

POSITION PAPER



**ESBG Response to the CEBS Consultation Paper
(CP14) on the First Part of its Advice to the European
Commission on Large Exposures**

15 August 2007



EUROPEAN SAVINGS BANKS GROUP



1. INTRODUCTION

General remarks

The European Savings Banks Group (ESBG) welcomes this opportunity to provide its comments to CEBS regarding the consultation paper 14 (CP14) on the first part of its advice to the European Commission on large exposures (LE). We believe that CP14 represents a positive step forward to re-define the new LE regime. However, our final evaluation will come only once the work is completed with the forthcoming advice on the second part of the Commission's Call for Advice.

In our opinion, the review process of the regulatory regime contains some weaknesses. Firstly, the short period available for CEBS to elaborate on the different and complex aspects of the LE regime, including a market analysis, led to the paradox of a regulatory outcome with a market analysis still in progress. We believe that it would have been much better to take the time necessary to elaborate in more detail some important aspects and to finalise the paper before the consultation.

Secondly, the review process takes place at a time when institutions are carrying out efforts to adapt to the Basel II requirements. This is especially relevant in jurisdictions where the adoption of the CRD and its transposition into national regulation remains unfinished. Against this background, any amendment to the current framework should be introduced only once the new regulation is "settled" and fully implemented by institutions. We believe that the actual framework has worked well in the past and that there is no urgency as regards possible changes to the system.

Assessment of the Current Framework and Possible Way Forward

Although we believe that the current regime, based on simple quantitative rules, has some weaknesses, it also has important merits. Generally, locally-active banks find the rules and limits both helpful and broadly appropriate. These institutions often use the regulatory limits as a basis for their internal approaches to the management of LE. On the other hand, for internationally-active and sophisticated banks, the management of LE on the basis of internal models is perceived as one aspect of concentration risk, which is dealt with under the second Pillar of Basel II.

Against this background, we believe that it would be appropriate to give due consideration to the introduction of a flexible supervisory approach for the management of LE. The proposed solution should be designed as a combination of the approaches used by sophisticated and less complex banks for the management of concentration risk. On one hand, this approach would avoid over-regulation for the smaller institutions and on the other it would prevent larger institutions from implementing an overly-complex, costly parallel structure for the management of concentration risk.

The limit included in the current framework, which prevents an institution from having a total exposure to an individual customer/ counterparty or to a group of closely related customers/ counterparties, that exceeds 25% of its capital, is considered relevant by the ESBG. Regardless of



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costs and benefits, the institutions are used to working with the current regulatory limits, which are complemented in some cases with additional internal management systems.

The question of reporting requirements is also an important aspect of the LE framework. In general terms, a more extensive review of the LE regime should lead to an alignment of the reporting requirements with institutions' actual internal risk management. As the review of industry practices carried out by CEBS during 2006 has shown, the mismatch that especially - but not only - larger and more sophisticated institutions experience between their own practices and the supervisory requirements, is reflected in a reporting burden that bears little or no relation to their internal risk management and limit systems. For these institutions, the current LE rules create a regulatory burden in the form of parallel reporting.

Finally, as regards the implementation of the framework in the 27 Member States, we support the objective of enhanced convergence in order to achieve an EU level playing field. That said, we also consider it important to take the specificities of the different Member States into account.

2. ANSWERS TO THE SPECIFIC QUESTIONS

Question 1:

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

The ESBG considers appropriate the analysis on the prudential objectives of a LE regime set out by CEBS. We agree with the view that a LE regime is helpful if it serves as a backstop against unforeseen event risk.

In this context, we strongly support CEBS' opinion that all issues concerning concentration risk should be dealt with under, and covered by, the second Pillar of the CRD. Currently, we see no potential problems or overlapping between the expected treatment of Pillar 2 requirements on concentration risk and the regulatory limits for LE. It is precisely in these Pillar 2 requirements that the incentives for institutions to improve their management of concentration risk are clearly present.

