regime and to avoid the problem of regulatory arbitrage, would cause other problems. A simple example illustrates some effects of treating trading book exposures in the same way as banking book exposures. An investment firm has own funds equal to €3,000,000 and a total capital requirement equal to €2,000,000 (which implies a capital adequacy ratio of 150 % and “additional capital” equal to €1,000,000). The investment firm receives an “all-or-nothing”-order from a client who wants 1,000,000 shares in a specific company within two days. The investment firm is, however, able to get only 800,000 shares the first day, at a total cost of €4,000,000. Until the investment firm has successfully fulfilled the contract, the firm holds the 800,000 shares on its own account in the trading book. Supposing the investment firm has no other exposures to the company, this exposure constitutes 133.33 % of its own funds, and thereby exceeds the limits which apply to banking book exposures. However, this exposure is in line with the regulations since the investment firm meets the additional capital requirement of €520,000 (= excess exposure * 200 % * 8 %). Applying banking book

regulation, the required level of own funds for the investment firm would have to be €16,000,000 (maximum exposure of 25 % of own funds).

180. Clearly, treating trading book exposures according to the existing banking book regulations will have strong adverse effects on investment firms' ability to provide investment services.

181. On the other hand, basing the large exposure limit in 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.

182. 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. 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 relevant for the large exposures regime.

Need for an update?

183. It has been pointed out that treating trading book exposures differently from banking book exposures could create regulatory arbitrage opportunities due to the fact that differences between the two books are increasingly blurred. It is claimed that the composition of the 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.

184. These products are generally less liquid and give rise to risks that were not adequately captured when market risk regulations were devised. The implementation of new international accounting and prudential standards are expected to lead to a further broadening of the contents of trading books.

185. To capture these risks in the trading book, the Basel Committee and the International Organisation of Securities Commissions (IOSCO) drew up a list of improvements to the three pillars of the Basel II regime (see "The Application of Basel II to Trading Activities and the Treatment of Double Default Effects", Basel Committee on Banking Supervision, BIS, July 2005). CEBS believes that these issues have been adequately addressed. However, CEBS initial thinking is that it may be necessary to amend the trading book large exposures regime in the context of the incremental default risk capital charge.

Q15. Do you consider that two different set of large exposures rules for banking and trading book are necessary in order to reflect the different risks in the respective businesses? What could be the costs/benefits of this? Please explain your views and provide as appropriate feedback on the cost and benefits of this.

Q16 Since the boundary between trading book and banking book exposures is increasingly blurred, do the current large exposures rules create an incentive to book business in trading book (which would otherwise be disallowed in the banking book)? Please explain your views and provide feedback on relevant costs and benefits.

Q17 Instead of the current risk based capital charge for excess exposures in the trading book, would a simple approach that allows any excess in the trading book to be deducted from an institution's capital resources be more appropriate in the context of a limit based back stop regime? Please explain your views. Please provide examples and feedback on relevant costs and benefits.

Q18. Do credit related products such as credit derivatives and structured products in the trading book require special attention and a different treatment from other positions in the trading book? Please explain your views, provide examples.

Chapter 6. Intra-group exposures (Scope of application; Specialised institutions)

186. A basic 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 traumatic loss as a result of the default of an individual counterparty due to "unforeseen events".

187. The first part of this section discusses the extent to which this basic market failure analysis applies to entities within groups on a solo, sub-consolidated or only on a fully consolidated basis. The second part discusses further market or regulatory failures that may be applicable to exposures between entities, or groups of sub-consolidated entities, within groups. Some high level cost/benefit analysis of imposing third party and intra-group large exposures limits on entities or sub-consolidations is then presented. CEBS is considering, on the basis of these analyses, a range of options for the prudential treatment of these exposures. Table [1] at the chapter's conclusion gives a short summary of the market failure and cost/ benefit analyses and range of options under consideration. Table [2] gives a very brief summary of the treatment of intra-group exposures elsewhere in the world.

6.1 Market Failure Analysis: what is the scope of application of the basic market failure analysis?

188. CEBS considers that the basic market failure analysis does not apply (on a solo basis) to entities that are part of sub-consolidations in which capital is fungible and common risk evaluation, measurement and control procedures apply. That is, it is not plausible for an individual entity to fail and other entities within the sub-consolidation to survive: they are, in all but legal form, the same institution. Therefore credit risk taken by one entity in the sub-consolidation is taken by the group as whole. For the same reason, CEBS does not consider that the basic market failure analysis applies to branches (distinct from the firm as a whole).

189. It is necessary for capital to be fully fungible because it must be possible for capital to be held in one legal entity to support losses arising in another. If this is not the case, the sub-consolidated group may be unable to rescue a failing entity. Therefore the third party credit risk taken by individual entities is not borne by the group as a whole.

190. It is also necessary for sub-consolidation level risk controls to be place. Without them, problems with information flows and managerial incentives may result in an inefficient distribution of capital within groups. Information problems may induce subsidiary managers to take excessive risk, potentially increasing the risk of the subsidiaries' failure. Without sub-consolidation level risk controls, the sub-consolidation does not function effectively as a single institution.

6.2 Market Failure Analysis: intra-group exposures

191. CEBS considers that the basic market failure analysis does not apply (on a solo basis) to exposures between entities in sub-consolidations that meet the criteria set out above, or between branches and their head offices. This is because entities within such sub-consolidations cannot take credit risk on each other in any meaningful way.

192. It may also be the case that the basic market failure analysis does not apply to other exposures within groups, i.e. exposures between entities that are not in a sub-consolidation that meets the criteria set out above. First, entities in the same group typically have access to much more information about each other than they do on other counterparties. There may also be a relationship of control. This reduces unforeseen event risk. Second, in the case of financial groups, most of the subsidiaries are themselves regulated entities subject to prudential supervision. This could possibly further reduce information asymmetries and make individual regulated entities less likely to fail.

193. However, a residual credit risk may remain for these exposures because they are not subject to common risk controls and capital is not fungible. This may be particularly likely to be the case for cross-border exposures outside of the EEA, where there may be political risks (e.g. ring fencing of capital) and control of and information about the group counterparty may be limited.

194. In addition to basic market failure, another set of market and regulatory failures may apply. They relate to negative externalities that arise as consequences of the insolvency of a group. They are not related to the credit risk that could cause such insolvency.

195. Large intra-group exposures could impose significant external costs following a group insolvency as they could inhibit the timely and efficient resolution of banking groups' affairs and prejudice depositors' interests.

196. The timely and efficient resolution of banking groups' insolvencies could be inhibited by large intra-group exposures as they could prevent otherwise fundamentally sound entities within a failed group from being sold or restructured quickly and efficiently. This could incur costs such as the unnecessary triggering of deposit insurance schemes and increased financial instability. This would impose significant external costs on the rest of the financial system and the economy at large.

197. Furthermore, in the absence of robust international cross-border insolvency or burden sharing agreements, exposures between group companies in different legal jurisdictions could lead to lengthy legal and/or political disputes over how the burden should be shared between creditors in the countries involved. In particular, institutional arrangements for providing emergency liquidity

assistance exist at the national level: large intra-group exposures could make a co-ordinated response more difficult to effect. Differences in insolvency laws could also mean that the claims of the various liquidators would be subject to considerable legal uncertainty. These problems could be described as regulatory failures.

198. Depositors could be put at increased risk if there are large intra-group exposures between deposit-taking and non-deposit-taking institutions (the extent of this problem may depend on the design of the deposit guarantee scheme). This regulatory failure applies both within and across national jurisdictions.

199. This problem has another dimension for cross-border intra-group exposures. Such exposures could cause depositors in one jurisdiction to bear losses on risks taken in another jurisdiction. Deposit guarantee schemes are generally run and funded at the national level (including within the EEA), and are effectively underwritten by national taxpayers. Large intra-group exposures could undermine the basis on which deposit protection schemes work.

200. In conclusion, the basic market failure analysis does not apply to entities within sub-consolidations in which capital is fungible and common risk controls are in place. Market failures that arise post-group insolvency may, however, apply to intra-group exposures, including those between entities within such consolidations. These market failures are particularly strong for cross-border intra-group exposures. This means that, even if there is no credit risk involved, there may be a case – depending on the cost/benefit analysis - for regulatory intervention on intra-group exposures.

Q19. Do you have any comments on the market failure analysis on intra-group exposures?

6.3 Cost/Benefit analysis of limits on intra-group exposures

201. This section sets out a high level analysis of the potential costs of imposing intra-group exposure limits. Potential costs or regulatory failures include an undue restriction on group liquidity management, competitive disadvantages between Member States of the EU, competitive disadvantages with third party jurisdictions and frustration of progress towards a truly single European financial services market. These costs may be very different across Member States depending on the extent of cross-border banking activity in a given Member State. Imposing limits on large intra-group exposures could possibly mitigate the problems set out in the market failure analysis above. They depend, to a large extent, on other institutional arrangements in place.

Impact on institutions' internal practice, including group liquidity management

202. CEBS' survey of the costs to the industry of the current framework suggests that the current intra-group regime as it exists does affect some groups' capacity to manage their liquidity at sub-consolidated or consolidated level. Some groups aim to maintain a "global pool of liquidity"; limits on intra-group exposures could undermine this approach as it would not always be possible for liquidity to flow to where it is needed most. This may mean that funds must be (more

expensively) raised in host jurisdictions, diversification benefits foregone and, under stressed conditions, illiquid but solvent group entities may be unnecessarily pushed into default. Intra-group limits could affect short term day-to-day liquidity management in which funds are shifted around groups in order to efficiently meet short-term funding needs. And could also affect longer term more "structural" use of deposits in one jurisdiction to fund risky lending in another.

203. Intra-group limits could potentially worsen a liquidity crisis. For example, the liquidity profile of some European banks could have been much worse during the recent period of market turbulence if intra-group limits had been applied without exemptions across the EU. Following a contraction in liquidity available on interbank markets, an obvious source of liquidity for an entity in a financial group is the liquidity provided by other entities within the same group.

204. However, large exposures rules are not the only constraint on group liquidity management. Banks themselves will seek to ensure that their entities are resilient to liquidity risk on a solo basis. Furthermore, domestic liquidity regulation may also constrain groups from moving liquidity across national jurisdictions from one entity to another. In delivering its final Advice to the Commission, CEBS will take into consideration the work of its Taskforce on Liquidity Risk Management.

205. Moreover, some institutions do not only manage liquidity risk in a centralized manner, also counterparty credit risk is managed on a consolidated basis. For these institutions, the intra-group limits increase their counterparty credit risk as these limits would amongst others affect the netting basis. Removing the ingra-group limits might have a positive effect for the institutions with regard to their exposures to other risks.

Competitive issues within the EU

206. Imposing limits on all cross-border intra-group exposures within the EU could put some EU Member States at a competitive disadvantage to other States as there are significant differences in banking industries across the EU. Countries in which banks do a lot of cross-border business and which have a limited depositor base would potentially be at a particular disadvantage. Uneven application of limits on intra-group exposures between Member States could help alleviate this problem but could potentially itself create some competitive inequalities.

Competitive issues with third party jurisdictions

207. CEBS has also given consideration to the wide variety of intra-group regimes existing across the world. Annex 2 sets out a brief overview of them. CEBS considers that overall the EU intra-group exposures regime puts European institutions at neither a systematic advantage nor disadvantage against third country banks.

Frustration of movement towards a truly single European financial services market

208. Cross border intra-group limits on exposures within the EU would hinder progress to a single European market as banks would face barriers to doing business across borders within the EU.

Benefits

209. Intra-group exposure limits could reduce exposure to unforeseen event risk, where such an exposure exists. They could, for example, prevent European banking groups from failing due to an idiosyncratic event affecting one of their subsidiaries that does not form part of their core group.

210. They could also reduce the impact of a failure of a cross-border European banking group. The extent of this benefit depends on whether robust cross-border loss-sharing and ex-ante resolution arrangements exist: if such arrangements can be made, there is less need for intra-group exposure limits to apply. CEBS will take into consideration the outcome of the Winding Up Directive review in preparing its final Advice to the Commission.

Q20. Could intra-group large exposures limits give rise to other costs and benefits? Please explain your response.

6.4 Range of Options available

Scope of Application for the general large exposures regime

211. CEBS considers that, on the basis of the market failure and high level cost benefit analysis set out above, third party large exposures limits should not apply to subsidiaries that meet the criteria set out in Article 69.1, holding companies that meet the criteria in Article 69.2 and parent companies that meet the criteria set out in Article 69.3 of 2006/48/EC (i.e. are situated in the same Member State, there is no impediment to the transfer of capital and there are consolidation level controls). Although there may be some post group insolvency negative externalities, common risk controls, capital fungibility, and a common insolvency framework help ensure that they are kept to a minimum.

212. CEBS would welcome industry input on whether it should propose to allow national authorities on a case by case basis to exempt subsidiaries of an institution based elsewhere in the EEA. Such an approach would have pros and cons. On the one hand, if the host national authority is satisfied that the creditor entity would be supported by its wider European group and is confident that capital and/or liquidity could be transferred cross-border, restrictions on business could be lifted. On the other, such an approach would not support harmonisation and there could be competitive issues. Furthermore, it could contribute to problems in winding up a group that would affect both home, host and, potentially, other Member States. It would also not be consistent with requirements for portfolio credit risk regulation in the CRD.

213. CEBS considers it inappropriate to propose that subsidiaries in host Member States be mandatorily exempted from large exposures regulation, because groups may not always support failing subsidiaries (which may be systemic from the host state's perspective) and there may be impediments to the movement of capital and liquidity across national borders in stressed situations.

Q21. What are your views on the proposals/options for the scope of application of the large exposures regime?

Intra-group exposures to entities within the same Member State

214. CEBS considers that, provided the conditions in Article 80.7 or 80.8 are met, intra-group exposures of creditor entities located in the same Member State as debtor entities should be exempt from the limits. We have established that the basic market failure analysis does not apply to such exposures – they do not present a credit risk. The post insolvency market failures might apply, although they are mitigated by the fact that group risk controls are in place and a common insolvency law applies.

215. CEBS is considering a range of options for exposures between group entities that are not within the same sub-consolidation but are in the same Member State. Options include full inclusion in the limits, national discretion to exempt, or mandatory exemption. Because capital is not necessarily fungible, credit risk may still apply. But unforeseen event risk may be reduced for exposures to entities regulated under the CRD and because the exposures are subject to the same insolvency regime and deposits protected by the same deposit insurance scheme, post insolvency market failures are limited. There may be a case for differentiating between exposures to prudentially regulated and non-prudentially regulated entities.

216. CEBS will ensure that, in whatever approach it finally recommends, it would not be possible for regulated institutions to escape third-party large exposures limits by channelling funds through unregulated entities.

Intra-group exposures to group entities in different Member States

217. The analysis set out in this paper indicates that intra-group exposures to institutions in a different Member State may be subject to a different degree of market/regulatory failure than similar domestic intra-group exposures. It also suggests that the costs and benefits may be different to those for third party exposure limits on exposures to "standalone" banks. This cost/benefit calculus may differ between individual Member States because of differences in banking industry activities and structures.

