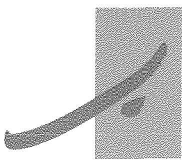

FEDERATION
BANCAIRE
FRANCAISE

La Directrice générale

Paris, 2 August 2007

French Banking Federation response to the CEBS consultation paper CP 14 on the first part of its advice to the European Commission on the Large Exposure Regime

Dear Mrs Nouy,

The French Banking Federation, on behalf of the French banking Industry, appreciates the opportunity to comment on this first part of the consultation advice on Large Exposures to the European Commission, which addresses appropriately most of the issues, even though some positions are quite normally debatable.

We also notice that some issues will rather be handled in the second part of the advice which will come later on during the second semester. This two step approach has clear merits in separating otherwise linked issues, however we cannot but underline the importance of the credit risk mitigation, indirect concentration risk, intra-group exposure and trading book exposure issues for the Industry. This is particularly true for the latter case where the time horizon and the management techniques are totally different from those used in the banking book world and probably deserve a specific approach.

We would also like to underline that the Industry needs a simple and/or principle based regulation. The growing burden of the current and planned regulation is such that this phenomenon is becoming a true jeopardy for the efficiency of the banking activities.

The French Banking Federation is committed to building a level playing field in Europe than a better regulation can contribute to create. FBF is at CEBS's disposal for any further discussion on these issues.

Please find attached our detailed comments on CP 14.

Yours sincerely,

Ariane OBOLENSKY

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CEBS Questions:

1. Do you agree with our analysis of the prudential objectives of a large exposures regime?

We agree that a Large Exposures regime should mainly aim at preventing unforeseen event risks that could negatively and significantly impact a bank's liquidity or solvency.

Materialization of such event risks usually relates to single name concentrations, as fraud or misrepresentations and do not affect whole industries or countries at the same time. Monitoring of single name concentrations in relation to the equity base of the bank should therefore definitely be a prime target of the regime.
We think useful, as the consultative paper seems to do to, not to commingle the L.E. regime with risk concentration management issues even though these two notions may sound quite close. The L.E. regime should be construed as the ultimate safeguard to prevent institutions from inappropriate and careless lending practices while Pillar 2 requirements should be focused on the improvement and efficiency of risk management. There are therefore two different while related prudential objectives, which then requires two different responses.
We consider that single name, sectorial and geographic concentration issues are clearly to be handled through Pillar 2 and a bank's specific monitoring by both its management and its supervisors. These concentration analyses must be tailored to the specific risk profile of the bank and the economic forecast; it cannot fit in a standardized approach. Concentration risk should be dealt internally by each bank with its own rules, the onus being on it to show the adequacy of its management through the ICAAP to its supervisor.
We do also agree that the undiversified idiosyncratic risk should not be considered at this stage in the Pillar 1 process
In short, we are in favour of a L.E. regime that will be a safeguard regulation to rein in careless lending, supplemented by a concentration monitoring which will be part of the ICCAP and Pillar 2 surveillance. The L.E. regime should be rather a simple, easily understandable, calculated and verifiable backstop while concentration risk should be principle based, reviewed within the bank's ICAAP. This clear separation would allow and justify different metrics and approaches to tackle these two different but again closely related issues.

2. With regard to the market failure analysis set out in Section IV. Do you agree with the analysis that there remains a material degree of market failure in respect of unforeseen event risk?

There are growing and new challenges due to the increasing product innovation, complexity, correlations, and potential contagion effect brought in by new financial players (Hedge Funds, CDOs, etc.)
However, banks' internal risk management and discipline have improved a lot and will continue to do so under the pressure of Basel II, including Pillar III but also under the pressure of the management itself whose objectives are also to keep the firm alive, steadily profitable, and efficient in the long run. We do not share the view that there could be an opposition between the management goals and the social interest, embodied by the supervisory body.
The examples given in the paper are not a convincing demonstration of this thesis. They just show examples of mismanagement and bad governance. The usual reaction of management facing unexpected losses is more to wind down its risk appetite than to double its stakes to restore its profitability. They do however show a need to stop these ever possible human deviations through a rather simple but necessarily loose straight jacket, as the current regime is, provided that some improvement, clarification and simplification be made as suggested later on in the paper.

3. Do you have any further evidence that you consider useful for deepening the market failure analysis?
No

4. Do you 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? If not, could you please provide us with a detailed explanation of where you consider that competitive distortions arise?
Because the L.E. regulatory framework is not equally applied worldwide, it creates a competitive disadvantage across countries with regard to large transactions. This is particularly the case for M&A operations, where secrecy is a key element at the origination of transactions: banks without L.E. regulation can discuss one to one. Clients are reluctant to discuss with banks limited by L.E. regulation since they must include other banks in the process to reach the global underwriting capacity.

