Slaughter and May
Submission to the Committee of European Banking Supervisors

Slaughter and May is an international law firm with offices in London, Paris, Brussels and Hong Kong. We act for a wide range of banks and other financial institutions.

We welcome the opportunity to respond to the second consultation paper on CEBS' technical advice to the European Commission on the review of the large exposures rules. We would be happy to discuss any part of this submission with CEBS. This submission is not confidential and we have no objection to it being published on CEBS' website.

National Discretions

We do not agree that CEBS should start with a presumption against the retention of national discretions in the implementation of the Banking Consolidation and Capital Adequacy Directives (recast). The retention of national discretions may serve legitimate policy considerations, particularly where they reflect differences in the stage of development of banking markets between Member States, or where alternative approaches are justified for individual firms or groups. Despite the creation of the single market, which we support, differences remain between Member States, and, particularly, between large internationally active banking groups and smaller institutions. **We are concerned that the removal of discretions, or policy options, could result in the application of a "lowest common denominator" approach that could be inappropriate for many institutions. We believe that in banking supervision outcomes are more important than the process by which such outcomes are reached, and that it is essential that supervisory techniques reflect the needs of individual markets and institutions.** We do not oppose the elimination of national discretions where they do not reflect the need for different policy outcomes and, in particular, if they reflect a historical approach on the part of national supervisors.

Q1. CEBS would welcome respondent's views on the high level impact assessment of the policy options.

We do not propose to comment on this assessment.

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.

We believe that the definitions of control and interconnectedness should be clear and based on objective criteria. A subjective test is not appropriate for a Pillar 1 rule, although such factors may (and in certain cases should) be taken into account under Pillar 2. The reason is that the limits on large exposures, and in particular, the 25% hard limit are a rule, breach of which may result in regulatory action. Firms need to be able to determine in advance which exposures are subject to large exposure limits to ensure that they are able to comply with their regulatory obligations. We note that the 25% limit is a backstop and that supervisors are able to take regulatory action under Pillar 2 if a bank's exposures give rise to inappropriate concentrations of risks below that limit.

Connected Counterparties

CEBS proposes to define a "connected party" as[1]:-

> (i) 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.
>
> (ii) 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.

We agree that natural persons who are involved with the management of a bank at a senior level should be treated as connected, although we would not expect loans to such individuals to give rise to a large exposure and would anticipate regulators intervening before such loans reached 25% of a firm's financial resources. We doubt whether a test based on the "building of networks" is sufficiently certain and would suggest referring instead to directors, senior managers, auditors and, if appropriate, other professional advisors of the firm.

In terms of legal persons, we consider that members of the bank's group, together with associates, should be treated as connected. Applicable EC directives define the members of a firm's group. The definition of "associate" should probably follow accounting standards. If CEBS wishes to extend the definition of a connected party further a clear test should be adopted setting out which other relationships are caught.

Connected Clients

We agree that exposures to connected clients should be aggregated where they constitute a single risk. However, firms should be able to comply with this rule without putting in place complex new systems and controls. A bank will have information about the members of its group, and its associates. However, this is not necessarily the case with regard to its clients. **We suggest that CEBS make clear that it does not intend to impose new burdens on firms, and that the review of firms' policies and procedures in respect of the collection of data will be carried out under Pillar 2 and not Pillar 1.**

We doubt whether it is appropriate to apply a test based on "dependency or correlation" (para 91). The concept of a "single risk" is well understood and the proposed guidance could be interpreted as relaxing the directive requirements. In particular, the list in paragraph 92 seems unhelpful as (1) a bank may be unaware of the relevant link and (2) while the existence of such a link *can* indicate dependency, it may not, and whether it does depends on other factors.

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[1] Para 75.

For example, an exposure to commercial property and to the tenant who pays the majority of the rent may constitute a single risk. However, this will not be the case if the property company and the tenant are well-capitalised entities, as in this case the default of one is unlikely to result in the default of the other. We note that it is likely to be rare that the default of a development company will lead to the default of its tenant(s) as it will be in the interests of the receiver or liquidator to continue to let the premises, or to sell the property subject to the lease. Whether the tenant's default will lead to the default of the developer depends on the state of the property market as well as the financial strength of the developer; only in the case of a thinly capitalised developer, or high-velocity commercial real estate, are the two likely to constitute a single risk.