We consider it to be of key importance to design the regime in a way that it does not hinder the development of internal concentration risk management approaches by larger institutions. At the same time, smaller institutions not willing to develop internal methodologies would be able to apply a framework similar to the current LE regime which has already proven its merits. Given the objective of the framework and the complexity to consider these "unforeseen risk events", it seems unnecessary to complicate the regime or to design it away from the lines of the CRD. This proposal would facilitate the introduction of the framework and reduce the costs for institutions.

Question 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?

Question 3:

Do you have any further evidence that you consider useful for deepening the market failure analysis?

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The ESBG welcomes CEBS' efforts to carry out these analyses which could give a good overview of the extent to which large exposures are addressed by other mechanisms that operate outside the regulatory framework (e.g. market discipline imposed by rating agencies or other stakeholders). However, we find the examples put forward in the paper questionable. In our opinion, these examples are more closely related to bad governance than to market failure as such.

In our opinion, the market failure analysis should consider the different sizes and business models of banks and counterparties. We also believe that although market discipline might be used as a motivating factor in theory, it would have little relevance in practice.

Finally, we would like to point out that the regulatory failure analysis referred to has yet to be carried out. Since CEBS indicates that further work is to be done on this chapter, we expect this section to be revised.

Question 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?

We welcome this analysis and would like to stress the importance we attach to the competitive aspect. We believe however, that the information provided does not make it possible to assess whether EU institutions are at a competitive advantage or not versus their international counterparts.

Question 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?

We support CEBS' view that counterparty credit quality should not be introduced generally into a new LE framework. However, certain exceptions to the regime, such as top-class ratings of countries, regional governments and local authorities, as well as banks (central banks) or some sorts of intra-group exposures, should be considered in a future regime.

Question 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 that the 800% limit system should be kept. Although for some larger and more sophisticated institutions this limit might not be relevant, we believe that it can provide useful guidance, in particular for the smaller and less sophisticated institutions.

Question 7:

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

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We believe that principles should be in line with the principles developed by CEBS on Pillar II and should also consider individual circumstances. In this regard, it could be relevant to apply the following principles: (a) definition of causes of concentration risks; (b) policies and procedures to manage, monitor, mitigate and report concentration risk; (c) design of worst-case-scenario analysis.

Question 8:

Do you consider that the principles outlined with respect to offbalance 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?

The ESBG welcomes CEBS' efforts to align the calculation methods of the LE regime with those of the CRD and believes that the suggested principles are in general appropriate. However, we believe that further alignment with the CRD calculation methods could be achieved, particularly between the LE approval tests and the review of the IRB system. In this context, we believe that, if an institution has demonstrated that a measure is acceptable for capital purposes, further tests relating to LE approval should not be requested.

Question 9:

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

Question 10:

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

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

As regards conversion factors for the calculation of exposure values, a risk-sensitive approach, taking into consideration the different risk characteristics of off-balance sheet items should be adopted. Particularly, conversion factors used by most member states in their LE regimes for low and medium risks have proved their merit and should be kept.

Concerning structured finance and/or basket products, we consider the method applied by large sophisticated banks to calculate exposure values too complex and costly. We therefore believe that a more suitable solution would be to apply the method outlined in paragraphs 212 a) and 213. Additionally, we are in favour of differentiating between baskets according to the number of transactions they contain.

Question 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?



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We find some of the methods described in this section difficult to understand and too complex to implement. We would welcome it if CEBS could provide further clarification and examples to illustrate the suggested methods.

We believe that a one-size-fits-all system for dealing with structured transactions is not appropriate because, in general, such transactions have very unique characteristics. In many cases, institutions do not have enough information available to apply the suggested solutions, as it is not always available on the market in such level of detail.

Finally, a solution to the above mentioned difficulties would be to grant institutions the option, depending on the risk profile of the position, of either applying a look-through solution or treating the structured transaction as a borrower.

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About ESBG (European Savings Banks Group)

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of € 5215 billion (1 January 2006). It represents the interest of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG members are typically savings and *retail* banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their *region*. ESBG member banks have reinvested *responsibly* in their region for many decades and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.



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Published by ESBG. June 2007.