218. There are strong arguments both for and against imposing limits on intra-group exposures within the EU. The basic "credit risk" market failure may apply because groups may be unwilling or unable to support failing entities (for example, because national authorities retain the right to "ring-fence" assets in stressed scenarios) even if they comply with the other Article 80.7 or 80.8 criteria.

219. Furthermore, there could be some benefits to imposing intra-group exposure limits between EEA jurisdictions because:

    i) deposit guarantee schemes are nationally funded with no cross-border loss-sharing arrangements,

    ii)entities within the failed group would be subject to incongruous and potentially competing sets of national insolvency laws.

220. From the perspective of cross-border banking group resolution, a preferred solution would be to address problems directly by agreeing to robust loss-sharing, emergency liquidity funding and group insolvency arrangements[19] at EU level. Such agreements are unlikely in the short to medium term, and there may be significant practical impediments to overcome (CEBS will consider the results of the Winding Up Directive review in its final Advice to the Commission). In the mean time, a second best solution may be to limit intra-group exposures.

221. On the other hand, intra-group limits within the EU could frustrate efficient group-level liquidity management and reduce potential benefits arising from being able to diversify sources of liquidity. In a liquidity crisis, this could be particularly problematic, as groups may be prevented from transferring excess liquidity in one part of a group to another part of the group that needs it. However, in such a crisis reputational contagion may mean that most or all parts of the group would be suffering liquidity problems.

222. It could also be argued that imposing intra-group limits at the European, but not national, level could distort competition within the EEA and frustrate progress towards a more integrated EU financial services market.

223. The liquidity regulation regime has an important bearing on the impact of intra-group liquidity: if solo liquidity requirements are in place, the marginal impact of intra-group limits on liquidity management will be less than if a fully consolidated liquidity regime were in place.

224. The following range of options is available to us:

i) Subject all cross-border intra-group exposures in the EEA to large exposures limits without exemptions. This would achieve maximum harmonisation and deal effectively with the identified market/ regulatory failures but it could contribute to the additional regulatory failures discussed above. Note that exposures within legal entities (branches) would remain exempt.

ii) As Option I except with a “safety valve” similar as that included in the US Federal Reserve Bank’s regime to give authorities the discretion to relax or remove intra-group limits in exceptional circumstances. The Fed has recently used its discretion to relax its intra-group limits for a number of large cross-border groups. [20]

iii) As Option I except with a broader range national discretions in addition to the safety valve to allow national authorities to impose looser (or stricter) conditions or limits on intra-group exposures, for example to facilitate group liquidity management. This would not achieve maximum harmonisation, but it would allow firms more scope to manage group liquidity, and provide the safety valve for liquidity discussed in Option II, whilst at least partially addressing the market failures identified above.

[19] The current Winding Up Directive does not achieve this because it applies to individual legal entities only: it does not cover groups that operate with subsidiaries, rather than branches, in different Member States.

[20] See http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2007/

iv) Do not apply limits to intra-group exposures within the EEA. This would achieve harmonisation and have the least impact on firms. However, it would do little to address the market/regulatory failures identified above. It is also incongruent with the CRD, as Article 69 provides discretion to disapply solo consolidated requirements at national level only and CEBS would need to ensure that any such proposal would prevent groups avoiding the third party large exposures regime by channelling funds through group companies in other Member States.

Exposures to group entities in non-EEA jurisdictions

225. CEBS considers that both credit risk related market failure and post insolvency problem related market/regulatory failures apply to exposures to group entities in non-EEA jurisdictions, particularly where the jurisdiction is non-CRD equivalent and/or where there is strong likelihood that capital would be ring-fenced in a stressed scenario. There are costs associated with imposing limits on such exposures: in particular, they may interfere with global liquidity management.

226. In this context, CEBS considers that the following options are feasible:

I. Impose limits on all intra-group exposures to entities in non-EEA jurisdictions. This would achieve harmonisation. But it could interfere with group liquidity management and it could in certain situations create trapped pools of liquidity within the EEA in a liquidity crisis (although this would not be the case if reputational contagion had drained liquidity from all parts of the group).

II. As Option I except with a "safety valve" similar as that included in the Federal Reserve Bank's regime to give authorities the discretion to relax or remove intra-group limits in exceptional circumstances.

III. As Option I except with a broader range of national discretions in addition to the safety valve to allow national authorities to impose looser (or stricter) conditions or limits on intra-group exposures, for example to facilitate group liquidity management.

Q22. Which treatment do you believe is the most appropriate for intra-group exposures i) *to entities within the same Member State; ii) to group entities in different Member States and iii) to group entities in non-EEA jurisdictions* ? Please explain your response.

How should intra-group limits be defined?

227. Should there be separate limits on exposures to each individual group entity, a single limit on the aggregate of all exposures to the rest of the group, something in between or some combination of both? That is, how should the numerator of individual intra-group limits be determined? And what is the correct level?

228. If intra-group limits existed purely to protect lending entities or consolidations against unforeseen event risk arising in some debtor entities/consolidations it would be logical to apply individual limits to such entities or groups of connected

entities that stand or fall together. There would be no strong reason to suggest that a different limit to that imposed on third party exposures would be required. On one hand, there is a case for a stricter limit to apply as firms have demonstrably weaker incentives to limit these exposures. On the other, increased informational flows and the possibility of control relationships make unforeseen event risk perhaps less likely to occur.

229. However, intra-group limits may also exist to address market/regulatory failures arising after group insolvency. There may therefore be a case for different limits to apply. Because they would not function to protect an entity as a going concern, a limit different on the amount necessary to protect against insolvency would still have some value (the current regime allows national discretion to impose a 20% limit, for example); alternatively, a higher limit might be appropriate if there was no credit risk involved.

230. CEBS has yet to conclude on what treatment it believes to be the most appropriate. However, in arriving at its decision CEBS will consider the following principles.

I. Intra-group exposures to entities or closely connected groups of entities that form a distinct part of the wider group and would not stand or fail with the creditor entity should be subject to individual limits of no more than 25% of the creditor's own funds.

II. Individual exposures between entities and other parts of a group should not unduly prejudice the ability of a liquidator to dispose of an otherwise fundamentally sound part of a group in a timely and efficient manner.

III. Individual cross-border exposures should not unduly compromise the credibility of national depositor protection schemes and/or place depositors in one Member State at a distinct disadvantage against another group of depositors or other creditors in another Member State.

IV. An aggregate intra-group exposure limit should be set at a level appropriate to contain potential regulatory arbitrage and minimise legal and political hazards to winding up a group.

V. Where possible, a harmonising approach should be taken to defining intra-group limits.

Q23. What are your views on the high level principles to define *intra-group limits*?

Table 1: Summary of market failure analysis, potential costs and range of options for intra-group exposures

Debtor entity	Market Failure Analysis (MFA) applicable	Potential costs of limits	Range of options under consideration

In the same Member State	- Problem with efficient sale of otherwise sound entities - Could put depositors at risk - Where Art 80.7 / 80.8 criteria are not met, Basic MFA applies - But mitigated by group-level control, reduction of information asymmetries	- Interference with group liquidity management - Could be administratively burdensome	- For exposures between entities in an Article 80.7 / 80.8 consolidation: mandatory exemption from intragroup limits; - For other exposures, including to non-financial group companies: exemption either mandatorily or at national discretion.
In a different EEA Member State	- Impact on national deposit protection schemes and home state depositors; - Political / legal impediments to swift resolution; - In some cases, the basic MFA may also apply in some cases - Potential Regulatory Failure	- Interference with group liquidity management - Could be administratively burdensome - Competitive issues within the EU and with other Member States - Frustration of progress to truly single financial services market	- Impose limits at the national level including EEA jurisdictions - Limits except with a "safety valve" to relax or remove intra-group limits - Limits except with a broader range of national discretions - Impose limits at EEA-consolidated level only
In non-EEA jurisdiction	- As above, but potentially more pronounced. - Basic MFA very likely to apply if jurisdiction is not CRD-equivalent - Potential regulatory failure	- Interference with group liquidity management - Competitive issues	- Impose limits on all intra-group exposures - Limits except with a "safety valve" to relax or remove intra-group limits - Limits except with a broader range of national discretions

Table 2: Intra-group exposures in non-EU jurisdictions

Jurisdiction	Information on treatment of intra-group large exposures
US (Federal Reserve Bank)	Exposures to individual group entities are generally limited to 10% of capital, and in aggregate to 20% of capital.
Japan	Exposures to single intra-group entities limited to 25% of capital; and to two or more related intra-group entities, 40%.
Australia	Intra-group exposures to domestic deposit institutions limited to 50%, other deposit institutions to 25%, unregulated entities, 15% of Level 1 Capital.
Canada	Exposures of subsidiaries to parents are limited to 100% of capital, but lower limits are generally expected to be kept.
Switzerland	Exposures within (nationally?) consolidated entities are exempt from limits.

6.5. Investment Managers

231. In its Part 1 advice, CEBS commented that it was conscious that the current large exposures regime applies not just to credit institutions but also to investment firms and investment managers.

232. As part of its work to respond to Part 2 of the Call for Advice CEBS has considered if it is appropriate for the large exposures regime to apply to all types of firms.

Directive requirement

233. Investment firms come within the scope of the large exposures regime because of Articles 28 – 32 and Annex VI of the recast CAD. Article 28(1) provides that "institutions" shall monitor and control their large exposures in accordance with Articles 106 – 118 of the recast BCD. "Institutions" are defined in Article 3(1)(b) of the recast CAD to include "investment firms" which are in turn defined in Article 4.1(1) of MIFID to include institutions carrying out a range of investment services. The result is that there is a large category of investment firms that are captured by the current large exposures regime via CAD and the cross reference in CAD to Article 4.1(1) of MiFID.

Analysis on investment managers

234. These firms mange client assets and earn a fee for providing this service. The client assets are segregated from the assets of the firm, for example under the custody of an independent custodian. Investment management firms may be

independently owned or subsidiaries within a banking or insurance group. Some operate as partnerships and others as incorporated entities. MiFID, amongst other things, specifies a number of requirements concerning the protection of client assets and the sales and advice process.

235. Client agreements determine the basis by which fees are calculated (e.g. if they are to be charged in advance or in arrears). The charging and collection of fees varies and could, for example, occur monthly, quarterly, semi-annually or annually. Also, different fee types may be collected at different times. For example, management fees might be invoiced quarterly whereas performance fees might be invoiced annually.

236. One of the key drivers for income is the assets/funds under management. Management fees are typically a percentage of the funds under management. Performance fees may also be part of the remuneration agreed between a firm and a client. These are usually charged as a percentage of the investment performance – the basis for the calculation will previously have been agreed with the client. If an investment management firm also manages authorised funds, fees may also be earned as a percentage of the value of the investment units sold.

Market Failure Analysis / Cost benefit analysis

237. The market failures identified in CEBS' Part One Advice as relevant to a large exposures regime are negative externalities and information asymmetry. However, investment management 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.

238. Investment management firms are not funded by depositors. The costs associated with failures of investment firms are likely to be relatively limited. If an investment manager were to fail the client assets would continue to belong to the clients. The MIFID requires client assets to be held separately from the firm's assets. Client assets if required could be transferred (at a cost) from one manager to another. 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.

239. Evidence from the CBA on the current large exposures regime suggests the rules do create a compliance burden for these firms. A number of respondents, while reporting some difficulty in providing cost data, did describe arrangements, systems and controls they had implemented to ensure compliance with the large exposures rules, which implies costs are incurred.

240. Some respondents questioned the value of reporting large exposures that arise from accrued fees. They said that a large exposure arises as a result of timing differences between the recognition of the fee and its settlement and there was no doubt that the fee would be paid, for example because the client agreement permitted payment by direct debit from the client assets in the investment manager's control after a specified time had elapsed. One respondent commented that it had structured new deals to ensure compliance with the limits (requiring monthly settlement) but it would have preferred semi-annual settlement. Another commented that the nature of the business reduced, to a material extent, the ability of the firm to manage the occurrence of an large exposures arising from accrued fees. For example, in times of good performance an investment manager could accrue a significant unpaid performance fee which could result in them breaching the large exposures rules.

241. The range of activities undertaken by an investment manager is also a consideration. For those investment managers that deal on own account only for the purpose of fulfilling or executing a client order or when acting in an agency capacity, etc (as provided by CAD Article 20.3(a)) the credit risk would appear principally to arise in connection with accrued fees, etc. In the case of the category of investment firms operating within the context of CAD Article 20.3(b), while they do not hold client money or securities, could include matched principal brokers.

Policy proposal

242. Based on the analysis and consideration of the costs and benefits, the CEBS' current view is that the case for including all investment managers within the scope of the large exposures regime is not made. The application of an large exposures regime to investment managers may be an example of regulatory failure since the regime imposes a burden of investment firms (including a reporting burden) without delivering benefits to consumers.

243. CEBS therefore proposes inviting the Commission to consider fully or partially exempting these institutions:

- a full exemption for those investment firms referred to by CAD Article 20(2); and

- a full or partial (discretionary) exemption for those firms referred to in CAD Article 20(3) reflecting that the case for exemption is less clear as this category includes matched principal brokers.

244. It is not proposed to exempt other investment firms (including those often called "investment banks").

Q24. Do you agree with the proposal to invite the Commission to consider exempting investment managers from a future large exposures regime? Please explain your views and provide feedback on the relevant costs and benefits.

6.6. Other financial institutions that are not credit institutions

245. CEBS is of the opinion that there is an important distinction to be made when conducting a differentiated MFA 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, for example leasing or factoring companies. In this latter case there are no depositors to protect nor risk of contagion through a crisis of confidence among other institutions' depositors. However, as part of the financial system, contagion could exist through other channels.

246. 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.

247. In view of the above arguments CEBS proposes that financial institutions not subject to the CRD should not be subject to large exposures limits on a solo basis but parent institutions should include their exposures on a consolidated basis.

Q25. Do you agree with the proposal? Please explain your response.

Chapter 7. Sovereigns, international organizations, multilateral development banks and public sector entities

248. As has already been said, a basic 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 traumatic loss as a result of the default of an individual counterparty due to "unforeseen events". Where this basic market failure analysis does not apply then there is no rationale for limiting those exposures.

249. CEBS has already stated that unforeseen event risk is not related to the *a priori* quality of the counterparty and it can arise, among other circumstances, from the default of the counterparty due to fraud, government action, loss of a major customer or market, or the breakdown of a business model. Since these types of events have a devastating impact on an institution's business and cannot be reliably predicted through a normal estimation process, they should be prevented through a backstop limits regime. However, these types of events, considered as plausible unforeseen event risks, do not apply to certain entities with different natures and purposes. This could be the case of with entities such as sovereigns, international organizations, multilateral development banks, regional governments and local authorities, and other public sector entities. 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 so well reward this risk averse attitude, leading institutions to follow the more common risky business practices.