Similar points could be made in respect of the other examples in paragraph 92. Whether the sole producer and sole buyer of a product constitute a single risk depends on the financial strength of both entities. For example, in many Member States there is a single producer for patented pharmaceutical drugs and a single, often state-owned, purchaser. It would not be sensible, however, to treat these as a single risk. In a relationship between two commercial companies, whether they constitute a single risk will depend on the degree of dependence of their business to the particular product. In other words, it *may* indicate dependence but equally may not. For the same reason, an exposure to undertakings with an identical customer base may but need not constitute a single risk. The premise appears to be that the insolvency of a customer is likely to lead to an increased risk of default by a producer due to a decline in demand. However, if both producer and customer are commercial entities, then the default of a "customer" (i.e. an intermediate producer) is likely to lead the remaining "customers" increasing demand.

We consider it is inappropriate to require firms to present "strong counter arguments for not grouping clients" that exhibit one or more of the relationships in paragraph 92. Whether such a relationship gives rise to a single risk depends on other factors, such as the financial soundness of the parties and the diversity of their business model that are not taken into account under paragraph 92. Our preference is to delete the list. If CEBS considers it necessary to provide guidance on this point, we believe the list should set out factors that banks may take into account, but without a presumption that where they are present there is a single risk.

We are unclear of the basis for the suggestion in paragraph 95 that an entity should not be included in more than one group of connected clients. It appears to us that an undertaking, A, may be connected with undertakings B and C, in that the default of A would be likely to lead to the default of B and C, even though the default of B is independent from that of C (and vice versa). A member of a group of connected clients may also be a connected counterparty, even though other members of the group of connected clients are not connected to the firm.

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.

We agree that exposure values should be based on applicable accounting standards. We also agree that this should be net of accounting provisions and value adjustments. Where an exposure has attracted an impairment charge, and been deducted from capital, this should be recognised for large exposures purposes. This does not provide an incentive for firms to incur

large exposures as a deduction from capital is equivalent to a capital charge of 1250%. Any other approach could penalise firms, and act as a disincentive to provision prudently against losses. In terms of off-balance sheet items, we see no reason to modify the approach in the Banking Consolidation Directive (recast) which was extensively consulted on by the Basel Committee and Community institutions.

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

We are not convinced by the arguments in favour of a uniform 100% conversion factor. This would introduce an unnecessary difference between exposure values calculated for credit risk purposes and those applied for large exposure purposes. This could have systems implications for firms. We also consider it right in principle to differentiate between the level of risk in off-balance sheet exposures. This is different from taking into consideration counterparty credit worthiness (which is not normally relevant for large exposures) as the focus when calculating conversion factors is on the degree of risk due *attributable to the transaction* (transaction risk) as opposed to the credit worthiness of the counterparty. For example, a general guarantee of indebtedness is more risky than a performance bond or a 364 day undrawn commitment whatever the credit quality of the underlying obligor.

Applying a 100% credit conversion factor could create incentives for banks to accept riskier commitments (as these will attract a higher commercial return) within the 25% and 800% large exposure limits. Given CEBS' proposal to allow advanced IRB banks to apply their own internal estimates of credit conversion factors, requiring standardised and foundation IRB banks to apply a 100% credit conversion factor risks disadvantaging smaller and less sophisticated institutions.

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.

We consider that there is scope to apply conversion factors between 0% and 100%. In our view, the appropriate conversion factors are those that apply under the CRD for credit risk. For the reasons given above, a different approach may expose firms to additional systems costs and does not appear justified by prudential considerations.

The concerns previously expressed in respect of 364 day undrawn commitments have been addressed by the Banking Consolidation Directive (recast). We therefore consider that a 100% conversion factor would be unduly conservative. Given current conditions in the credit markets, the introduction of stricter limits could also reduce the willingness of banks to provide short-term liquidity.

We do not oppose elimination of the national discretion in respect of the 50% risk-bucket. This reflects a prudential decision on the level of risk in such transactions.

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?

We are somewhat surprised by the suggestion that a 0% conversion factor applies to liquidity facilities in structured finance transactions. In the United Kingdom, such facilities are generally not unilaterally cancellable by the lending institution. Rating agencies insist on a facility of at least 364 days with a right (but not an obligation) on the lender to renew the facility. If the lender decides not to renew the facility, the amount is paid into an escrow account from which it can be drawn by the borrower over a defined time period. The purpose of this mechanism is to enable a new facility to be put in place to ensure timely payment to investors. Such a facility is not eligible for a 0% conversion factor.

