CEBS

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EAPB comments on the

CEBS consultation paper (CP14) on the first part of its advice to the European Commission on large exposures

The European Association of Public Banks (EAPB) represents the interests of 25 public banks, funding agencies and associations of public banks throughout Europe, which together represent some 100 public financial institutions. The latter have a combined balance sheet total of about EUR 3,500 billion and represent about 190,000 employees, i.e. covering a European market share of approximately 15%.

We thank CEBS for the opportunity to comment on the consultation paper on large exposures. Likewise we very much appreciated the hearing organised by CEBS in July 2007 and the comprehensive work CEBS has already accomplished on this issue so far.

We would first like to make some general comments on CEBS' considerations before answering the questions posed in the paper.

1. General Remarks

As already expressed at the hearing on large exposures held in July 2007 at CEBS' premises by different participants, the importance of the large exposure regime varies considerably among institutions. More sophisticated banks have implemented their own approaches for the management of concentration risk, whereas smaller and less complex institutions use the large exposure regime as a kind of guidelines. In our view, a revised large exposure regime therefore has to be flexible enough to be of use for both groups: smaller institutions should not be burdened with excessive regulation and larger banks should not be charged

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with a costly parallel system. CEBS' current approach widely takes these considerations into account, which we very much appreciate. The simpler the future large exposure regime will be kept, the more it will be of use to all parties involved.

2. Answers to questions

Q1. Do you agree with our analysis of the prudential objectives in this context?

We very much welcome CEBS' consideration that the central purpose of the large exposures framework is to limit the degree to which institutions are exposed to incidents of traumatic loss, likely to threaten their solvency, due to the occurrence of an event which is outside the parameters of portfolio capital allocation.

We would also like to note that we fully agree with CEBS' opinion to favour a "light touch" regulatory regime, set out in paragraph 110, where regulatory limits operate as a "regulatory backstop". For smaller institutions such a regulatory backstop can be used as some sort of guidance in the management of their concentration risk. However, in order to serve smaller institutions without providing a handicap for larger institutions using internal concentration risk management approaches, a backstop regime should be kept as simple as possible.

As regards concentration risk in general we understand that CEBS takes the view that these risks fall under Pillar 2 of the CRD and should be dealt with under the ICAAP and Supervisory Review Process. In particular, CEBS notes that no Pillar 1 treatment should be developed for concentration risks. We fully support this view, as dealing with these issues under Pillar 2 provides for more flexibility.

Q2. Respondents are asked for their comments on the market failure analysis set out above. Do you agree with the analysis that there remains a material degree of market failure in respect of unforeseen event risk?

Q3. Respondents are asked for any further evidence that they consider useful for deepening this analysis.

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We very much appreciate CEBS conducting a market failure and regulatory failure analysis following the Better Regulation principles.

However, we feel that the examples chosen by CEBS are not relevant for this purpose. Rather, the potential market failures identified by CEBS refer to operating risks (e.g. improper business practice) which are covered by capital under the CRD.

Apart from the examples chosen, we take the view that the analysis also needs to take a more differentiated approach, distinguishing between institutions of different sizes and business models. We are confident that CEBS will deal with this issue appropriately in part 2 of the call for advice on this issue.
We would also like to express our doubts as regards market discipline and its actual ability to serve as motivating factor to manage an institution's risk in accordance with the regulatory risk appetite.

- Rating agencies contacted by CEBS indicated that they do assess an institution's exposure to single name concentration risk (paragraph 77 seq). However, we feel that such an analysis is more focused on the redemption of a concrete liability than on concentration risks. Moreover, (potential) market discipline imposed by rating agencies is – if at all – exerted on big banks and hardly at all on smaller institutions.
- The link between management compensation and incentives as well as criminal penalties for financial mismanagement (paragraph 70, 71) seems to be very general and should – if maintained – be better founded.
- We also have doubts as regards the possible contribution of disclosure requirements to market discipline. They are usually updated to infrequently to offer timely information. Against this backdrop, any overly detailed disclosure requirements would not contribute to the understanding of a firm's risk profile.

In general we would like to note that in our view, large exposures are not more affected by market failures than exposures in general or the whole operation of the credit institution. [imp

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Q4. Respondents are asked whether they agree with our perception that there are broad consistencies between the EU LE regime and those in other jurisdictions such that there is no systematic competitive disadvantage for EU institutions? To the extent that you do not agree with this we would be grateful for a detailed explanation of where you consider that competitive distortions arise.

The consideration of approaches taken in other jurisdictions regarding single name counterparty risk in the market failure/regulatory failure analysis is very much appreciated under competition aspects. However, we would like to place the following remarks.

We do not fully agree with the conclusion drawn by CEBS regarding exemptions available in the US (paragraph 11). From our member's experience, the required capitalisation in the US is so low that levels will be met by all major banks. European banks suffer a considerable competitive disadvantage from this fact. This is in particular the case in the field of short-term financing of mergers and acquisitions. Also, in the US only the current exposure of derivatives, with no add-ons, have to be taken into account in large exposures rules.

As set out in the Annex 2 of the consultation paper, there are non-EU countries applying more favourable large exposure regimes in relation to connected undertakings / affiliated companies. This is for example the case regarding Japan, which privileges exposures to affiliated companies (40 % limit instead of 25 %). Therefore, we suggest reviewing the current limit regarding the exposures towards connected undertakings of banks, currently being stricter than the general 25 % limit.