250. Sovereigns have tax-raising power over their own citizens and can also print money in their own currency; hence they cannot default when debts are in their own currency. However if the currency is not the same as the currency of the bank taking the exposure there is a foreign exchange exposure which could be subject to unforeseen event risk.

251. Besides that, there is no incremental market failure if a sovereign defaults. If that happens there are larger problems which are outside the normal regulatory framework, mainly in the sovereign state in which the bank is operating, but which could also extend to other sovereign states that play a pivotal role in the word economy or that play a pivotal role in the economy where the bank has their main exposures.

252. Moreover developed countries, international organizations founded and financed by them, as well as multilateral development banks founded and financed in the same way, are not subject to a plausible unforeseen event risk. On the contrary, an unforeseen event in this field would be considered a clear exception, and if that happens probably the adverse domino effect would be unstoppable through a large exposures regime. Therefore, it is CEBS' 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.

253. CEBS' proposal is that the exposures described in Art. 113(3), paras. (a) - (f) should be exempted from the large exposures limits. And this would require the deletion of the current national discretion to fully or partially exempt these exposures from the large exposures limits.

254. Similarly to Sovereigns, some regional governments and local authorities have specific revenue-raising powers over their own citizens. Therefore, and for the same arguments explained above, they are not subject to a plausible unforeseen risk. CEBS' initial proposal is that exposures to regional governments and local authorities when they have specific revenue-raising powers should be exempted from the large exposures limits. This would also require the removal of the current national discretion to fully exempt these exposures from the large exposures limits.

255. Consistent with the idea that unforeseen event risk is not related to the creditworthiness of the exposure, if there is a possibility that regional governments or local authorities can default, then the consistent rule should be not to exempt them for the large exposures regime. If this possibility can be ruled out because there is explicit or implicit state support or because the national law does not allow these entities to default (e.g. something is forecasted by law) then these exposures should be fully or partially exempted.

256. This change could potentially have an impact on the financing of these regional governments and local authorities. This impact could be quite important given that the financial needs of these entities could be more likely to represent 25% of a financial institution's capital than a private exposure. Then it would be necessary for these authorities to obtain funds from several institutions instead of one, or to provide collateral, etc. This of course would imply more expensive financing that in the end will imply lower welfare for the taxpayers in this area.

257. On the other hand, the change would reduce the possibility of traumatic losses for the institutions exposed so contributing to the stability of the financial system.

Q26. What are your views on the proposal to remove the national discretion and to automatically exempting exposures to sovereigns and other international organisations (within Art 113.3 (a – f)), as well as some regional governments and local authorities?

Q27. Please provide feedback on the costs and benefits that you consider would arise from the proposal.

Q28. Is there room for further exemptions? Please explain your views and provide feedback on the costs and benefits that you consider would arise from the further exemptions that you propose.

Chapter 8. Interbank exposures

258. Exposures to institutions regulated by the CRD (which will be referred to in this document as "interbank exposures") are subject to a complex range of national discretions and derogations set out in Directive 2006/48/EC, Articles 113(3)(i), 115(2) and 116. Broadly, and with one or two exceptions, Member States currently exempt, or subject exposures to a 20% weighting of the exposure amount[21], unsecured interbank exposures of less than one year's maturity.

259. Summarised below are the results of CEBS' differentiated impact analysis of applying the proposed backstop regime to all unsecured interbank exposures.

260. First, a theoretical market failure analysis is set out which explores whether banks themselves are subject to "unforeseen event risk", drawing on empirical evidence. The extent to which systemic risk and moral hazard could theoretically affect the market failure analysis for interbank exposures is assessed, followed by some discussion of whether this is borne out empirically.

261. CEBS' conclusion is that there is evidence that a market failure could exist with respect to large interbank exposures as such exposures give rise to systemic risk and are associated with moral hazard problems.

262. Second, a cost/benefit analysis is presented that seeks to ascertain an estimate of the net benefits (or costs) of introducing a 25% limit on large interbank exposures. The costs are estimated using aggregate data on interbank large exposures supplied to CEBS by authorities in eleven Member States. A key

[21] That is, they impose an effective limit of 125% of own funds.

assumption of the basic analysis is that firms would be able to collateralise, diversify or otherwise extinguish interbank exposures above 25%. The benefits may be inferred from assessing the effect such limits would have on the probability of a systemic crisis occurring.

263. CEBS' conclusion is that the introduction of limits on all interbank exposures would bring benefits to some Member States in terms of reduced risk of contagion in the banking sector.

264. However, this benefit may not be felt equally across all Member States because of differences in the structures of national banking systems. Furthermore their introduction would also give rise to significant costs for banks that are unable to easily diversify or collateralise their interbank exposures. There are also other important caveats: for example, the costs are likely to be proportionately higher for smaller banks, because of economies of scale, as the assumptions made in the analysis require interbank markets to be deep, wide and liquid across the EU and the role of ex-post intervention is excluded. To some extent, the costs will depend on the treatment of collateral in the revised large exposures regime.

265. CEBS would very much welcome industry's views on this cost/benefit analysis, in particular whether the assumptions underpinning it are generally correct.

Market failure analysis

Are regulated institutions themselves susceptible to unforeseen event risk?

In order to verify that the basic market failure analysis applies to interbank exposures, it is necessary to assess whether banks and other CRD-regulated institutions are themselves susceptible to unforeseen events. Based on evidence of default rates and empirical observations, our conclusion is that such institutions are indeed susceptible to unforeseen event risk.

266. It could be argued that exposures to regulated institutions could be associated with lower unforeseen event risk because they are more tightly regulated than most other counterparties and therefore that the basic market failure analysis, set out in Chapter 1 does not apply. However, to what extent does their failure due to unforeseen events remain plausible? CEBS considers that, despite regulation, unforeseen event risk does apply to institutions regulated by the CRD. This conclusion is based on two sets of evidence.

267. First, recent studies by Moody's[22] and Fitch[23] demonstrate that, although the default rate of banks and other financial institutions is lower than the average, it remains significant, particularly taking account of ex-post measures taken or facilitated by the public authorities to prevent the failure of banks that would otherwise have defaulted.

268. The Moody's study demonstrates that the one year default rate for banks in their ratings universe between 1971 and 2006 was 0.38%. This is lower than every

[22] *Corporate Default and Recovery Rates, 1920-2006* (revised version of 27 June 2007), Moody's (2007)
[23] *Fitch Bank Failures Study 1990 – 2003*, Fitch Ratings (2005)

other industry group except utilities, although there were years in which the bank default rate was higher than average, for example it was 2.18% in 1988, higher than all but one of the other eleven industry groups.

269. The Fitch study takes into account the effects of ex-post external intervention to rescue banks. This study concludes that, after taking these effects into account, there is no difference in the likelihood of developed country banks failing than that of corporates worldwide: between 1990 and 2003 both groups had an average 1 year failure rate of 0.77%.

270. Second, there are examples of banks that have failed or have required external support due to unforeseen event risk. BCCI and Barings failed after fraud was uncovered. More recently, external intervention was required to support Northern Rock[24], IKB and Sachsen LB after their business models suddenly became, at least temporarily, unviable. These cases demonstrate empirically the plausibility of unforeseen events that could in some cases lead to bank failure.

Are there particular market failures that apply to interbank exposures?

The network structure of the banking system and authorities' incentives to intervene to prevent banks from failing could affect the market failure analysis as it relates specifically to interbank exposures. CEBS' conclusion is that, due to the presence of systemic risk and moral hazard, there is evidence that particular market failures might apply to interbank exposures.

271. Because of the banking system's unique network structure a different form of market failure may also apply to these exposures. Banks, by their nature, depend on one another to provide liquidity and other services to each other. This connectedness gives rise to a negative externality: the failure of one bank could, through the network structure described above, adversely affect other banks in the system. If large net exposures exist within the system, the scope for onward contagion from the initial failure to other banks is increased. This is an example of "systemic risk". The negative externalities to which it gives rise are part of the general rationale for prudential supervision described in Part 1 of CEBS' Advice on large exposures.

272. Systemic risk gives rise to a moral hazard, which in this case is a form of regulatory failure. The Fitch study, academic empirical literature[25] and some of the examples described above demonstrate that public authorities have clear ex-post incentives to intervene to prevent a bank from failing in order to avert a systemic crisis. Some banks and other creditors may cease to view institutions with a perceived government guarantee as a credit risk (or regard them as less of a credit risk) and so may extend large amounts of credit to them and take less care of the management and mitigation of their exposures to them.

[24] 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.

[25] For example, Gropp, Vesala and Vulpes (2002), *ECB Working Paper No.150*, "Equity and Bond Market Signals as Leading Indicators of Bank Fragility" and Hughes & Mester (1993), *The Journal of Productivity Analysis*, "A Quality and Risk-Adjusted Cost Function for Banks: Evidence on the 'Too Big to Fail' Doctrine".

273. This causes two problems from a public policy perspective. First, it gives rise to allocative inefficiencies, as implicitly supported banks obtain funds more cheaply than those banks and non-banks without state support. Second, and worse, it aggravates the negative externality of systemic risk as the potential for contagion is increased (because the exposures are larger than they otherwise would be). This is particularly problematic when the structure of the banking market is more concentrated.

274. To what extent does contagion through large interbank exposures due to idiosyncratic shocks actually pose a systemic threat to European banking systems? This has been the subject of a number of studies by central banks over the past decade. A recent BIS Working Paper[26] provides a useful summary. The general conclusion appears to be that, although it is not thought plausible that an idiosyncratic bank default could trigger a catastrophic collapse of a banking system, there remains considerable scope for direct counterparty credit risk contagion to have a serious systemic effect on the banking system in many countries.

275. CEBS has also examined the results of the IMF's FSAP programme for each of the 26 EEA members for which an FSAP report, published between 2001 and 2007, exists. Of these, nine contain no reference to interbank markets (most of these were published early in the period) and six find that national interbank markets were in nascent stages of development. The IMF concluded that there is a significant risk of interbank contagion in six of the remaining countries but that in the other five any risk of contagion had been contained or eliminated by stress testing or the structure of the banking system.

276. Furthermore, data collected by CEBS from eleven Member States demonstrates that some European banks did have some very large exposures to one another at the end of 2006.

277. CEBS notes that some European banks have, since early August, generally become reluctant to lend to one another, particularly at longer maturities, and markets for longer term interbank credit have temporarily ceased to function effectively as result. The drying up of the interbank market in the context of the sub-prime turmoil suggests that banks quickly adjust their assessment of, and their exposures to, other institutions under certain circumstances. CEBS considers that, under these conditions, market failures associated with excessive counterparty credit risk in the interbank market do not apply.

278. The causes and consequences of this tightening in liquidity conditions will be discussed by CEBS in other publications and forums. In the context of very tight liquidity conditions and uncertainty surrounding counterparties' credit exposures via, for example, ABCP conduits, the moral hazard of implicit state support may be more than offset by the need to manage liquidity and credit risk more tightly. It is important to note that any market failures at work here are different to the ones that a large exposures regime is designed to address, that is excessive lending or risk-taking leading to increased systemic risk in normal market conditions. It is important to ensure, however, that any large exposures regime does not aggravate any market failures associated with conditions such as those

[26] Upper (2007), *BIS Working Paper No 234: Using counterfactual simulations to assess the danger of contagion in interbank* markets, Section 3 (pp9-10).

observed over the summer. This issue is addressed in the cost/benefit analysis below.

279. There is also the question of 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.

280. In summary, there is evidence that in some Member States there is normally a risk of contagion in the banking sector. As articulated in the first part of the Advice, the large exposures regime is a backstop regime. CEBS considers that, although the market failures identified may not currently apply equally across the Member States, there remains the possibility for systems' structures to change over time. Therefore CEBS considers that there is evidence that a market failure might apply to interbank exposures in normal market conditions.

Q29. Do you consider that large interbank exposures of all maturities are associated with the market failures described above?

Cost / benefit analysis

281. In Annex 4 the cost/benefit analysis made by CEBS using data supplied by some national authorities is set out. It includes an analysis of the approximate cost of imposing a limit of 25% on all interbank exposures. CEBS would very much welcome industry's views on this analysis, in particular on whether the assumptions on which we base the analysis are broadly correct.

282. Based on the assumption that banks would generally be able to diversify or collateralise their large exposures, it is possible to estimate the upper bound of the current opportunity cost to the industry of imposing limits on interbank exposures. CEBS' conclusion is that a central, conservative, estimate of the annual opportunity cost of introducing limits on unsecured interbank exposures for the eleven countries for which data are available is €89mn as this represents the implied cost of collateralising exposures when spreads are higher than usual.

283. On the question of what would be the approximate benefit of imposing a limit of 25% on all interbank exposures, and using data from the academic literature, historical bank default rates and data supplied by national authorities to CEBS, it is possible to estimate an annual benefit of interbank exposure limits, which is manifested in terms of reduced probability of a systemic crisis. Although it is difficult to arrive at a single central estimate, CEBS concludes that it is most likely that it lies between €33mn and €402mn per annum.

Caveats to the cost / benefit analysis

This section presents caveats to the conclusions of this analysis. Crucially, there are large differences in the cost/benefit calculus between Member States because of differences in the structures of banking systems and stages of

development of interbank markets, and the impact on smaller banks may be significantly different to that on large banks. Some interbank exposures also cannot, by their nature, be easily diversified or collateralised.

284. There are some important caveats to these results. First, the data relate only to those eleven members that have provided it. Second, there are significant cross-country differences that mean that the costs of imposing interbank limits in some countries would, presently, outweigh the benefits because of differences in the structures of national banking systems. Third, the role of ex-post intervention is ignored on both sides of the calculus: intervention would clearly reduce the cost of a crystallisation of systemic risk, but it would also give rise to moral hazard.

285. Fourth, the analysis ignores the non-systemic risk related benefits, which include the benefits of protecting banks whose failure would not precipitate a systemic crisis and the improvement in overall allocative efficiency associated with a reduction in moral hazard. Furthermore, the fact that a defined 25% own funds limit provides certainty regarding the maximum exposure any particular bank could have to a failed or failing institution is of value. On the other hand, it also does not capture any increased administrative costs.

286. A fifth and important caveat is that the analysis rests on deep, wide and liquid markets being available to all banks without undue cost. For the smallest banks that rely on a single counterparty effectively to access interbank markets on their behalf this might not be the case. Having to engage with multiple counterparties may incur significant costs for some of the smallest. It might even be that smaller institutions fail to find counterparties on an unsecured basis given the very limited amount that 25% of their own funds represents. On the other hand, doing so may increase the smaller banks' operational resilience and reduce the systemic impact of the failure of one major bank to which many smaller banks are exposed.

287. Sixth, increased demand for collateral occasioned by limits on unsecured interbank exposures could increase the price of such collateral, thereby increasing the costs. This would depend in large part on first, whether banks could in fact mostly diversify, rather than collateralise, exposures and second, the range of collateral available to reduce or extinguish exposures for the purposes of the limits. For example, only a limited proportion of European government debt is actively traded (although widening the range of collateral eligible for large exposures would help alleviate this problem). Furthermore, we assume that the secured/unsecured markets are efficient: we know that, in reality, they are not (e.g. sometimes unsecured rates dip below secured rates). Therefore the opportunity cost estimate might not be accurate.