Facilities that can be unilaterally cancelled prior to draw do not involve the firm in credit or operational (legal) risk. They do, however, involve reputational risk. Reputational risk was deliberately excluded by the Basel Committee from the Basel 2 framework, and is not subject to capital charges under the Banking Consolidation Directive (recast). We do not consider that it would be appropriate to seek to bring it within the scope of the large exposures regime until an appropriate treatment has been agreed for reputational risk. Doing so could expose EEA banks to an uneven playing field with competitors in other financial markets. More generally, we are not aware of any internationally agreed methodology for dealing with reputational risks.

We note that many banks have extended liquidity to SIVs to address the reputational risk of the SIV becoming insolvent. However, it is only because the banks concerned were well capitalised, and able to bear the capital and opportunity cost of doing so, that they provided liquidity. A bank under financial stress would not provide such support. We are not aware of any examples where liquidity has been provided due to legal or credit risk i.e. the securitisation documentation was not effective to achieve a “clean break”.

Requiring banks to assume that non-contractual liquidity will be always be provided would overestimate the level of credit risk. The same applies if banks were required to treat unilaterally cancellable facilities as having a longer maturity. There is also the practical difficulty of what maturity should be ascribed to facilities if not the contractual maturity. Once one departs from the terms of the contract there do not exist any objective and verifiable criteria for determining the term of a facility. This applies to all facilities, and not just to those that are unilaterally cancellable. Most 364 day facilities include an option, at the lender’s discretion, to renew the facility (see above). Should these be treated as having a longer maturity than 364 days? If so, what maturity should be applied? The facility *could* be renewed until maturity/termination of the structure. However, requiring a bank to assume that it *would* extend the facility merely because it might do so significantly overstates the level of risk involved.

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.

We agree that advanced IRB banks should be able to rely on their own internal estimates for conversion factors. The factors taken into account when recognising internal estimates

should be the same as apply for credit risk. The possible use of inappropriate internal estimates referred to in paragraph 114 should be addressed either as part of the IRB approval process or under Pillar 2 through requiring modifications to a firm's IRB model. We consider the factors listed in paragraph 113 to be useful, albeit they should be integrated in the model approval and review process.

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.

For financial derivatives and securities financing transactions we consider that exposure values should continue to be calculated in the same way as for credit risk.

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

We consider that the recognition of credit risk mitigation techniques should be the same for large exposures and credit risk. Any other approach could result in material systems costs for firms. We also question whether it is prudentially justified as the purpose of large exposures regulation is to limit the loss to the firm as a result of the unexpected default of a counterparty. It does not seek to address the risk of default of an unrelated issuer whose securities are provided as collateral, or who is the provided of unfunded credit protection (unless, of course, there is a material positive correlation between the two). The reason is, as stated in paragraph 126 of the consultation paper, that a large exposure scenario implies the default of a direct counterparty through idiosyncratic causes.

We agree with CEBS that recovery must be timely and certain and note that this is already incorporated in the Banking Consolidation Directive regime. If problems arise in practice we suggest that the appropriate response is through amending the criteria in the directive to ensure that necessary standards are met. While we recognise that credit risk mitigation may raise short-term liquidity issues, we do not consider that the large exposures regime is the appropriate place for addressing bank liquidity, which raises wider issues that are under consideration elsewhere.

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.

Proposal 1 is to "accept the same protection treatment in both the large exposures and the minimum capital frameworks (eligibility, minimum requirements and effects)". For the reason give in response to question 9 we agree with this approach.

Proposal 2 would "accept the same treatment in the large exposures framework as in the minimum capital framework only for those CRM instruments considered liquid enough". Under Proposal 2 the range of credit risk mitigants would be more limited. As this is the proposal consulted on in questions 12 and 13 we refer to our answers below.

Proposal 3 would 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).

The difficulty with proposal 3 is its complexity. Firms would need to assess the eligibility and effect of credit risk mitigation separately for credit risk and large exposures purposes. In principle, we consider that the Banking Consolidation Directive should define the appropriate standards in respect of haircuts, volatility, the level of collateralisation, etc. based on a prudent approach. If these standards are adequate for credit risk we do not see why they should be treated as inadequate for large exposures.

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 ?

There are potential systems costs if firms are required to redesign internal systems to apply different approaches for credit risk and large exposures.

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.

This proposal seems an appropriate change for smaller institutions, although we have no detailed comments.

