European Association of Public Banks

– European Association of Public Banks and Funding Agencies AISBL –

CEBS

cp16@c-ebs.org

22 February 2008

EAPB comments CEBS' second consultation paper on the review of the Large Exposures rules

We thank CEBS for the possibility to submit our comments on CEBS' preliminary views on the issues included in the European Commission's second call for advice, part 2 with regard to the review of the Large Exposures rules. We would very much appreciate CEBS taking our remarks into account.

Before going into detail, we would like to make some general comments.

1. General Remarks

As already mentioned at the public hearing beginning this year, the general feedback of our members on the document has been quite positive. We very much welcome CEBS' comprehensive analysis.

In particular, we fully support CEBS' proposal to **keep the present limit-based regime**. The current regime has proven its value in the past. Therefore the current rules should not be unduly tightened. Some of the proposals, however, would have significant impacts on the current regime and would limit the banks' possibilities to grant loans.

We further very much welcome CEBS' view that a large exposures regime should **focus on the single name risk** whereas sectoral and regional risks should be better dealt with under Pillar II of the CRD.

Also, we would like to underline that from our point of view it is very important to **align the large exposure regime with the solvency rules to the greatest possible extent**. Such an alignment would help reducing costs due to the achieved synergies. We would very much welcome CEBS proposing such alignment in more areas in the final advice.

Avenue de la Joyeuse Entrée 1 - 5, B-1040 Brussels ● Phone :+32 /2 / 286 90 62 ● Fax : +32 /2 / 231 03 47

Website : www.eapb.eu

2. Comments on the proposals in detail

2.1. Definition of Large Exposures – "interconnectedness"

We welcome that CEBS wants to keep the current definition of large exposures. However, CEBS considers it important to clarify the concept of "connected clients" with the aim of ensuring a harmonised implementation of the rule among Member States and suggests a high level interpretation of "control" and "interconnectedness".

"Interconnectedness"

The EAPB members take the view that by extending the interpretation of connected clients to "interconnectedness" a convergent implementation of the rules might be even more difficult to achieve, as it would be very difficult to apply them. The outcome would be a considerable lack of clarity.

First of all, the criterion is too imprecise and would lead to unmanageably complexity. It could cover virtually any type of relationship and it is unclear what type of precisely definable connection has to exist between the clients to trigger this criterion. Clients would have to be grouped already if one client's illiquidity might cause another client's illiquidity. Linked with the criterion of "control" the criterion of interconnectedness expands the scope of connected clients to irreproducible entities.

We also reject the criterion because applying this criterion would lead to very large groups of connected clients, often mapping sectoral or regional aggregations. But, as CEBS itself acknowledges in its first part of advice to the Commission, sectoral or regional risks are not at issue in a large exposure regime and should be dealt with under Pillar II. What is more, this interpretation would significantly reduce the scope to lend to small and medium-sized enterprises if, for example, they were the main subcontractors of a large firm. This would have a significant negative impact on small regional banks, whose clients are often strongly financially dependent on one another.

Finally, the suggested broadening of the definition would sharply increase both the number and volume of large exposures. This is at odds with CEBS's objective of retaining the existing system as a backstop regime.

Against this background, we **strongly reject the proposed broad interpretation of "interconnectedness"** and the explanation provided in CEBS' examples. Given the above-mentioned difficulties we recommend to abolish the criterion of "interconnectedness" and subsequently deleted it in Art 4(45) of the CRD.

Avenue de la Joyeuse Entrée 1 - 5, B-1040 Brussels ● Phone :+32 /2 / 286 90 62 ● Fax : +32 /2 / 231 03 47
Website : www.eapb.eu

"Control"

We advocate to only use the criterion of control which would guarantee that the rules are applied consistently throughout the EU. Thereby CEBS refers to a situation whereby two or more persons constitute a single risk for the lender because one of them has control over the other(s) and the lender is unable to assess the borrower's ability to bear the risks.
It is current practice to assume that control exists in case of a majority voting right or in case of exercise of legally binding agreements among undertakings. Banks have fair access to this kind of information and can take these factors into account.

Nevertheless, we would like to note the following with regard to the concept of "control".