288. A seventh caveat is a question over the extent to which all European banks have access to a sufficiently wide range of counterparties. CEBS considers that, since the passage of the Large Exposures Directive in 1991, European interbank markets have grown in breadth and depth. The introduction of the euro has given banks in the euro zone greater scope to engage with a wider range of counterparties and since the euro's introduction turnover in the unsecured and,

particularly, secured euro money markets have increased significantly[27]. Innovations such as the 1992 ISDA Master Agreements and, more recently, increased access to triparty repo facilities in euros, DbVs in Sterling and innovations such as Eurex Repo's Euro GC Pooling platform, have made netting or collateralising interbank exposures more cost effective.

289. Despite such developments in secured markets, in some Member States at least, there remains a question over whether there are a sufficient number of creditworthy counterparties to enable banks to diversify unsecured exposures without significantly reducing the average counterparty creditworthiness (collateralising might not always be desirable or appropriate) and/or being forced to engage in cross-border transactions. Despite the introduction of the euro, anecdotally it appears that banks prefer to do business with other domestic banks. On one hand the introduction of interbank limits could have an adverse effect on some banks' risk profiles. On the other, it could help foster the development of truly pan-European interbank money markets if it led to more cross-border interactions between European banks.

290. A final caveat is that there may be some unsecured interbank exposures that cannot be collateralised or otherwise extinguished without imposing disproportionate or inappropriate restrictions on banks' activities. These include, for example same day fx trades or unfunded credit derivatives (where there is counterparty as well as an underlying credit risk). If CEBS were to advise that limits be imposed on interbank exposures, we would need to be sure that they would not have unintended adverse effect on banks' capacity to carry out these important parts of their business.

Q30. What do you consider to be the implications of the caveats set out above for the conclusions of the cost/benefit analysis? Do you have any other comments on the cost/benefit analysis?

Conclusion

291. There is evidence to suggest that a market failure could exist with respect to large interbank exposures. In some Member States, the cost/benefit analysis suggests that the benefits of correcting this market failure outweigh the cost of any regulatory failure that intervention might introduce, although in other Member States this is not the case. Furthermore, the impact of introducing limits also varies depending on the size of the institution and the type of activity it engages in.

292. CEBS would welcome industry's views on this analysis, the assumptions underlying it and the appropriate parameter estimates to use in calculating the benefits of the limits. At this stage, CEBS has yet to conclude what the most appropriate treatment for interbank large exposures is but aims to do so in presenting its final response to the European Commission, after taking industry comments into account. CEBS will be considering whether a differentiated approach should be taken to institutions of different sizes and natures. CEBS will also consider a full range of policy options, including a reporting-only regime,

[27] Euro Money Market Study 2006, ECB (2007). Available at http://www.ecb.int/pub/pdf/other/euromoneymarketstudy200702en.pdf

hard limits based regimes featuring various degrees of national discretion, and other potential regulatory solutions.

Q31. Given the market failure and cost/benefit analysis set out above, what treatment would you consider appropriate for interbank exposures?

Q32. Would a 25% limit on all interbank exposures unduly affect institutions' ability to manage their liquidity? Should maturity of the exposure continue to play a role? CEBS would find any practical examples useful as aids to its thinking (CEBS would not disclose confidential information).

Q33. If you believe there is a market failure but a hard 25% limit would not be appropriate, what would you consider an appropriate treatment for interbank exposures?

Chapter 9. Breach of limits

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

- Art 106 provides that "all elements entirely covered by own funds may, with the agreement of the competent authorities, be excluded from the determination of exposures"
- the institution reports quarterly all cases where the limits laid down in Art. 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.

294. CEBS has observed that there is a broad range of practices across Member States regarding the supervisory reaction to a breach of the banking book limits. Therefore CEBS deems it necessary to obtain convergence on this aspect to avoid competitive distortion.

295. CEBS notes that apart from the treatment of excesses for the trading book there are other circumstances where the breach of limits is understandable, for instance, when the excess is caused by reason of an affiliation between previously unconnected counterparties, or an affiliation between the institution itself and another. However, it should be pointed out the impossibility to

increase the value of the exposure, as well as the need to define a maximum time period to bring the exposure into compliance with the limits.

296. CEBS' view is that limit breaches in situations other than the ones considered above, should not be accepted, as provided for in the current regime.

297. From this perspective, because of the backstop nature of the regime, whenever a breach occurs, it should trigger a prompt response from the supervisory authority.

298. CEBS has discussed three possible supervisory reactions to a breach of the limits.

299. The first option is not to accept the breach at all. In that case the required actions to be considered by the institution are, separately or in combination, exposure reduction, the use of credit risk mitigation techniques or an increase of own funds in order to come back within the rule. (The institution would need an increase in capital equivalent to four times the extent of the breach).

300. The second option is that supervisory authorities agree with the institution an adjustment period in order to facilitate institution's return to a compliant situation. As noted above, Art 106 paragraph 3 of the CRD provides for that a breach can be maintained over a certain period of time provided the deduction of the excess from own funds

301. The third option considered by CEBS is that the breach can be maintained over a longer period of time provided there is deduction of the excess from own funds. In this case, supervisory authorities would require a minimum capital level not lower than the sum of the Pillar 1 and Pillar 2 requirements and coverage of the limit excess in order to accept the breach of the limits for an extended period of time. Besides the own funds coverage of the excess, supervisory authorities would also take into consideration other circumstances such as the total level of own funds, the compliance history of the institution and a rigorous assessment of the internal management and reporting of large exposures.

302. The question when a deduction of the excess from own funds is allowed is (i) should the entire exposure be covered by own funds; or (ii) should only that portion of the exposure that is in excess of the large exposures limit be deducted from own funds.

Q34. Respondents' views on the approaches to non trading book breaches of the limits would be welcomed. Please explain your views and provide examples and feedback on relevant costs and benefits.

Chapter 10. Reporting issues

303. This chapter considers the options for reporting large exposures.

304. The CRD requires the reporting of large exposures to the competent authorities. In CEBS' review of industry practices carried out during 2006, it emerged that institutions have internal policies and procedures for reporting large exposures on a regular basis, though with the frequency varying by institution. For some

institutions these internal reports are based on the regulatory reporting requirements. Regulatory reporting of large exposures varies between different Member States.

305. CEBS has given some consideration to the purposes of this reporting and recognizes, that in order to create a useful reporting framework which meets the need of the supervisors without demanding too much of the institutions, it is necessary to define the purpose and objective of the reporting.

306. CEBS is of the opinion that the most important objective that should be met by the reporting is allowing the supervisors to be informed in time when concentration risk occurs.

307. The reporting should also allow the supervisors to make comparisons between institutions regarding their single name concentration risks.

308. Data on concentrations of bilateral exposures between financial institutions are also needed for a full assessment of systemic risk - to understand and quantify how a shock could spread through a system, and to identify the financial institutions that are important from a systemic risk point of view, for analysis both ex ante and in a crisis. Therefore it is crucial that these data cover all types of secured and unsecured exposures (across the full range of financial instruments) and that they are for consolidated entities.

309. The supervisory reports could also be considered as a tool to ensure the awareness of the institutions of their exposures exceeding 10 % of their own funds.

310. CEBS has considered several possible options regarding reporting:

1. Pillar 3 reporting:

    - apart from additional capital requirements due to large exposures[28], currently no Pillar 3 reporting on individual large exposures is requested;

    - CEBS believes that it would be too burdensome for the institutions to provide a full overview of their individual large exposures on a regular basis within their Pillar 3 reporting.

2. Reporting to supervisory authorities based on financial institutions' internal reports:

    - allowing internal reporting would reduce the burden on the institutions;

    - it could be difficult for the supervisors to make comparisons between institutions; and

    - internal processing of the reports by the supervisors might be difficult. This in turn could have repercussions for the institutions due to an

[28] Directive 2006/48/EC: annex XII, part 2, point 9.

increased amount of questions and requests for delivery of additional data to supervisors.

3. Reporting to supervisory authorities based on reports defined by the supervisors:

    - this option would allow supervisors to analyse on a horizontal basis the large exposures of the institutions and make comparisons between them;

    - the internal processing of all data received by the supervisors would be facilitated;

    - the reporting burden for the institutions could be minimised by installing harmonized reporting at the European level, meaning an identical template with unique definitions for the information requested; and

    - the proposed increased alignment between the calculation of large exposures and risk weighted assets is expected to reduce the burden for institutions with regard to reporting.

311. The frequency of the reporting could be a trade-off between a defined reporting frequency (e.g. on a quarterly basis) or event reporting (only reporting when a defined event took place, e.g. exposure exceeded x% of own funds).

312. Regular reporting would allow supervisors to analyse ex ante the risk within the backstop regime. It would also allow institutions for further support internally to carry out the internal reporting (as indicated by some institutions in the industry stock take).

313. CEBS is of the opinion that the review of the large exposures regime is a good opportunity to consider the purpose of reporting large exposures and where there might be opportunities for harmonisation. Therefore it supports regular reporting with reports defined by the regulators/supervisors. In addition to the standard prudential reporting, the immediate reporting of breaches of the backstop limit would be necessary.

Q35. What are your views on the 3 reporting options? Please explain and provide feedback on the costs/benefits of CEBS' initial views.

Q36. Do you support CEBS' thinking on the purpose and the benefits of regular reporting using predefined reporting templates?

314. Further, CEBS proposes that the key elements within a large exposures reporting regime might include:

    - reporting of large exposures should be based on gross exposure values. So all exposures over 10 % of the own funds/consolidated own funds of the reporting institution should be reported, despite the fact that the exposure after applying credit mitigation techniques (CRM) or full or partial exemption would be under 10 %;

- gross exposure value in the context of the large exposures regime means exposure net of value adjustments and provisions;

- net exposure value as well as CRMs used should be included in the reporting template;

- in cases when the substitution principle of 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;

- all intra- group and Interbank exposures should be reported regardless of the decision on whether or not to impose limits on those exposures;

- exposures exempted from the imposition of the limits, for example because of their 0 % risk weight in the capital adequacy framework, should be reported;

- even though reporting would be based on the gross values, 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; and

- the aggregated exposure of all counterparties belonging to the same group (group of connected clients) is relevant for triggering the reporting obligation as well as obeying the large exposure limit. In this respect the composition of a group of connected clients is crucial for the scope of institutions' lending. In order to allow the supervisors to verify that institutions comply with such rules the institutions should indicate the composition of the group in their reports.

315. CEBS is also considering whether breaches of the backstop limit should be included in the disclosure requirements of Pillar 3.

316. CEBS recognizes the need for the harmonization of large exposures' reporting based on the current structure of the reporting framework and future developments. CEBS will consider developments on the reporting frameworks and will take them into consideration in its further work on large exposures.

Q37. What is your opinion on CEBS' initial thinking regarding the elements to be reported under the large exposures regime?

Chapter 11. Credit risk management

317. The Basel II approach introduces incentives to good practices through a dual system that implies that only banks qualified as advanced can benefit from a major freedom in calculating the measure of risk. However, no matter the sophistication in risk calculus, the minimum solvency ratio is always fixed at 8%.

318. CEBS has considered if there is merit in analysing to what extent this feature can be translated to the large exposure limits.

319. CEBS has previously proposed that the purpose of a large exposures regime is to address unforeseen event risk. Given this, it is not possible to think of an

institution subject to credit risk and not subject to a potential event risk due to an excessive exposure to a counterparty.

320. However it is possible that not all institutions have the same incentives/ possibilities to manage this risk by diversifying their portfolios.

321. Large banks by definition are in a better position to diversify their portfolios. Indeed some large banks stated that these limits are not so effective for them as for small banks. They said that they set internal limits stricter than the regulatory limits. Moreover they are usually rated by credit rating agencies and therefore more subject to market discipline.

322. However, the results of an analysis conducted by CEBS based on data from large exposures reporting of the five largest banks in each country were that the 25% limit can bite even on large banking groups in a significant number of countries, although it seems that for other countries this limit does not constitute a real constraint[29].

323. Although it is true that it is less likely for a large institution to incur a large exposure it cannot be completely ruled out (e.g. corporate loans).

324. Another consideration is that in terms of market value for certain counterparties, 25% of the capital of a large bank could represent a big percentage in terms of the capitalization of the counterparty thus adding liquidity problems to the solvency problems.

325. CEBS' orientation is that the market failure analysis does not justify exempting from the large exposure limits the advanced institutions even where they have sophisticated systems and controls. CEBS has previously noted, that it considers a large exposures regime to be a back stop limit based regime to address unforeseen event risk. Part 1 Advice noted some examples of such events including unidentified fraud within a counterparty, the default of a counterparty because of unforeseen government action, loss of a major customer or market, or an unexpected breakdown in the validity of the institutions business model.

326. However, CEBS' opinion is that the recognition, 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 net exposure value to which the limits are applied.

Q38. Do you agree with CEBS' views on the recognition of good credit management? Please explain your views.

[29] We have to bear in mind that the largest five banks in each country could mean very different things in terms of size, but also in terms of business profile. Some of these differences could explain the different picture we have for the different countries. Also there could be different credit mitigation policies that if taken into account would lead to a more balanced picture.

Annex 1. High Level Impact Assessment of policy options

1. The purpose of this Annex is to outline, in very broad terms, the possible consequences of the six policy options set out in Chapter 2 of the first part of CEBS' technical advice to the European Commission on the review of the large exposures rules. These options include:

    1. no specific regime (i.e., remove existing regime);
    2. Pillar 2 (i.e., based on firms' own assessments and supervisory review);
    3. market discipline enforced by Pillar 3 disclosure;
    4. market discipline enforced by rating agencies;
    5. (maintain/amend) current regime; and
    6. amended limit based backstop regime.

2. This Annex describes the costs and benefits that may arise under each of the policy options. These impacts are all discussed relative to a baseline, which, in this case, we take to be the current large exposures regime. For example, in describing the effects of option 1 (removing the existing regime), we set out the 'marginal' -- or incremental -- effects that may occur when eliminating the formal regulatory requirements of the current regime. Costs include those incurred by supervisors (direct costs) and firms (compliance costs), as well as opportunity costs and other indirect costs (for instance, changes in the quantity, quality or variety of lending, or changes in the effectiveness of competition). Indirect costs could also include a reduction in benefits that derive from the current regime or unintended risks that might arise from a certain regulatory intervention.[30] Indirect effects tend to be the most important issues in weighing policy measures, but, at the same time, they are typically the most challenging to assess and, in particular, quantify. Where possible, the note distinguishes between costs that are likely to be fixed and those that may vary with quantity, and also between those costs that are likely to be one-off costs and those costs that may be on-going.

3. Benefits may include reductions in costs (mentioned above) that could derive from policy measures. While it is useful to understand this impact, the indirect, marginal benefits are usually the most important in assessing the merits of regulatory intervention. These would encompass the influences that policy may have on, for example, market confidence and financial stability more widely.