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

We disagree with the proposal that physical collateral should be ineligible. The consultation paper does not give any positive reason for the exclusion of physical collateral. We assume that CEBS is concerned that such collateral may not be liquid enough, or that there may be difficulties in obtaining an accurate valuation. It is unclear whether the discussion of physical collateral in the consultation paper is restricted to "other collateral" (Annex VIII, Part 1, para 21 of the Banking Consolidation Directive) or whether leasing and receivables are covered as well.

Recognition of "other collateral" is subject to the agreement of the competent authorities. It follows that a class of assets may only be recognised if the national supervisor is satisfied that it would be prudent. In addition, the directive requires: (a) the existence of liquid markets for disposal of the collateral in an expeditious and economically efficient manner and (b) the existence of well-established publicly available market prices for the collateral.

We consider that these criteria are also appropriate for larges exposures. If collateral is otherwise acceptable, there is a liquid market in which it can be disposed and there exist well-established publicly available market prices then this ought to be sufficient. Examples of collateral that would meet these criteria are aircraft and ships, as well as some manufacturing plant. Such collateral is likely in many cases to be more liquid than commercial property, which is prone to cyclical variations in price and saleability. We are not aware of a reason why the commercial property market should be treated more favourably than aviation, shipping or manufacturing. We also do not understand the reason for the exclusion of receivables, if this is intended by CEBS. Finance leasing should be treated in the same way as collateralised lending.

We agree with CEBS' proposed treatment for guarantees and credit derivatives.

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 .

We agree with CEBS that it is not practical to establish quantitative criteria to address indirect exposures. We recognise that such risk is a source of unexpected loss for banks and that the most appropriate approach is through stress tests as suggested in paragraph 162 of the consultation document.

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.

We believe that the retention of different rules for trading book and non-trading book exposures is necessary and appropriate. The removal of the soft limits under the trading book could have a serious adverse effect for investment firms and, potentially, banks with a significant trading book business.

The reason for the distinction in treatment is the difference in risk between the trading book and non-trading book. Article 11(1)-(2) of Directive 2006/49/EC defines the trading book as follows:

> 1. The trading book of an institution shall consist of all positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book and which are either free of any restrictive covenants on their tradability or able to be hedged.

> 2. Positions held with trading intent are those held intentionally for short-term resale and/or with the intention of benefiting from actual or expected short-term price differences between buying and selling prices or from other price or interest rate variations. The term 'positions' shall include proprietary positions and positions arising from client servicing and market making.

Internal hedges are also included (Article 11(5)). Firms are required to implement strategies, policies and procedures to manage trading book positions (Article 11(3)) and systems and controls (Article 11(4)). Firms are required to have clearly defined policies and procedures for overall management of the trading book.

It will be apparent from these provisions that exposures can only be included within the trading book if they are actively traded in accordance with pre-agreed trading policies, or hedge other trading book exposures.

Such transactions present different risks to those included in the non-trading book in that they are either short-term, or are capable of being traded out of in the short term. For such exposures the principal risk is market risk. In the case of non-trading book exposures, a bank is dependent on the performance of the obligor. With a loan the lender is dependent on the performance of the borrower, and will suffer loss if the borrower defaults or becomes insolvent. In the case of a trading book position the firm seeks to make a profit, or avoid a loss, as a result of short-term movements in the market price. As the position is short term, the likelihood of unexpected loss due to idiosyncratic factors specific to the issuer is considerably reduced.

We believe that these factors justify a degree of flexibility when applying large exposure limits to the trading book. This is what the soft limits achieve through permitting temporary and limited excess positions provided that the firm meets an additional capital requirement. The existence of this capital requirement (the CN COM) provides a disincentive for firms to allow excesses to exist.

We would also mention two aspects of the CN COM that discourages inappropriate risk taking by firms. First, the soft limits are sensitive to the number of days for which the excess has persisted, with a 600% hard limit for excesses that have persisted for more than 10 days (Article 31(d)). Secondly, under Annex VI: (1) after 10 days the capital charge increases from 200% up to 900% depending on the size of the excess. Further, in applying the capital charges in Annex VI firms are required to allocate exposures in ascending order of specific-risk requirements in Annex I and/or requirements in Annex II. The effect is therefore:

(1) the greater the excess, the greater the capital charge; and

(2) those items with the highest individual capital charges attract the highest CN COM percentages under Annex VI.

We also note that the capital charge for trading book excesses increases significantly as the credit quality of the exposure deteriorates. Such a conservative approach is appropriate. However, it should be recognised as an additional disincentive towards inappropriate risk taking by firms.