- CEBS in para 88 proposes different indicators of control. The criteria, in our view must be clear-cut and distinguishable from one another. With regard to "power to decide on crucial transactions" we think that this is not the case.
- The possibility to demonstrate that ownership does not constitute control as set out by CEBS in para 86 is particularly important and should be transposed in all Member States.
- We can not approve CEBS' proposal in para 94 to give the supervisory authority the final decision on whether a client must be regarded as connected client. Such a rule would give rise to considerable legal uncertainty.

In general, we would like to note, that the definition of connected clients must be strictly aligned between the CRD and the large exposures regime. Deviating definitions would lead to an unacceptable burden for control and reporting systems in each institution.

2.2. Definition of Exposures Value – off-balance sheet items

As set out in our general remarks, we would very much welcome an alignment of the large exposures regime with the solvency rules which would result in synergies of processes and systems entailing an enormous cost-cutting potential.

Standardised and Foundation IRB institutions

CEBS considers rightly in the consultation paper (para 106), that a general 100 % conversion factor might prove to be too conservative for certain transactions. From our point of view it would constitute a substantial disruption of the present regime, which we do not consider justified from a risk perspective. As practice shows (80 % of the Member States use conversion factors below 100 %), a reduced conversion factor applied to off-balance sheet items has not caused any problems in the field of large exposures in the past. Therefore, we

Avenue de la Joyeuse Entrée 1 – 5, B-1040 Brussels ● Phone :+32 /2 / 286 90 62 ● Fax : +32 /2 / 231 03 47
Website : www.eapb.eu

institutions using the standardised or the foundation IRB approach should be able to use the conversion factors specified in the solvency provisions.

Advanced IRB institutions

We welcome CEBS' proposal that banks applying the advanced IRB approach may use their own calculations to calculate large exposures.

However, we strongly reject CEBS' proposal (para 113 (2)) that these institutions must demonstrate to the competent authorities the suitability of the calculations. There is no reason for any further approval test, as exposures are calculated on the basis of methods which have been approved by supervisors.

We furthermore completely disagree that IRB institutions should use a mandatory 100 % conversion factor (para 114). There is no prudential rationale, in our view, for introducing a more conservative factor than in the solvency regime. We assume that the banks' estimates are also in a position to deliver appropriate results for so-called higher risk items.

2.3. Credit Risk Mitigation

As for the definition of exposure values, we very much welcome any alignment of large exposure and solvency rules for credit risk mitigation purposes. In particular, we consider CEBS' approach to deem real estate collateral eligible for large exposure purposes as very sensible and encourage CEBS to adhere to this view.

However, we are somewhat disappointed that, apart from real estate collaterals and financial collaterals, CEBS does not consider other collaterals as being eligible under the large exposures framework and does thus not align large exposure rules and solvency rules in this respect. We therefore like to reemphasise the benefits of such an alignment and ask CEBS reconsider the issue.

The explanations on guarantees are not sufficiently clear to us. As we understand CEBS' remarks, it wants to base the calculation of the value of the guarantee on the corresponding solvency rules but also wishes to use the substitution principle. However, the substitution principle is only applicable if the collateral or guarantee provider is a customer of the bank. This is not always the case. Collateral and guarantees are often provided by economic entities which have no relations with the bank.

Avenue de la Joyeuse Entrée 1 - 5, B-1040 Brussels ● Phone :+32 /2 / 286 90 62 ● Fax : +32 /2 / 231 03 47
Website : www.eapb.eu

We therefore suggest the following calculation method:

Exposure value (E)
– Adjusted value of the collateral (C_A) or guarantee (G_A)

= Adjusted exposure value (E_A).

E_A will then be taken into account with regard to the limit of the client.

2.4. Trading book issues

We consider the existing rules on assigning positions to the banking or trading book to be appropriate. Currently, each bank has to have its trading book policy approved by the competent authority. Positions are then assigned to the trading book on the basis of this policy, and not based on results. Large exposure rules consequently cannot create an incentive to assign inappropriate business to the trading book.

Given, in addition, that the existing limits have proved their worth over the years, we do not see a necessity to change them at this stage.

2.5. Intra-group exposures

According to the current CRD provisions on large exposures (Art 113 (2) CRD) it is up to the Member States to fully or partially exempt exposures incurred by a credit institution to its parent undertaking, to "sister" undertakings and to own subsidiaries under certain conditions. We take the view that the Member States' discretion in Art 113 (2) CRD should be kept and should – ideally – be transformed into a general rule, thus contributing to more convergence.