[30] An often cited example of such an indirect effect relates to increased moral hazard, or risk-taking incentives, that derive from lender of last resort facilities or deposit insurance schemes. Policymakers need to weigh such effects carefully in the light of the attendant benefits (e.g., increased financial stability and market confidence) that such mechanisms are designed to produce.

4. This Annex includes a high level qualitative assessment of the potential impacts of the various high level policy options that have been considered as part of this review. Although discussed as separate and distinct options below, several of the options under consideration subsume one another. For instance, the effects of options 1 (i.e., removing the regime altogether) and 4 (i.e., market discipline enforced by rating agencies) need to be considered together in evaluating the former. For that reason, it is difficult to evaluate the merits and draw conclusions about some of these options on their own. Nevertheless, key highlights and suggestions for further work are as follows:

- A common benefit of removing the large exposures regime (under Options 1 to 4) would be an on-going reduction in systems and regulatory reporting costs. These benefits need to be weighed carefully in the light of indirect costs that could arise from the loss of 'critical' regulatory information on large exposures. That is, the loss of such information may adversely impact supervisory (risk-based) resource allocation and approaches. To the extent that the lack of these data results in inefficient direction of supervisory resources, this shortfall could reduce the likelihood of timely detection and resolution not only of large exposure risks but also other systemically important risks. Both effects could translate into higher expected resolution costs overall. Such costs depend on the extent to which supervisors currently rely on regulatory reporting information in monitoring and addressing unforeseen event risk in regards to single name borrowers.

- Allowing firms to manage large exposures using internal models/ practices and to hold capital for unforeseen event risk that derives from exposure to single name borrowers (set out in option 2) may produce significant benefits, including those discussed above. This approach would, among other things, afford greater flexibility in the management of large exposures and better align the management of this risk with internal economic capital models. Because this process would be subject to supervisory review, another key benefit would be increased incentives to improve risk management practices and economic capital planning with respect to unforeseen event risk (i.e., to reduce regulatory capital costs). Again, however, the benefits would need to be considered in the light of the potential costs arising from the loss of routine, standardized regulatory report data (as described above). There may also be further costs, including capital compliance costs, and implications for competition in the market for large exposures if Pillar 2 supervisory reviews are not consistent.

- Reliance only on market mechanisms to address unforeseen event risk (set out under options 3 and 4) may have further benefits beyond the reduction of systems and reporting costs noted above. These include increased flexibility afforded to institutions in the way that they manage large exposures and heightened incentives to improve transparency of large exposures and their underlying risk management practices. This latter benefit will depend on the extent to which market confidence is affected by the presence of a large exposures regime and the extent to which firms are exposed to market discipline (e.g., imposed by rating agencies or other key counterparties that routinely evaluate the risk

profile of an institution in pricing contracts with/securities issued by them).

5. The potential shortcomings of relying on market discipline mean that an amended backstop limit (option 6) may be the most proportionate policy to adopt, although this will depend somewhat on exactly how the current limits based regime is amended. The costs and benefits under this approach will depend on whether the amendments increase regulation or introduce deregulatory measures for some types of firms and exposures. Increased regulation may lead to cost increases for firms if further regulatory reporting and exposures monitoring is required. However, the benefits resulting from increased systemic stability and reduced risk of failure and contagion may be significant.

Option 1 - No specific regime

6. This section outlines the potential impacts of removing the existing large exposures regime altogether.[31] Under this scenario, institutions would be free to operate within their own internal practices. The degree to which firms expose themselves to unforeseen event risk with respect to single name counterparties would, in this setting, not be constrained by regulatory limits. Instead, it would depend on, among other things, firms' risk appetites and (the quality of their) risk management and corporate governance practices (including systems and controls). Such exposure would also be influenced by supervisory oversight as well as market discipline (e.g., imposed by credit rating agencies or key counterparties). As noted below, however, the absence of a formal reporting requirement similar to that under the current regime could affect these external forces in influencing institutions' management of large exposures and unforeseen event risk in particular.

Direct costs

7. Loss of regulatory reporting information could have a negative effect on the ability of supervisors to monitor and evaluate banks' exposures to large, single name counterparties in between routine on-site inspections or examinations to the extent that these are conducted.[32] This problem could be especially pronounced in countries that do not undertake regular on-site examination of banks and, instead, rely on reported information in evaluating institutions' risk profiles.

8. The loss of standardized regulatory reporting information would also impede supervisors' ability to compare large exposure risk, which could have

[31] The option would effectively involve the removal of Title 5, Chapter 2, Section 5 of the Directive 2006/48/EC and Chapter V, Section 4 of the Directive 2006/49/EC.

[32] The final report on the 'Supervisory Stock Take on Large Exposures' issued by CEBS in April 2006 noted that all Member States require immediate reporting of any breaches of large exposures limits as well as an explanation of their underlying causes. Under the Capital Requirements Directive, Member States are allowed to collect large exposures report information annually or quarterly. The report indicates that no Member State had chosen the annual reporting option, with the majority requiring quarterly reporting and a few receiving monthly or semi-annual reports. This background suggests the importance of these data to supervisors in their ongoing surveillance of large exposures risks.

negative implications for countries that rely on this information in allocating supervisory resources or in risk-focusing efforts. This could give rise to inefficiencies in the use of supervisory resources.

9. The loss of key regulatory report information may prompt more on-site supervision and/or requests for other information (e.g., management information reports). Increased on-site supervision and/or data requests may require additional supervisory staff (both one-off and on-going costs).

10. If regulators were to rely on internal, firm-specific management information reports to monitor concentration risk and large exposures risk in particular, there could be an increase in processing costs. (This could, as described below, have repercussions for institutions due to an increased amount of questions and requests for delivery of such data.)

Compliance costs

11. There will be an immediate (and on-going) impact on the costs of regulatory reporting, the net effects of which may depend on supervisory and market responses. While the on-going reporting costs of the existing regime will decrease, the responses that supervisors and markets make to deal with the loss of regulatory information could have cost implications. For example, supervisors could demand more information from firms regarding their exposures and supervision of large credits. This information could take the form of information already produced by institutions' management information systems. As a result, the costs of providing such information to regulators may be minimal. On the other hand, if national supervisors use their discretion to demand information different from that used by institutions in their management of large exposures, this could entail both significant one-off and on-going reporting costs.

12. To the extent that the market relies on the current regulatory regime to contain risk to single name borrowers and unforeseen event risk, then the absence of formal, regulatory requirements may prompt the market to demand additional information to evaluate this risk.

13. There may be costs associated with additional management time and resources in dealing with potentially more on-site supervision or increased supervisory data requests to offset loss of regulatory reporting data. This effect could be especially pronounced in cases where the supervisors currently rely on large exposures reporting data to evaluate/monitor risk.

Indirect costs

14. The lack of a large exposures regime of any kind could adversely affect the benefits that underlie the purpose of the regime. Those benefits include a reduction in the likelihood of a significant disruption to the business operations and credit facilitation processes of banks due to unforeseen event risk and exposures to single name counterparties in particular. To the extent that the existing regime lessens this chance, then this probability could increase in the absence of a large exposures regime and ostensibly have further cost implications for the economy more broadly. However, this

may be mitigated to the extent that supervisors decide that it is necessary to undertake increased supervision.

15. There may be a reduction in market confidence (to the extent that a regime contributes to market confidence) which could impact on creditors' cost of capital.

16. There is the potential for a negative impact on market discipline to occur to the extent that rating agencies rely on, for example, the regulatory limits and reporting requirements in making judgments about firms' financial condition, concentration risk and exposure to single name counterparties. Any reduction in market discipline could lead to increased costs arising to the extent that it increases risks in the system.

17. The loss of regulatory report information may reduce supervisors' abilities to monitor and evaluate concentrations of bilateral exposures among financial institutions and therefore systemic risk. This shortfall could lessen the chance of identifying potentially important systemic risks before they crystallise and could increase the expected costs of systemic problems.

18. The loss of regulatory report information on, for example, breaches of large exposures limits may also cause supervisors to lose information useful for assessing wider control issues. This could lead to increased losses and likelihood of insolvency by creditors more broadly. As described above, it could also prompt supervisors to take a more rigorous, on-site approach to assessing risks that could have cost implications for institutions.

Benefits

19. Dropping formal regulatory requirements surrounding large exposures will afford institutions more flexibility in their management of large exposures and unforeseen event risk in particular. These benefits could be limited for smaller firms that tend to rely on the existing large exposures regime as a framework for measuring, monitoring, and managing large exposures. In addition, large firms typically manage large exposures using systems that are separate and distinct from the large exposures regime, so a key benefit of this proposal would most likely be limited to the reduction in unnecessary systems/reporting costs (noted above) to comply with regulatory requirements.

20. There may be a reduction in opportunity costs to the extent that the existing regime constrains firms' abilities to lend or forces them to turn away business (e.g., M&A financing). These benefits could be limited, as most firms (especially the largest firms) indicated that existing large exposures limits do not constrain their lending.

21. Dropping large exposures limits may increase competition in the market for large credits as there would be no regulatory lending limits beyond those imposed by regulatory capital constraints, internal lending standards or perhaps market discipline/forces. We do not have evidence that, in the absence of large exposures limits, competition would increase. This increased competition could potentially reduce borrower costs (although this

effect could be limited by the extent to which firms have the resources/abilities to evaluate and monitor large loans).

Option 2 – Large exposures dealt with under Pillar 2

22. This section outlines the potential impacts of removing the existing large exposures regime altogether[33] and allowing firms to manage large exposures/unforeseen event risk under their own process subject to supervisory review. Under this scenario, institutions would be free to operate within their own internal practice. Firms would be expected, in their capital planning and assessment process, to consider concentration and unforeseen event risk associated with exposure to single name counterparties. They would be required to demonstrate how these considerations are reflected in their capital assessments and make adjustments on the basis of supervisors' assessments of that process.

23. The degree to which firms expose themselves to unforeseen event risk with respect to single name counterparties would, in this setting, not be constrained by regulatory limits, but instead, would depend on, among other things, firms' risk appetites and (the quality of their) risk management and corporate governance practices (including systems and controls). Such exposure would also be influenced by supervisory oversight as well as market discipline imposed, for example, by credit rating agencies or key counterparties. As noted below, however, the efficacy of these influences could be severely hindered in a setting with no formal regulatory reporting requirements similar to those under the existing large exposures regime.

24. Under this option, the current regime would be removed and firms would be permitted to operate within their own internal practice subject to their own constraints and national supervisory review under Pillar 2.

Direct Costs

25. Many of the direct costs discussed under option 1 (removing the regime altogether) apply to this proposal as well. These costs would include, among other things, those that may derive from the loss of key regulatory report information: sub-optimal direction/use of supervisory resources, need for additional supervisory review staff (e.g., to train supervisors in evaluating and for on-going validation and monitoring of large exposures risk), increased supervisory resources to deal with the transitory and highly complex nature of many large exposures. This may require significant specialist supervisory resources to review these exposures effectively (e.g., M&A exposures are typically short-lived and Pillar 2 reviews may be after the event in many cases).

26. In case of failures because of large exposures, legal risk for the regulator would increase as moral hazard has increased.

Compliance Costs

[33] The option would effectively involve the removal of Title 5, Chapter 2, Section 5 of the Directive 2006/48/EC and Chapter V, Section 4 of the Directive 2006/49/EC.

27. Many of the compliance costs described under option 1 may also extend to this option (e.g., possible increased costs associated with additional resources and time dealing with increased supervisory reviews and information requests; possible impact on reporting costs, since reporting may need to be changed to reflect the nature and duration of the exposures in question).

28. The details and the amount of information that the regulator requires should change in nature. More senior involvement would be required to address Pillar 2 requirements. A higher reporting/disclosing frequency may be warranted and so higher on-going compliance costs may arise.

29. There is the potential for an increase in capital compliance costs (compared with a regime that does not deal with single name counterparty risk in Pillar 2) to the extent that regulators impose high capital charges for exposures to single name counterparties.

Indirect Costs

30. Variations in implementation of Pillar 2 across Member States may inevitably lead to competitive distortions with a possible mixture of capital and non-capital supervisory treatment, especially during the early stages of the new Pillar 2 regime.

31. There may be uncertainty among market participants over the potential maximum exposure size of lenders'/banks' counterparties since different institutions would inevitably come to different conclusions with individual supervisors on the maximum acceptable size of exposures allowed. This may cause institutions to unduly restrict their large lending and so the quantity of large lending may reduce and additional opportunity costs may arise.

32. There is a risk that a Pillar 2 regime will not be able to constrain large exposure lending to the same extent as hard limits and this may result in a greater probability of firm failure (and associated economic costs) due to unforeseen event risk with regards to single name counterparties.

Benefits

33. A Pillar 2 approach may afford increased flexibility to firms in their management of large exposures. This benefit may be limited to the extent that firms already rely on their own internal processes and assessments in managing this type of risk.

34. This approach could encourage on-going improvement in the risk measurement, monitoring and management practices of firms with regards to unforeseen event risk, which could, in turn, strengthen financial stability. However, if validation of large exposures management is regarded as a Corse's patent by the regulated entity, greater moral hazard would arise and less financial stability would result.

35. A Pillar 2 regime may also provide increased incentives to firms to improve market disclosures surrounding their large exposures risk/management. To

the extent that this is information is timely and useful it could lead to increased market confidence.

36. New business opportunities may materialise as more tailored assessment by the regulator could allow institutions to take on larger exposures than is currently the case. This may increase the quantity of large lending and could reduce opportunity costs to the extent that current limits bite on institutions.

37. The structuring of deals (e.g., monthly payments instead of half yearly payments) will be in accordance with business needs and will not result from the wish to avoid the impact of the large exposures limits. This could result in lower opportunity costs for firms.

Option 3 - Market discipline through Pillar 3 disclosure

38. This section outlines the potential impacts of removing the existing large exposures regime altogether and requiring firms to disclose their large exposures to the market through Pillar 3 disclosure mechanisms. Under this scenario, institutions would be free to operate within their own internal practice but would be required to disclose their large exposures to the market on a timely basis.

39. The degree to which firms expose themselves to unforeseen event risk with respect to single name counterparties would, in this setting, not be constrained by regulatory limits, but instead, would depend on, among other things, firms' risk appetites and (the quality of their) risk management and corporate governance practices (including systems and controls). Their exposures would also be influenced by the market discipline imposed by key stakeholders, including depositors, debt holders and stockholders, as well as by ratings agencies.

Direct costs

40. There may be additional costs for regulators who will be required to monitor the Pillar 3 disclosures to ensure that firms are complying with the disclosure requirements. However, there may be some reductions in direct costs if the regulator no longer needs to deal with the large exposures information and to the extent that supervisors do not need to focus on large exposures issues (i.e. they let market discipline take its course).