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.

We agree that prior to the implementation of Basel 2 and the CRD such blurring had taken place and may have created incentives for firms to book business in the trading book. We understand that this happened principally due to the lower capital charges for credit/market risk rather than because of large exposure constraints.

This issue was directly addressed in the Trading Book Review carried out by the Basel Committee. This resulted in the new definition of the trading book set out in Article 11 of Directive 2006/49/EEC as well as the requirements of Annex VII D. **We consider that the new requirements should be given the opportunity to work in practice, and that given recent changes a case has not been made for further significant modifications at this time.**

We would also mention that the inappropriate allocation of transactions to the trading book is not an issue specific to the large exposures regime. The inappropriate inclusion of transactions in the trading book should, in our view, be addressed by reinforcing the requirement of "trading intent" rather than through changes to the large exposures regime. We therefore agree with CEBS that it is "the task of the supervisor to determine whether all positions in the trading book are really held with trading intent in line with the institution's trading strategy" (paragraph 182).

For completeness, we are aware that recent events have raised questions concerning the appropriateness of some firms' procedures for valuing positions in the trading book. These concerns need to be addressed. However, we do not consider that the large exposures review is the appropriate place to tackle this issue.

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.

We are not persuaded that it would be appropriate to replace the existing treatment of trading book excesses by a deduction approach. The reason is that this could impose significant new costs on firms for their trading book business. A deduction from capital is equivalent to a capital charge of 1250%. This compares to a CN COM that varies from 200% for excesses that have persisted up to 10 days and 200% to 900% of the capital charge under Annex 1 or Annex 2 where the excess has persisted for more than 10 days.

We do not oppose making a deduction approach available as an option for banks and investment firms. It is possible that there may be some small firms which would benefit from such an approach.

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.

We are not persuaded that a different approach should be applied to these products for large exposure purposes. Applying a different definition could result in systems costs for firms. We are also unaware of factors *specific to large exposures* that justify separate treatment.

We recognise that such products may be less liquid than other instruments traditionally included in the trading book, and that the complexity of some structured products makes them more difficult to value. In our view, these points raise the question of whether it is appropriate for such products to be included in the trading book at all. We believe these issues should be kept under review by CEBS and CESR. If the market fails adequately to respond to these concerns, then there may be a case for targeted supervisory intervention.

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

The market failure analysis draws a distinction between entities that are part of a sub-consolidation in which capital is fungible and common risk evaluation, measurement and control procedures apply, and other members of a firm's group (paragraph 188).

In CEBS' view it is not plausible for an individual entity to fail and for other entities within the sub-consolidation to survive as they are in all but legal form the same institution. CEBS considers that 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 (paragraph 189). It is also necessary for sub-consolidation level risk controls to be in place. Without them, problems with information flows and managerial incentives may result in an inefficient distribution of capital within groups (paragraph 190).

We agree that the CEBS analysis sets out an appropriate basis for permitting the solo consolidation of subsidiary undertakings with a parent bank. However, we would suggest that such an approach may be too narrow when taking account of group diversification benefits. In our view a distinction should be made between the legal framework applicable to solo consolidation, and solo large exposure limits to intra-group transactions.

In our view, even where the criteria in paragraph 188 are met, it does not follow that it is not plausible for an individual entity to fail and for other entities within the sub-consolidation to survive. Where capital is fungible and there is no impediment to its transfer, it follows that a banking group may transfer a capital surplus from one part of the sub-group to cover losses in another part. However, it does not follow that because support is possible that it will always be available. Further, company and insolvency law may place limitations on intra-group transfers of capital.

Under English law, each company is treated as a separate entity and company and insolvency law applies to each member of the group on a stand alone basis. The result is that while a parent undertaking may, as a general matter, support its subsidiaries, as the success of its subsidiaries will normally benefit the parent, the converse is not true. The directors of a subsidiary undertaking may take account of the company's position as a member of a wider corporate group. However, they may incur liability for misfeasance, and possible

disqualification, if they disregard the interests of the subsidiary where it conflicts with those of its parent or other group members. For example, upstream lending to a group company that is insolvent, or doubtful solvent, and which imperils the financial position of the subsidiary will often amount to misfeasance.

Equally, a solvent parent company may decline to support an insolvent subsidiary where to do so would not be in the interests of the parent and its group. An example would be where such support could put at risk the financial viability of the parent. For example, it would be wrong for a solvent parent bank to support an insolvent regulated or unregulated subsidiary where the result of providing support was to expose depositors in the parent to the risk of losing their deposits.