In any event, we oppose to the introduction of a large exposure limit for a group's subsidiaries as such limits would significantly restrict their possibilities of managing liquidity on a group-wide basis.

Such a limit could also set banks in smaller Member States in a competitive disadvantage, as CEBS also acknowledges in para 206.

Although we principally accept CEBS' concerns expressed in the paper, we believe that the benefits of the free flow of funds within a group far outweigh the potential disadvantages.

Avenue de la Joyeuse Entrée 1 – 5, B-1040 Brussels ● Phone :+32 /2 / 286 90 62 ● Fax : +32 /2 / 231 03 47
Website : www.eapb.eu

On the other side, we very much welcome CEBS' proposal to exempt intra-group exposures of creditor entities located in the same Member State as debtor entities under the conditions of Art 80.7 and 80.8 CRD. This exemption is very much in line with our call for more alignment of the large exposure regime with solvency rules. Where the requirements for a 0 % weighting are met under the solvency regime, exposures should also not have to be considered in the area of large exposures.

Finally we would like to come back on the issue of limits with regard to non-bank group undertakings. The current CRD provisions set a large exposure limit of 20 % for group units which are not banks. Yet the information available about a member of the same group is of far better quality than that about a client outside the group. Therefore, we do not see a point in keeping this limit. In our view, the limit should hence be raised to the general 25 % level.

2.6. Interbank exposures

We very much call on CEBS to not propose any further regulation on interbank exposures. Any tightening of interbank exposure rules would be mainly to the detriment of smaller local banks who would find refinancing much more difficult in this event. Smaller banks would hence be put in a considerable competitive disadvantage vis-à-vis larger banks. A differentiated treatment according to the size of an institution would, however, not be a sensible solution neither, as it would cause problems of definition and competitive distortions.

However, we do not disapprove any changes. In particular we would be in favour of taking the lower risk of shorter maturities better into account. The 0 % weighting for interbank exposures up to one year should of course be retained as there is no risk associated with these short-term exposures. They currently account for a large portion of the total interbank business. In addition, we would support also a preferential treatment for interbank exposures of more than one year.

We furthermore do not share the view that the cost of additional collateral would be moderate if a large exposure limit were introduced because collateral markets are sufficiently deep and liquid. Take derivatives, for instance. Derivative transactions between banks are normally concluded at a market value of zero so that there is no need for collateral to reduce risk. Changes in the market value over time are accommodated by margining. For prudential purposes, however, the add-on of the transactions calculated according to the market valuation method would have to be considered when calculating the large exposure. Yet the add-on would not be covered by margining. For this reason, banks would need to collateralise the add-on amount of a very large number of derivative transactions not because this would have a risk-mitigating effect, but simply to avoid the amount counting towards the large exposure limit.

Avenue de la Joyeuse Entrée 1 - 5, B-1040 Brussels ● Phone :+32 /2 / 286 90 62 ● Fax : +32 /2 / 231 03 47
Website : www.eapb.eu

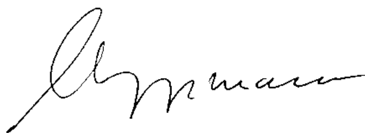
2.7. Reporting

We consider CEBS' proposed option 3 (reporting to supervisory authorities based on reports defined by the supervisors) as the most suitable option. We are very much in favour of harmonising reporting at European level. However, we fear that harmonisation would be effected with the highest common denominator.

In contrast to option 3, we vehemently oppose to option 1, i.e. the pillar III reporting. There might be good reasons for exceeding a limit temporarily and these must be analysed confidentially with the responsible competent authority. The requirement provide for additional regulatory capital is already a sufficient incentive to avoid such a situation. Any further market pressure is not required in our view. What is more, disclosure could have a negative impact on the market with undesirable consequences for the bank's refinancing.

Please do not hesitate to contact us if you have any questions.

Kind regards,



Henning Schoppmann
EAPB

Walburga Hemetsberger
EAPB

The European Association of Public Banks (EAPB) represents the interests of 28 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%.

Avenue de la Joyeuse Entrée 1 – 5, B-1040 Brussels ● Phone :+32 /2 / 286 90 62 ● Fax : +32 /2 / 231 03 47
Website : www.eapb.eu