Compliance costs

41. To the extent that market participants require greater amounts of information to be disclosed (to ensure that it is properly understood) then additional compliance costs may arise for firms. The format for disclosure may also need to change to suit the needs of the market rather than the regulator and this may impose additional costs on firms. A higher reporting/disclosure frequency is also likely to be warranted under this approach and this may lead to additional staff and systems costs. So, both one-off and on-going compliance costs may arise.

42. To the extent that disclosure requirements differ between jurisdictions, there may be additional costs to firms that are internationally active.

Indirect costs

43. For firms that are not exposed to significant levels of market discipline (e.g., small firms with stock that does not trade actively), market discipline may not be effective, potentially increasing the chance that these firms could fail due to unforeseen event risk associated with large, single name borrowers.

44. The maximum exposure to a unique counterparty would be determined by private market players, so its level may not necessarily take into account the externalities associated with a failing counterparty for the whole system. The intra-group exposures may, for example, be assessed more loosely (or not at all if such information is not disclosed to the market). Moreover, depositors will not necessarily play a role as they may find it difficult to understand the associated risk, and act accordingly. To the extent that these two issues mean that market discipline does not result in socially optimal levels of large exposure lending then there may be additional costs through increased risk of firm failure and the economic costs that this may involve.

45. Key stakeholders may incur large costs from analysing the data that is disclosed. In particular, small investors or depositors may find it difficult to interpret properly the publicly available data.

46. If firms do not wish to disclose large lending, they may stop undertaking this activity or try to find other ways so that they do not need to disclose (this will depend on disclosure criteria and, for example, the definition of large exposures under a Pillar 3 regime). But this is likely to lead to increased costs and may militate against market discipline working effectively.

47. There is some risk that market discipline will not necessarily result in socially optimal levels of lending. This may mean that some lending may not take place or the size of some individual lending may be larger than the socially optimal level. This will only lead to additional costs to the extent that the limits imposed through market discipline are less optimal than those included in the current limits based regime.[34]

Benefits

48. There may be increased market confidence to the extent that there is a reduced probability of failure due to an unforeseen event in respect of single name concentration risk. Benefits will arise to the extent that the probability of failure is reduced and a 'safer' financial system may lead to a lower cost of capital for market participants. However, the extent to which benefits may arise will depend on the market's ability to evaluate properly the information that is disclosed and price contracts to influence lenders' behaviour, and to the extent that this market discipline imposes more

[34] No view has been taken here on whether the current limits are optimal, or otherwise, from a cost/benefit point of view.

socially optimal lending decisions than the current regime. This will also depend on the level and timeliness of banks' transparency regarding exposures to large, single name counterparties. In short, these benefits will result if disclosure is a) relevant, so that it is able to inform market players and b) reliable, so that the information provided is accurate.

49. There may be a reduction in opportunity costs for firms if the market judges that exposures can be greater than those allowed under the current limits. In addition, the structuring of deals may be made more in accordance with business needs rather than a wish to avoid the impact of the large exposures limits.

50. New business opportunities may materialise if the market judges that the limits currently set by the regulators are too low.

51. The structuring of deals (e.g., monthly payments instead of half yearly payments) will be in accordance with business needs and will not result from the wish to avoid the impact of the large exposures limits.

Option 4 - Market discipline enforced by ratings agencies

52. This section outlines the potential impacts of removing the existing large exposures regime altogether and relying only on market forces to influence risk management of large exposures.[35] The impacts are informed, in large part, by our understanding of how rating agencies approach the evaluation of large exposures risk and the role this plays in influencing firms' decisions under the existing regime.[36] Under this scenario, institutions would be free to operate within their own internal practice. The degree to which firms expose themselves to unforeseen event risk with respect to single name counterparties would, in this setting, not be constrained by regulatory limits. Instead, such exposures would depend on, among other things, firms' risk appetites and (the quality of their) risk management and corporate governance practices (including systems and controls). They may also be influenced by supervisory oversight as well as market discipline imposed, for example, by credit rating agencies or key counterparties. Because institutions' cost of capital depends, in part, on external credit ratings, and management may often target a particular rating (typically more favourable than the implicit rating consistent with the regulator's risk appetite), they are motivated to satisfy rating agencies about systems and controls over large exposures and their risk management practices in this area more broadly.

Approaches of Rating Agencies

53. Concentration risk forms an important part of rating agencies' assessment of a financial institution's risk profile. Rating agencies adopt a mixture of quantitative and qualitative approaches when making such assessments. The assessment commences with a review of a list of large exposures to

[35] The option would effectively involve the removal of Title 5, Chapter 2, Section 5 of the Directive 2006/48/EC and Chapter V, Section 4 of the Directive 2006/49/EC.
[36] This understanding is based on the CEBS's discussions with two large rating agencies (see paragraphs 72 to 87 of CP14 for more detail).

counterparties or groups of related counterparties, where exposure is measured as gross exposure (i.e., independent of, say, collateral or the credit quality of the counterparty). The list forms the basis for initial discussions with management. In these two regards, it is not significantly different from the information and use of regulatory report information under the existing large exposures regime. On the other hand, rating agencies indicated that it was important also to take into account the credit quality of single name counterparties on this list when assigning their overall ratings.

54. Overall, rating agencies do consider concentration risk when they assign ratings to financial institutions. Rating agencies indicated, however, that the regulatory and supervisory setting in which a financial institution conducts business is a material consideration in rating agencies' assessments. This makes it difficult to disentangle the effects of the rating agencies from the regulatory framework on firms' management practices surrounding concentration risks.[37] In what follows, we attempt to describe the possible effects of relying on market discipline imposed by rating agencies in the absence of a regulatory regime over large exposures. Many of the effects described under Option 1 (removal of the large exposures regime altogether) are similar under this option.

Direct costs

55. Many of the direct costs discussed under option 1 (removing the regime altogether) apply under this proposal as well. Among other things, these costs would include those that may derive from the loss of key regulatory report information: sub-optimal direction/use of supervisory resources, need for additional supervisory review staff (e.g., to train supervisors in evaluating and for on-going validation and monitoring of large exposures risk), increased supervisory resources to deal with the transitory and highly complex nature of many large exposures. The loss of regulatory report information could potentially lead to other effects, some of which are described in more detail under the indirect costs below.

56. If regulators were to rely on internal, firm-specific management information reports to monitor concentration risk and large exposures risk in particular, there could be an increase in processing costs (this could have repercussions for institutions due to an increased number of questions and requests for delivery of such data).

57. To the extent that regulators place more reliance on credit rating agencies in disciplining risk taking by firms, there may be increased (one-off and on-going) costs associated with interacting with rating agencies to gain a better understanding of their assessment processes and to evaluate the efficacy of their rating processes.

Compliance costs

[37] The perceived likelihood of government intervention for trouble institutions may further complicate this assessment.

58. There may be a reduction in compliance costs if firms are no longer required to comply with the current regime. However, there may be additional time and resources (and costs) associated with potentially more on-site supervision or in dealing with increased supervisory data requests to offset loss of regulatory reporting data (this effect could be especially pronounced in cases where the supervisors currently rely on large exposures reporting data to evaluate/monitor risk).

Indirect costs

59. The lack of a large exposures regime of any kind could adversely affect the benefits that underlie the purpose of the regime. Those benefits include a reduction in the likelihood of a significant disruption to the business operations and credit facilitation processes of banks due to unforeseen event risk and exposures to single name counterparties in particular. To the extent that the existing regime lessens this chance, then this probability could increase in the absence of a large exposures regime and ostensibly have further cost implications for the economy more broadly.

60. The loss of market confidence (e.g., to the extent that events undermine the credibility of credit rating agencies) could impact creditors' cost of capital[38].

61. There may be a negative impact on market discipline to the extent that rating agencies rely on, for example, the regulatory limits and reporting requirements in making judgments about firms' financial condition, concentration risk and exposure to single name counterparties.

62. The loss of key information on breaches of large exposures limits may also cause supervisors to lose information deemed useful for assessing wider control issues. This could lead to increased losses and the likelihood of insolvency by creditors more broadly.

63. The loss of standardized reporting information would reduce the ability of supervisors to monitor and evaluate concentrations of bilateral exposures among financial institutions and therefore systemic risk. This could reduce their ability to monitor unforeseen event risk (to single name counterparties) on a timely basis, which could ostensibly reduce the chance of identifying and mitigating problems before they crystallise. This shortcoming could increase the expected costs of bank failures.

Benefits

64. There will be more flexibility for firms in managing large exposures and unforeseen event risk in particular (these benefits could be limited for smaller firms that tend to rely on the existing large exposures regime as a framework for measuring, monitoring, and managing large exposures). It is also the case that large firms typically manage large exposures using systems that are separate and distinct from the large exposures regime, so the benefits of this proposal would most likely be limited to the reduction in

[38] Recent market turmoil suggests that 'missed' or incorrect credit ratings can have significant implications for the market's confidence in these assessments which can have more widespread market confidence problems.

unnecessary systems/reporting costs (noted above) to comply with regulatory requirements.

65. There could be a reduction in opportunity costs (to the extent that the existing regime constrains firms' abilities to lend or forces them to turn away business (e.g., M&A financing). These benefits could be limited, as most firms (especially the largest firms) indicated that existing large exposures limits do not constrain their lending.

66. There may be increased competition in the market for large credits as there would be no regulatory lending limits beyond those imposed by regulatory capital constraints, internal lending standards or perhaps market discipline/forces. This could potentially reduce borrower costs (although this effect could be limited by the extent to which firms have the resources/abilities to evaluate and monitor large loans).

Option 5 - Current Regime

67. The current regime is being used as the baseline against which the high-level description of costs and benefits of the various policy options have been considered. The regime is essentially a backstop limits based regime.

68. The current regime may exhibit some instances of regulatory failure in that it covers certain types of exposures or types of firms for which there is no good case to suggest that material market failures exist. In addition, there may be some areas that are currently exempt from the large exposures regime but for which there may be a case to include them in the regime.

69. Although the current regime is being used as the baseline against which the high level description of benefits and costs of the other policy options are assessed, it is worthwhile describing some of the features of the current regime. Further information on the costs[39] associated with the current regime can be found in Annex 2.

70. Some other features of the current regime are described below:

- The current regime is essentially a limits based backstop regime but there is no clearly stated underlying rationale for having the regime. 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' intention to propose a reduction in 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).

[39] Where we have referred to costs they simply indicate what the costs of running the current regime are (they have been evaluated as part of consideration of the current costs of the regime) and are used to give the reader a sense of the actual regulatory costs of the regime. Where we have referred to costs and benefits under other policy options then they are in comparison to the costs of the current regime.

- 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 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"[40] 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.

- Some further consideration of whether additional capital requirements have a role to play, and if so what role, in a backstop regime is required (particularly with regard to the current scale of capital charges for excess large exposures in the trading book).

Option 6 – Amended limit based backstop regime

71. This section outlines the potential impacts of making various adjustments to the existing large exposures regime. Under this scenario, there may be adjustments to the types of exposures and/or the types of firms that are covered by the large exposures regime. However, regulatory limits would still apply where firms continue to be covered by the large exposures regime.

72. An amended limit backstop regime, properly designed and implemented, has the potential to lead to net benefits arising when compared with the current large exposures regime. Further analysis of the various types of institutions and exposures for which the large exposures regime may reasonably be applied is still being carried out, but there may be scope for removing large exposures requirements in certain circumstances and for adding large exposures requirements in some areas. However, imposing the large exposures regime on firms/exposures that are currently exempt may result in additional costs.

73. For the sake of simplicity, this section has been split depending on whether the amendments increase the requirements or decrease the requirements.

Increasing Requirements

Direct Costs

74. There will be increased costs to supervisors who will be required to spend resources on monitoring the new firms. These may include increased staffing costs which will be on-going and potentially some further systems costs. The extent of these costs will depend on whether staff and resources used in monitoring firms no longer within the scope of the large exposures regime can be effectively transferred to monitor the new firms.

Compliance Costs

[40] Article 4 (45)

75. There will be increased costs to the firms who are subject to the new regulation. Firms may have to set up new systems to collect and analyse their exposures and may have to employ further staff. Larger firms that are currently subject to the large exposures regime have indicated that they tend to have their own risk monitoring systems and that the regulatory requirements lead them to spend additional resources on meeting their regulatory requirements that they would not otherwise have to do. This could be similar for new firms brought within the scope of the large exposures regime. Smaller firms are more likely to adopt the regulatory standards as part of their own risk management systems, and to the extent that any new requirements are not already considered by these firms then additional costs will be imposed.

76. Imposing limits around lending may also lead to increased opportunity costs for firms who engage in lending if the regulatory limits are tighter than their in-house limits. For example, imposing limits on exposures which are currently exempted could lead to the re-organisation or reduction of the affected business area with all the consequences that a reduction of business would entail. Furthermore, firms would have to modify some of their group wide practices, which may lead to increased costs. There may be opportunity costs to the extent that firms are restricted from engaging in lending that they would otherwise do. There may also be additional costs to borrowers to the extent that they are required to go to more than one lender to raise necessary funds.

Indirect Costs

77. If new limits are imposed on certain types of exposure or types of firm then the quantity of large lending may be reduced. This may impose additional opportunity costs on lender firms who cannot engage in lending which they would have otherwise undertaken. There may also be additional costs to borrowers who may be required to go to more than one institution to obtain their required funding.

78. If limits are lowered across the board, there is some risk that borrowers may be pushed towards larger banks, simply to avoid having to go to multiple lenders (if their preferred lender cannot extend them funds to the extent that they desire). This may have some competitive effects which may favour larger institutions.

Benefits

79. In broad terms, the incremental effects of amending the existing regime will be to change the likelihood of failure or major disruption of an institution's activities that could arise from an unforeseen event with regards to a single name borrower. If the amended large exposures regime can reduce this probability then the benefits will lower expected costs associated with failure or major disruption of a firm's activities (these costs of failure may include systemic costs of the failure of the institution, that is the costs that are imposed on other firms due to its failure).

Decreasing Requirements

80. An amended backstop regime may also lead to some deregulatory measures. It may be the case that the large exposures regime is not considered to be appropriate for certain firms or certain types of exposures that are currently subject to the regime. If areas of regulatory failure can be identified then removing regulation will give rise to net benefits.

Direct Costs

81. The removal of the large exposures regime for some firms and/or some types of exposure may result in reduced costs for supervisors. Direct costs to supervisors will be reduced because regulators will no longer be required to monitor compliance with the regime. There may be reduced systems costs needed to collect and process data and reductions in staff needed to monitor and analyse the information to ensure firms are compliant. These cost reductions will be on-going. However, these cost reductions may be mitigated to the extent that supervisors feel it necessary to engage in greater on-site supervision because certain exposures or firms are no longer subject to a large exposures regime.

Compliance Costs

82. The compliance costs for firms will be reduced as they will no longer require staff and systems to monitor and report their exposures to the relevant regulator. Any firms who are exempt from any form of large exposures regime may have more significant reductions in costs as they will not be required to have any systems in place to monitor exposures, nor any staff to ensure that relevant regulations are adhered to. However, if these firms would monitor their large exposures even in the absence of a large exposures regime then the reductions in costs may be minimal. There may be minimal reductions in compliance costs for firms who are no longer required to adhere to the large exposures regime for certain transactions but are for others. These firms are still likely to require staff and systems to monitor those areas where the large exposures regime still applies. However, to the extent that regulators engage in greater supervision then compliance costs to firms may increase.