Q5. Respondents are asked for their views in respect of the analysis set out above and our orientation not to reflect further the credit quality of highly rated counterparties in large exposures limits.

As set out above, the large exposure regime should be a simple "regulatory backstop". Introducing different limits according to the counterparty credit quality would counteract this goal. Therefore, we support CEBS' view that counterparty credit quality should not be introduced in general as criterion.

Nevertheless, we believe that in certain cases or for certain counterparties, exceptions to this general rule should be established. This could be the case for regional governments and

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local authorities, central banks top-class ratings of countries and certain intra-group exposures.

Furthermore, we would like to underline that credit risk mitigation techniques should be accepted further on.

Finally, we suggest discussing the introduction of credit quality in evaluating collateral providers. It should also be possible to exempt exposures with very short maturities (e.g. guarantees of M&A transactions of first-class credit quality).

Q6. What do you consider to be the risks addressed by the 800% aggregate limit? What are your views as to the benefits of the 800% limit?

The importance of the 800 % limit varies across the different institutions. Whereas the said limit does usually not affect larger banks at all (as it does not act as limit system), it is necessary for the smaller and medium-sized institutions to have sufficient margin for the management of large exposures.

As the European credit sector does not suffer from any competitive disadvantage due to the current limit we **suggest to maintain the 800 % limit** and oppose to any attempt to reduce this limit.

Q7. What principles or criteria might be applied for an institution to demonstrate its ability to measure and manage the relevant risks?

In our opinion, the principles should be set up in accordance with the requirements of Pillar 2 and should consider individual circumstances. CEBS' ICAAP guidelines comprise the principles and criteria by which an institution can demonstrate its ability to measure and manage the relevant risk.
In particular, the following principles seem to be suitable:

- definition of causes of concentration risks;
- analysis of correlations between risks;
- internal regulations based on the aforesaid principles;
- adequacy of worst-case-scenario analysis.

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Q8. Respondents are asked whether they consider that principles along these lines would be suitable to govern the calculation of exposure values by institutions using the Advanced IRB Approach for Corporate exposures and/or the Internal Models Method (EPE) for financial derivatives and/or securities financing transactions.

In general, we support the principles set out by CEBS in the consultation paper and welcome CEBS' efforts to align the large exposure calculation methods with those of the CRD.

However, we oppose to the proposed test set out in paragraph 195 (4) (a) according to which an institution should either demonstrate that the size of the exposure is not a material driver or that it has effectively incorporated the size of exposure as a material driver in its values. This would provide an additional burden and goes beyond the review of the IRB system. In addition, it is not clear to us how institutions should provide this evidence.

Furthermore, the tests mentioned in paragraph 195 (3) and 195 (4) (b) are already part of the IRB recognition test. As far as computation methods are recognised and given IRB approval, we suggest to automatically authorise them for the purposes of large exposures as well.

Q9. Do respondents support harmonisation of the conversion factors applied to the off-balance items set out above? How important are these national discretions?

Q10. How are these facilities, transactions etc. regarded for internal limits-setting purposes? What conversion factors do respondents consider appropriate?

Q11. In the above analysis we have not given consideration to the appropriate treatment of either (a) liquidity facilities provided to structured finance transactions or (b) nth-to-default products. We are interested in receiving views from respondents on how they calculate exposure values for such products for internal purposes.

We suggest to adopt a risk-sensitive approach regarding conversion factors for the calculation of exposure values. The conversion factors which Member States have used so far in their large exposure regimes for low and medium risks have proved effective and should in our view be upheld.

Regarding structured finance and/or basket products, the most suitable method for the favoured "light touch" regulatory regime would be in our view the one set out in paragraphs

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212 (a) and 213. Furthermore, we would recommend differentiating between baskets according to the number of transactions they contain.

Q12. Respondents are asked whether they consider these suggested principles appropriate for application to institutions´ exposures to collective investment schemes and/or structured finance transactions?

Collective Investment Undertakings

From our point of view CIU should be excluded from this analysis since principles for a "look-through" treatment of CIU do already exist. Also, the requirement of daily information does not seem to be absolutely necessary.

As to the principles set out in paragraphs 212 a)-c) we would like to ask CEBS to perhaps illustrate its suggested method with an example. We interpret this paragraph as meaning that each time an exposure to a borrower exceeds 5% of the bank's own funds, all transaction possibilities, known here as "schemes", must be investigated to determine whether or not they still contribute to the total exposure value of the counterparty. This method is excessively complex and we do not support it. An implementation in practice would be very difficult if not impossible. It would mean having to conduct this test on a larger number of borrowers than if the 10 % large exposures limit would be applied.

Whether or not a look-through solution is in reasonable proportion to the prudential objectives depends on the number of transactions involved. Banks should therefore have the option of either categorising the scheme, as such, as a borrower or assigning individual components of the scheme to individual borrowers.

Structured finance

We would like to stress in general, that structured finance transactions vary considerably from one to another. Therefore, a one-size-fits-all approach regarding the reporting of large exposures would not be appropriate. In general, we welcome the principles set out by CEBS in paragraphs 212 (d) to 215. However it has to be taken into account that financial institutions do often not have all the required information at their disposal.

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Also, principles as set out in the Annex 6 of the Basel II Recommendations "Supervisory slotting criteria for specialized lending" could be helpful; they are often considered for internal guidance purposes by institutions.

If you have any questions please do not hesitate to contact us.

With best regards,

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