5. What are your views in respect of the analysis of the recognition of credit quality in large exposure limits and our orientation not to reflect further the credit quality of highly rated counterparties in large exposure limits?
In the case of single name concentrations, unforeseen risk events would typically be cases of fraud / misrepresentations on highly rated counterparties, becoming "fallen angels". Their rating would not be relevant. We then concur with the orientation not to reflect further the credit quality of highly rated counterparties in large exposure limits. However we feel that making no difference between OECD sovereigns or banks and any other exposures is rather rough and does not work in favour of the acceptance of the regulation. We would suggest a simple three weighting system: 0% for OECD sovereigns, 20% for OECD banks and 100% for all other exposures.

6. 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?
We believe this limit as being a good compromise; it leaves some leeway to small and specialized banks; it does not interfere with the concentration management that the largest banks will have to develop anyway within Pillar 2.

7. What principles or criteria might be applied for an institution to demonstrate its ability to measure and manage the relevant risks?
Strong internal control, an adequate and effective ICAAP (Analyses of economic capital concentration and stress testing) and, eventually compliance with the L.E. regime are certainly the most relevant ways to control these risks. The L.E. regime, as a backstop, and a concentration management satisfying the Pillar 2 requirements appear to the Industry a satisfactory framework.

8. Do you consider that the principles outlined with respect to off balance sheet items 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?
We believe that the calculation of the exposure value should be as simple and, hence, as consistent as possible with the Basel 2 EADs. Such an approach would simplify a lot the calculation process and its understanding while the drawbacks, from a methodological standpoint, are minimal. What is good for the capital requirement measurement should also

be for the L.E. regime purpose. We therefore strongly support the use of Basel 2 compliant EADs, whether they are internally defined or based on the regulatory assumptions, to report and verify the L.E. limit compliance.

We are then in favour of the two-tier approach to the L.E. regulatory framework, whereby most sophisticated banks would be allowed to use their own EADs to assess their large exposures.

It seems to us, although the paper outlines well the issues, that the four principles to be met for reporting exposures on financial derivatives and securities financing transactions (multiplicity of possible measures, EPE or high percentile) do not give sufficient clarification and will need to be further elaborated.

Banks who use the formula "marked to market + add-on" must be permitted to report these EADs in the L.E. regime.

For banks who use Internal Models Method (EPE), we believe that the principles should define the time horizon over which to consider potential future exposures, as well as the statistical measure to use.

In terms of time horizon, using a one-year horizon would be the most appropriate as it is consistent with the regulatory and economic capital process.

In that case, as for the statistical measure to use, the large exposure value should be derived from the EE (Effective Exposure) profile. Indeed, using a percentile approach depending on the limit framework of each bank would create competitive distortions between banks, favouring those who use the lowest percentiles. The EE measure has thus the advantage of being unique, well defined and consistent across all banks. In addition, the EE approach has the advantage of being consistent with the approach for loans thus creating no competitive distortions between different departments of a bank.

9. Do you support harmonisation of the conversion factors applied to the off balance sheet items set out in Section IX.II? How important are these national discretions?

We support harmonisation of the conversion factors.

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

The closer the L.E. regime will be to the principles we agreed upon above: Basel II EADs associated to three counterparty weightings, the easier it will be understood and seen as a useful backstop system for internal purposes. The more principle based the concentration risk analyses within the ICAAP will be the more tailor made and, hence, useful it will be for management purposes, as well.

11. 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) to default products. How do you calculate exposure values for such products for internal purposes?

Some structured credit products bear a risk linked to the underlying exposures, some products bare a risk which is not directly linked to the default of the client (such as securitizations of a set of receivables) and is thus extremely granular. Due to the large variety of products, the treatment should be left to the bank, on a case by case basis, based on the way banks follow such risk.

Liquidity facilities on bankruptcy remote vehicles bear a very small credit risk. Their main risk is a liquidity risk which is monitored under pillar 2 with Contingency Funding Plans. Therefore, such liquidity facilities should be included in the L.E. regulation with a 20% risk weight.

12. Do you consider the suggested principles set out in Section IX.III appropriate for application to institutions' exposures to collective investment schemes and/or structured finance transactions?

We consider the look-through principle inappropriate as these kinds of structure are meant to modify the underlying risk. For complex schemes such as securitization vehicles or funds, no broad principle should be set and a case by case approach is required.

From a reporting point of view, a look-through regime for single name concentration evaluation purposes would be difficult if not impossible to implement, the aggregation of underlying and direct exposure irrelevant, and its cost to benefit probably prohibitive:

- The information at a very detailed level such as names of legal entities composing the underlying assets is not always available (funds, securitization structures where the bank is a mere investor, etc.).

- Structures attached to securitisation vehicles for instance are most often a complex risk allocation between the Seller, the bank, other forms of credit enhancement, etc. There is a form of risk diversification and mutualisation where the relative risks borne by the bank can significantly vary from one structure to another. It would be excessive to consider that the bank is directly bearing the risk of the underlying assets.

Same for funds where there are some diversification principles (more or less pronounced, depending on the degree of regulation applying to the fund), as well as some support from asset managers, such as to mitigate single name risks.

Banks are not exposed to the default risk of a given fund/securitization's underlying in the same way as when directly lending to this underlying. Aggregating it to the rest of the bank's exposure on such name would make little sense and will not materially change the concentration picture of the bank.