Indirect Costs

83. Opportunity costs may be reduced as the size of lending to single name counterparties is no longer restricted by the large exposures regime. Although this will only occur to the extent that the regime constrained lending and to the extent that other mechanisms (e.g., market discipline, firms' own risk management practices) do not constrain lending.

84. The quantity of large lending may increase, but only to the extent that lenders were restricted in their lending and borrowers did not go elsewhere to obtain the funds that they desired. The variety of lending (in terms of the size of lending from an individual institution) may increase, although only to the extent that the regulations restricted firms from engaging in lending activities that they may have otherwise engaged in. For some firms, it may be the case that their internal lending requirements were more stringent

than the regulatory limits and so there will be little impact on their lending activities.

Benefits

85. A more differentiated market failure analysis may lead to the conclusion that there are some areas where it is difficult to make a case that suggests that market failures exist or are likely to arise. If regulation is removed in these areas then there will be no loss of benefits from removing the regime. If no material market failure exists then it is not likely that regulation is replicating the workings of the market any better than the market is doing itself. As such, it is not likely to be resulting in any benefit and its removal will not lead to any loss of benefits. In addition, further analysis may lead to the conclusion that some degree of market failure may exist but that the large exposures regime is not the best method of solving the market failure (i.e. it may mitigate the market failure to some extent but there may be better options available that are outside of the scope of this review). In this case, removal of the large exposures regime may lead to some loss of benefits to the extent that the regime did mitigate the market failure.

Annex 2. Summary of administrative and other costs arising from the current large exposures regime

1. The impact assessment approach requires that having identified a market or regulatory failure there should be a consideration of the costs and benefits that arise from the alternative proposals.

2. Annex 1 provides a high level qualitative assessment of the potential impact of the six policy options[41] that have been considered by CEBS.

3. This Annex provides an overview of responses to the CEBS cost gathering questionnaire. In the first half of 2007 CEBS issued a cost gathering questionnaire to a sample of firms across 15 EEA Member States[42] [43]. The purpose of the questionnaire was to obtain information about the costs of the current large exposures regime.

4. It was recognised that it would not be possible to generate data with high levels of accuracy – for example, because of the difficulties of quantifying some of the costs involved (e.g. opportunity costs). Also, the exercise was not exhaustive – for example not all Member States participated. Instead, it was intended to provide an overview of the nature and level of costs associated with compliance with the current regime.

5. In total, 163 completed responses were received from market participants and included 106 banks and 57 investment and investment management firms. The banks and investment firms that responded ranged in size from very small to large banks/investment firms and investment managers.

Messages gathered from the questionnaire responses:

Administrative costs

6. Section 1 of the questionnaire sought to obtain information about the costs that firms incurred as a result of complying with the administrative and reporting requirements of the European large exposures regime

   Number of persons:

7. In response to question 1.1, "Please note the number of 'full time equivalent' persons dedicated to gathering and reporting data and otherwise ensuring compliance for purposes of large exposures regulation", the average across all respondents was approximately 0.86 people per institution. This varied across institutions, with size 1 institutions (e.g. >€100bn assets for a bank) reporting an average of 2.3 people.

[41] The Policy Options were set out in Chapter 2 Policy Options – different regulatory tools - in CEBS First Advice (6 November 2007).
[42] Belgium, Finland, France, Germany, Hungary, Ireland, Italy, Lithuania, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, United Kingdom
[43] The questionnaire can be found at Annex 1 of CEBS CP14

8. On average banks reported 1.2 people compared with 0.25 for non-banks dedicated to gathering and reporting data and otherwise ensuring compliance.

9. The maximum figure was 15 people reported by one UK bank and one German bank reported 14.50 people.

Costs:

10. We tried to understand the additional burden placed on firms by the current large exposures regulation. "In Box 7, please note the percentage of the costs you indicated at Box 6 that you estimate you would have incurred anyway even if there was no large exposures regulation in place."

11. A large number of firms (49) gave "0" as a response implying either that they were unable to answer or that 100% of the costs were as a result of the regulation. The total average percentage across all firms was 46.6% vs. 67.2% for firms submitting a non-zero (positive) percentage. For banks these figures were 49.8% for the percentage across all banks vs. 65.3% for non-zero responses. These data imply that between half and two-thirds of the administrative costs of the current regime would be incurred anyway by firms.

12. The average total administrative and reporting costs (question 1.5) were just under €100k for banks against approximately €75k for all firms.

13. Remuneration costs: The total remuneration costs for the people involved in data gathering and reporting for the purpose of large exposures regulation (question 1.2) were generally in alignment with the numbers of people reported. The higher remuneration costs were reported by banks in line with them generally reporting higher numbers of people involved in administrative work on large exposures issues. However, there was some variation and it may be that different respondents included different cost types in their calculations.

14. Other costs: Questions 1.3 and 1.4 asked for annual systems costs and other direct expenditure costs related to large exposures administration activity. The responses received were variable and some respondents did not provide any figures. Some respondents explained the cost types they had included and these covered a wide range including systems and software development and maintenance costs; training; auditing, legal and other professional and consultant costs, allocated share of heat/light charges, etc.

15. Comments from respondents: Some respondents commented that where they had to report to different authorities in different Member States they had to analyse data in different ways for different purposes and manual intervention was required in some cases. Other respondents commented that the different requirements did not cause them to incur additional costs. Some commented that large exposures requirements were a part of credit risk management and internal systems and controls.

16. Costs unique to large exposures regulation: Question 1.8 dealt with the percentage of the administrative and reporting costs directly and uniquely arising from the requirements of European/national large exposures regulation that would no longer be incurred if there were no differences between the large exposure regulatory requirements applied in the different European Member States.

17. The majority of respondents entered "0" in response to question 1.8. In some cases it appeared that the respondent did not consider the costs to be unique to large exposures regulation – as in other parts of their response they said they thought they would incur costs anyway. Others – particularly for investment firm and asset manager respondents - commented on the difficulty of providing a view.

18. There were 13 respondents that did provide a clear numerical response to Q1.8, and of these 6 firms reported a figure above 10% (and 2 firms above 50%) and the average across all firms was approximately 2.5%.

19. In reply to Q1.10, 34 respondents said they operated in 2 or more Member States. Of the 2 firms reporting they considered that 50% plus of the large exposures costs related specifically to large exposures regulation, one said it was active in 3 Member States and the other that it was active in 7 Member States. Of the other respondents to question Q1.10, there were 4 that had reported "0" in response to Q1.9 (i.e. did not regard large exposures costs as unique to large exposures rules) but in response to Q1.10 said that operated in 5 or more Member States.

Opportunity cost

20. Section 2 of the questionnaire was designed to obtain information on the profits foregone due to having to comply with European large exposures regulation.

21. Question (Q2.1) asked institutions to note how many transactions they rejected or partially rejected during the 12 months to 31 December 2006 because to enter into them would have resulted in breaching large exposure regulatory limits. The average across all firms was approximately 3.5 with banks being only slightly higher (still 3.5 to a significant figure). However this masked the fact that only 31 respondents gave non-zero answers and only 8 gave numbers greater than 10. The averages are dominated by 2 responses both significantly greater than 50 transactions.

22. However, it appears that institutions generally found it very hard to estimate opportunity costs and it is possible that firms do not pursue business opportunities because of the large exposures limits. The vast majority of non banks did not provide any numerical or written comments on opportunity costs.

23. Comments from respondents: Some banks commented that they or entities within their group entered into syndicated loans. One said large deals were "distributed" over several of its group members. Several banks said that the syndication of loans was a normal part of risk sharing. Some banks said that if there were no large exposures limits they would be able to enter into

larger deals. One bank commented that it took large exposures limits into account when structuring deals and this might for example result in structuring a deal so that it paid down on a monthly basis rather than a half yearly basis to avoid the impact of the large exposures limits.

Compliance and other costs

24. Section 3 of the questionnaire asked for cost information not already provided in response to sections 1 and 2 of the questionnaire.

25. Very few comments or numerical responses were received in response to the questions in this section. Of those that did comment the majority were banks. The basis of responses was variable and so it was difficult to draw statistics from the responses. No investment management firms responded to this section.

26. Comments from respondents: Some respondents provided limited comments on collateral. One said it incurred legal costs. Three respondents commented that it was more usual to enter into an arrangement to share an exposure rather than to hold collateral to reduce a very large exposure to within the large exposures limits. One respondent commented it did not hold unfunded credit protection for the purpose of complying with the large exposures limits. Two respondents said that they did use some element of unfunded credit protection.

Costs in relation to intra-group limits

27. This section asked for cost information in relation to intra-group exposures and the large exposures rules.

28. Very few comments or numerical responses were received in response to the questions in this section. Of those that did comment the majority were large banks. The basis of responses was variable and so it was difficult to draw statistics from the responses.

29. Comments from respondents: A number of respondents noted that there were administrative costs associated with intra–group exposures, for example, costs associated with the booking and maintenance of intra-group transactions, remuneration and systems costs for relevant staff and systems, loan administration, guarantee specialists and various legal costs, client relationship staff and the credit organisation at the parent bank, costs associated with letters of credit. Some said that not all costs for intra-group exposures arose as a consequence of the EU large exposures rules.

30. One respondent commented that as a result of having to put relevant arrangements in place to ensure compliance with the large exposures rules the speed at which they could respond positively to a customer was slower and that it might lose business to competitors working with a larger capital base and thus being able to move faster.

31. One respondent commented that parental guarantees were occasionally provided to subsidiaries to facilitate third party counterparty exposures. Some respondents said they used collateral as part of managing their intra-

group exposures within the large exposures limits. One respondent said it had allocated capital against guarantees provided for intra-group exposures.

32. One respondent commented that because of different approaches in the Member States it had to take a case by case approach to obtaining approval for some of its exposures and as a result incurred costs that it would not otherwise have incurred. Another respondent that operated in more than one Member State said that problems did not arise.

Annex 3. Example of a proposal on the treatment of Structured products.

3.1 SCOPE OF APLLICATION

- The treatment works for ALL structured products:
  - ⇨ funded/unfunded, cash/synthetic, single tranche, tranched cover…
- The treatment should be applied to ANY sort of securitisation exposures according to CRD2006/48:
  - ⇨ On-balance sheet: bonds, subordinated loans…
  - ⇨ Off-balance sheet: liquidity facilities, credit lines…
- First to default and Nth to default not included in this treatment: there is no subordination with the transfer of risk

3.2 PRINCIPLES OF THE TREATMENT

- The treatment recognises the credit risk mitigation that subordination of tranches provides to the structure
  - ⇨ tranches benefit from large exposures reduction according to credit enhancement
- Only for first loss tranches (=1250% RW) no mitigation is recognised among them => all first loss tranches are evaluated together.
- Securitisation positions that must be deducted or otherwise 1250% risk weighted, are also subject to the large exposures limits.
- The proposal is dynamic => the limits will be varying as losses affect the underlying pool => continuous evaluation.
- When total exposures resulting from large exposures treatment add up to less than the exposure value of the position, the remaining amount should be always assigned to the SPV
- If the institution does not know the underlying names, it can assign all its exposure to the SPV. Special attention to this case will be given.

3.3 SUMMARY OF large exposures TREATMENT FOR STRUCTURED PRODUCTS

- For FIRST LOSS POSITIONS (those receiving 1250% RW)
  - ⇨ It will be considered that the institution holds, according to its participation in the total amount of first loss tranches (%PPP), an exposure with respect to each of the underlying names (Exp(i)) equal to the amount of each name without exceeding the amount of the first loss tranches (PP) outstanding at each date.

$$ExpGR(i, PP) = Min[Exp(i); PP \times \%PPP]$$

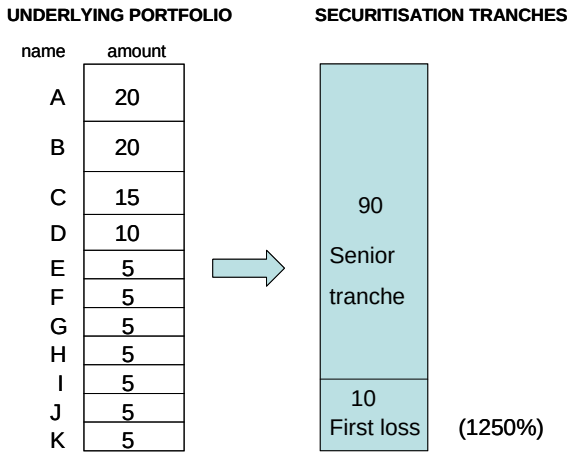
- For the remaining POSITIONS

  ⇨ It will be considered that the institution holds, according to its participation in each tranche (%PT), an exposure with respect to each of the underlying names (Exp(i)) equal to the amount of each name in excess to the amount of all subordinated tranches to the one being evaluated (ST)

$$ExpGR(i,T) = Min[Max[Exp(i) - ST; 0]; T] \times \%PT$$

3.4 EXAMPLES USING THE PHORMULAE

EXAMPLE 1: TWO TRANCHES



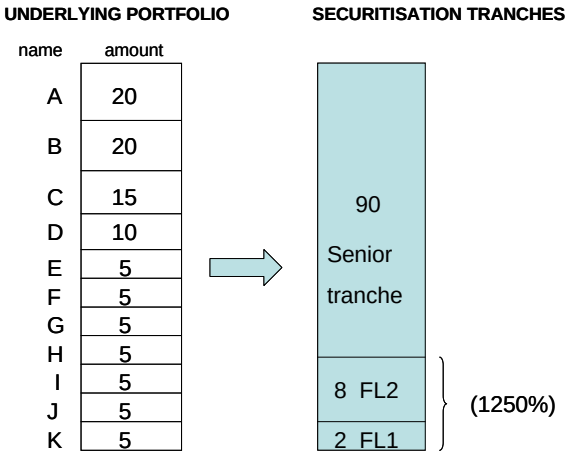
Investor 1, on the senior tranche must recognise:

0 with debtors D to K
5 with debtor C
10 with A and B
65 (90-25) with the SPV

Investor 2, on the first loss tranche:

5 with debtors E to K
10 with debtors A to D
0 Max[(10-75);0] with the SPV

EXAMPLE 2: TWO FIRST-LOSS TRANCHES



Investor 1 on the Senior tranche :

0 with D to K
5 with C
10 with A and B
65 with the SPV (*)

Investor 2 on First Loss tranche 2:

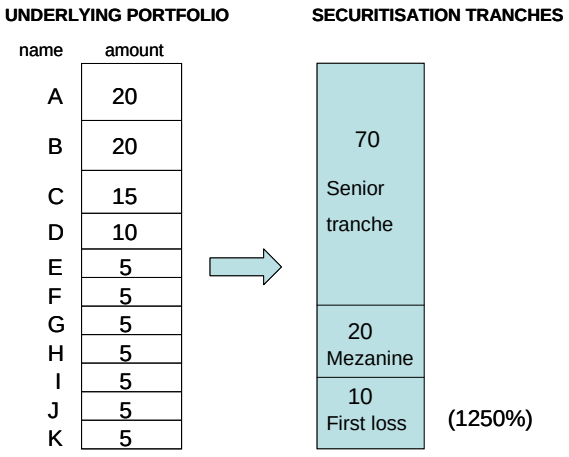
5 with E to K
8 with D to A
0 with the SPV

Investor 3 on First Loss tranche 1:

2 with A to K
0 with the SPV

(*) If investor 1 = investor 2, then the recognition with SPV would be equal to 97-(25+67) = 6

EXAMPLE 3: SENIOR, MEZANINE AND FIRST LOSS TRANCHES



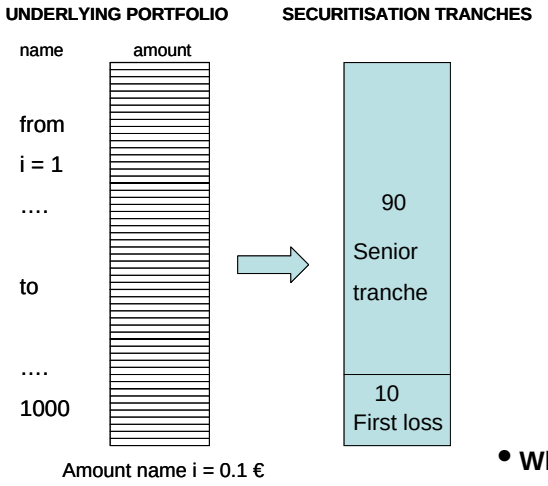
Investor 1 on the Senior tranche :
0 with A to K
70 with the SPV

Investor 2 on Mezanine tranche:
0 with D to K
5 with C
10 with A and B
0 with the SPV

Investor 3 on First Loss tranche:

5 with E to K
10 with A to D
0 with the SPV

EXAMPLE 4: GRANULAR CASE



Investor 1 on the senior tranche :
0 with debtors i= 1 to 1000
90 with the SPV

Investor 2 on the first loss tranche:
0.1 with debtors i=1 to 1000
0 with the SPV

- **When investors do not know all underlying names, Spanish Circular gives the option to recognise one single exposure with SPV**

⇒ **Formula converges to same result for non first loss tranches**

3.5 OPEN ISSUES

- Should a threshold of granularity be set for investor's in First Loss tranches (e.g. i^{th} debtor < 0.5% portfolio) in order to recognise one single exposure with SPV?

  ⇨ First loss tranche treated as a senior one

- Special attention should be given to the cases when investor in securitisation positions argues that it doesn't know the underlying names of the pool

  ⇨ There should be a penalisation treatment if used perversely

Annex 4. Cost / Benefit analysis for interbank exposures

Cost / benefit analysis

What would be the approximate cost of imposing a limit of 25% on all interbank exposures?

Using data supplied by eleven national authorities, we estimate the annual opportunity cost to industry of collateralising exposures in excess of a given level of their own funds. This analysis is based on the assumption that institutions would be able to collateralise or diversify without incurring high administrative costs or reducing the average counterparty credit quality; further caveats are set out in Chapter 8. A conservative central estimate for the countries in which data are available is €89mn per annum.

1. This section is a basic quantitative cost/benefit analysis of imposing a 25% of own funds limit on interbank exposures. The baseline against which this is compared is no interbank exposure limit at all. CEBS would very much welcome industry's views on this analysis, in particular on whether the assumptions on which we base the analysis are broadly correct.

2. Imposing a limit on unsecured interbank exposures would force banks with large unsecured exposures above or near to the limit to a) diversify, b) switch to lending on a secured basis, or c) otherwise extinguish a sufficient proportion of these exposures to comfortably comply with the limit. CEBS considers that, all things being equal, (b) is strictly more costly than (a), and (c) is strictly more costly than (b).

3. Our starting assumption is that banks would generally be able diversify or collateralise their large exposures. This rests on unsecured and secured interbank money markets being sufficiently deep, wide and liquid.

4. Based on this assumption, it is possible to estimate the upper bound of the current opportunity cost to industry of imposing limits on interbank exposures by calculating the aggregate implied cost of collateralising exposures above, for example, 20% of own funds so that all banks comfortably comply with the limits (note this does not account for any increased administrative costs). Assuming that markets are efficient and that there is a zero price elasticity of demand for collateral eligible under the large exposures regime, this cost is equal to the spread between the observed interbank market rate for secured and unsecured lending.

5. CEBS has been able to obtain data on the aggregate value of banks' unsecured interbank large exposures in eleven EEA States: Belgium, Finland, Greece, Hungary, Ireland, Italy, Lithuania, Norway, Slovakia, Spain and the UK. Most of the data relate to exposures reported for 31 December 2006. CEBS has used the daily published spreads between the one month EURIBOR and EUREPO rates (and for the UK data, BBA LIBOR and BBA repo) for 600 daily observations between January 2005 and May 2007 to estimate the implied per unit cost of collateralising exposures. A maturity of one month was chosen as CEBS understands that most interbank exposures have a short maturity (and exposures of less than 1 month accounted for 96% of turnover in money markets in 2006), and although we recognise that the choice is somewhat

arbitrary it is not unrepresentative. Multiplying the amount of exposures outstanding by these spreads yields the following opportunity cost estimates.

Table 1: Estimated aggregate implied annual cost of collateralising all third party unsecured interbank exposures above the indicated percentage of own funds in Belgium, Finland, Greece, Hungary, Ireland, Italy, Lithuania, Norway, Slovakia, Spain and the UK

	> 10%	>15%	>20%	>25%	>50%
5th percentile spread	€99mn	€55mn	€39mn	€31mn	€13mn
Mean spread	€173mn	€95mn	€66mn	€52mn	€21mn
95th percentile spread	€227mn	€126mn	€89mn	€70mn	€30mn

6. Thus, a central, conservative, estimate of the annual opportunity cost of introducing limits on unsecured interbank exposures for the eleven countries for which data are available is €89mn as this represents the implied cost of collateralising exposures when spreads are higher than usual.

What would be the approximate benefit of imposing a limit of 25% on all interbank exposures?

Using data from the academic literature, historical bank default rates and data supplied by national authorities to CEBS, it is possible to estimate an annual benefit of interbank exposure limits, which is manifested in terms of reduced probability of a systemic crisis. Although it is difficult to arrive at a single central estimate, CEBS concludes that it is most likely that it lies between €33mn and €402mn per annum

7. The primary benefit of introducing a limit on interbank exposures is, as discussed above, a reduction in systemic risk and moral hazard. If one major bank fails directly because of its exposures to another major bank, we consider this a crystallisation of systemic risk or a "systemic crisis". It becomes possible to estimate the annual benefit, in terms of systemic risk reduction through using the following formula:

   GDP, multiplied by

   Percentage of GDP lost in a systemic crisis, multiplied by

   Annual probability of a major bank failure, multiplied by

   Probability that such a failure will lead to a systemic crisis.

8. Note that this does not include benefits in terms of a reduction in moral hazard, which are manifested in a reduction in the implicit subsidy provided by the government to banks' depositors, creditors and (potentially) shareholders. It also assumes that introducing limits would reduce to zero the probability of a systemic crisis via counterparty credit risk contagion of an idiosyncratic bank default.

9. It is impossible to make a single point estimate for the last three of the above four parameters. Presented below is some discussion of how to narrow down the estimates to plausible ranges, followed by a set of tables that demonstrate, for different combinations of input parameters, the estimated benefits for the countries that have supplied aggregate large exposures data to CEBS.

10. Hoggarth, Reis and Saporta[44] put an estimate of the cost of a systemic banking crisis at 15-20%, albeit with a relatively wide standard deviation. It covers 24 crises between 1977 and 2000 and there appears to be consensus in the literature that its estimated average cost is of the correct order of magnitude. Because circumstances vary so much from crisis to crisis, and extreme crises are much less probable than less extreme crises, it is worth looking at a range of crisis costs, bearing in mind that 15-20% of GDP is the most likely outcome. Another caveat to note is that, although the episodes covered all involved banking sector crises, it is difficult to disentangle the costs of such crises from those of more general macroeconomic malaise that occurred at the same time as, and may have been the cause of, many of the banking sector crises. The estimates in Annex 1 therefore cover a range of crisis costs below 15%.

11. The annual probability of a major bank failure is discussed above. On this basis, it seems reasonable to use estimates ranging between about 0.25% and 0.75% per annum (Basel 2, for example, is calibrated to achieve a probability of failure of no greater than 0.5% per annum). A figure of 0.75%, based on the Fitch study, seems a reasonable number to use if one wishes to abstract from the influence of ex-post interventions. However, some downward adjustment may be necessary to account for the fact that we are concerned here with the probability of a bank failure large enough potentially to prompt a systemic crisis, which may be somewhat less than the probability across all banks. A range of 0.1% to 0.75% is therefore given in the tables.

12. The probability of one bank's failure giving rise to a systemic crisis through interbank large exposures is probably the most problematic parameter to gauge. It is also likely to vary the most widely across Member States because of differences in the structure of national banking systems. In the countries for which data are available, 28% of banks in the countries in question had at least one large exposure to another bank of at least 25% of own funds and 17% of banks had at least one interbank exposure of over 50% of own funds. Unfortunately, we generally do not know exactly how many of these banks were large banks (or banks that could be considered potentially systemically important in the system(s) in which they operate), and which banks they were exposed to.

13. The aforementioned IMF FSAP studies and other empirical analyses of interbank contagion risk suggest that, in some Member States, it is an "extreme but plausible" risk (but not in others); and Upper (2007) concludes that contagion caused by an idiosyncratic shock could directly affect 15-20% of banking systems. A wide range of probabilities are therefore given, although the most realistic are probably towards the lower end (e.g. 5% or 10%).

14. CEBS' estimates of the annual benefits of introducing limits on large exposures for those countries which have been able to provide data (i.e. Belgium, Finland, Greece, Hungary, Ireland, Italy, Lithuania, Norway, Slovakia, Spain and the UK) are shown in Table [y]. They are calculated on a risk-neutral basis, that is on the assumption that a given percentage point reduction in the impact of a systemic crisis is of equal value to a reduction in the probability of a systemic crisis of the same value.

[44] Hoggarth, Reis and Saporta, *Costs of Banking System Instability*, Bank of England (2001).

15. Although the analysis does not provide a definitive estimate, from it we could conclude that a conservative central estimate is most likely to be found in the following ranges:

    Percentage of GDP lost in a systemic crisis: 5% - 15%

    Annual probability of a major bank failure: 0.25% - 0.5%

    Probability that such a failure will lead to a systemic crisis: 5% - 20%.

16. This would imply that a conservative central estimate of the benefits of a 25% interbank limit would lie between €33mn and €402mn per annum.

Table 2: Estimates of annual benefits arising from a large exposures limit of 25% on interbank exposures (no shading: benefits are less than upper bound cost estimate of €89mn per year, shading: benefits exceed upper bound cost estimate of €87nm per year),

Probability of contagion crisis given major bank failure	1%	Probability of major bank failure (annual)			
		0.1%	0.25%	0.5%	0.75%
Cost of crisis (%GDP)	1%	£0mn	£0mn	£1mn	£1mn
	2%	£0mn	£1mn	£1mn	£2mn
	5%	£1mn	£2mn	£3mn	£5mn
	10%	£1mn	£3mn	£6mn	£9mn
	15%	£2mn	£5mn	£9mn	£14mn
	20%	£2mn	£6mn	£12mn	£18mn

Probability of contagion crisis given major bank failure	20%	Probability of major bank failure (annual)			
		0.1%	0.25%	0.5%	0.75%
Cost of crisis (%GDP)	1%	£11mn	£27mn	£54mn	£80mn
	2%	£21mn	£54mn	£107mn	£161mn
	5%	£54mn	£134mn	£268mn	£402mn
	10%	£107mn	£268mn	£535mn	£803mn
	15%	£161mn	£402mn	£803mn	£1,205mn
	20%	£214mn	£535mn	£1,071mn	£1,606mn

Probability of contagion crisis given major bank failure	5%	Probability of major bank failure (annual)			
		0.1%	0.25%	0.5%	0.75%
Cost of crisis (%GDP)	1%	£1mn	£2mn	£3mn	£5mn
	2%	£1mn	£3mn	£6mn	£9mn
	5%	£3mn	£8mn	£15mn	£23mn
	10%	£6mn	£15mn	£31mn	£46mn
	15%	£9mn	£23mn	£46mn	£69mn
	20%	£12mn	£31mn	£61mn	£92mn

Probability of contagion crisis given major bank failure	30%	Probability of major bank failure (annual)			
		0.1%	0.25%	0.5%	0.75%
Cost of crisis (%GDP)	1%	£16mn	£40mn	£80mn	£120mn
	2%	£32mn	£80mn	£161mn	£241mn
	5%	£80mn	£201mn	£402mn	£602mn
	10%	£161mn	£402mn	£803mn	£1,205mn
	15%	£241mn	£602mn	£1,205mn	£1,807mn
	20%	£321mn	£803mn	£1,606mn	£2,409mn

Probability of contagion crisis given major bank failure	10%	Probability of major bank failure (annual)			
		0.1%	0.25%	0.5%	0.75%
Cost of crisis (%GDP)	1%	£1mn	£3mn	£6mn	£9mn
	2%	£2mn	£6mn	£12mn	£18mn
	5%	£6mn	£15mn	£31mn	£46mn
	10%	£12mn	£31mn	£61mn	£92mn
	15%	£18mn	£46mn	£92mn	£138mn
	20%	£24mn	£61mn	£122mn	£184mn

Probability of contagion crisis given major bank failure	100%	Probability of major bank failure (annual)			
		0.1%	0.25%	0.5%	0.75%
Cost of crisis (%GDP)	1%	£54mn	£134mn	£268mn	£402mn
	2%	£107mn	£268mn	£535mn	£803mn
	5%	£268mn	£669mn	£1,339mn	£2,008mn
	10%	£535mn	£1,339mn	£2,677mn	£4,016mn
	15%	£803mn	£2,008mn	£4,016mn	£6,023mn
	20%	£1,071mn	£2,677mn	£5,354mn	£8,031mn

Table 3: Effective risk-weight currently applied to exposures to OECD credit institutions or investment firms by maturity and country

Effective risk-weight applied to exposures to OECD credit instiutions 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	**0**	**?**	**?**
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**
Liechenstein	**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	**0**	**?**	**?**
Slovakia	**?**	**?**	**?**
Slovenia	**0**	**20**	**50 / 100**
Spain	**50**	**100**	**100**
Sweden	**0 / 20**	**0 / 20**	**20 / 50 / 100**
United Kingdom	**0**	**100**	**100**

These figures are based on Annex II-D of CEBS' review of supervisory practices on large exposures.