It follows that even where the criteria set out in the CEBS paper are met there will always remain a risk that the members of the sub-consolidation will not constitute a single risk in stress situations. The existence of this risk is, in our view, relevant when considering whether it is appropriate to extend the recognition of group support to situations where the criteria in paragraph 188 are not met.

The relationship between solo and consolidated capital requirements was analysed in the FSA Discussion Paper 07/5 Review of the Interaction of Our Solo and Group Capital Requirements[2] as follows:

> 2.14 Any approach to supervision of a group has to balance two views. One view is of a group as a single economic entity, across which risks are pooled and diversified (which should therefore be supervised as a single entity under a 'group only' approach). The other view sees a group as a set of separate legal entities (which should therefore be supervised as individual entities under a 'solo' approach).
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> 2.16 A 'solo-only' approach is one that seeks to insulate the firm from the risks elsewhere in its group. It might, for instance, involve financial and operational ring-fencing and/or conservative capital treatments of the risk relating to the entity's membership of a group, including intra-group transactions and exposures. The capital adequacy treatment of limited licence and limited activity firms that have a waiver from consolidation goes some way towards a solo-only approach.
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> 2.17 At the other end of the scale, a 'group-only' approach would treat the whole group as a single entity, ignoring the distribution of risk and resources within it. This approach would only be feasible if, among other things, the group's resources were fully transferable, at will, between firms that are members of the group.
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> 2.18 In reality, any workable regulatory approach is likely to fall between these two extremes.

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[2] October 2006.

We agree.

The approach in the EC has developed incrementally, with the focus initially on the solo supervision of banks through the First Banking Directive. Supplementary supervision of banking groups has evolved in stages through the First and Second Consolidated Supervision Directives, the Banking Consolidation Directive and now the CRD. **We suggest that a new approach should be informed by market failure analysis and focus on the strengths and weaknesses to banks as a result of their membership of a wider banking group. In doing so the rules should not seek to privilege or disadvantage any one business model. In particular, there should be no systematic bias in favour of a group structure that relies on branches as opposed to subsidiaries.**

Paragraph 192 suggests that it may be the case that the market failure analysis does not apply to other exposures within groups, i.e. exposures between entities that are not in a sub-consolidation. We agree that national supervisors should have the ability to waive large exposure limits between members of a corporate group in such cases provided that it is prudentially justified. We suggest that this might be possible where:-

(1) the parent bank is able and willing to support direct or indirect subsidiary undertakings; and

(2) the parent is able to procure the repayment of surplus capital from its subsidiaries, either through the payment of dividends, or by the winding up or sale of the subsidiary.

We consider that in assessing (1) national supervisors could focus on the following factors (amongst others):-

(a) the commercial willingness of the parent to provide support to its subsidiaries;

(b) insolvency and other laws that limit the provision of such support, or prevent the parent or subsidiary from providing support in a time of financial stress; and

(c) the financial soundness of the parent. A parent undertaking can only be expected to provide support to the extent that it has surplus capital and liquidity. If the parent is regulated, it may be subject to solo regulatory requirements and cannot be expected to provide support that would result in a breach of such obligations.

In assessing (2) national supervisors could take into account:-

(d) the ownership structure of the subsidiary, including any restrictions on the payment of dividends or impediments to winding up;

(e) any adverse consequences on the payment of dividends or winding up e.g. material withholding taxes; and

(f) exchange and capital controls that may prevent the parent from benefiting from a surplus in its subsidiaries.

For the reasons given above, we consider that CEBS should concentrate on the fungibility of capital, requiring firms to identify and address legal and practical restrictions on the transferability of capital, or the provision of support. Regulatory requirements should, however, recognise that there will remain a risk that capital may not be available in certain stress situations. In such cases a proportionate approach is required that reduces such risks to an acceptable level.

We are unclear why large intra-group exposures should impose external costs through inhibiting the timely and efficient resolution of a group's affairs. We are not aware of any major banking insolvency having been caused by intra-group exposures. Nor do we see why large exposures should make the timely and efficient resolution of an insolvency more complex. Intuitively, the fewer exposures to be dealt with, the simpler the insolvency, although we accept that other factors will have a bearing on the complexity of any single banking insolvency.

We are also unclear why large *intra-group* exposures present a greater risk to depositors' interests than other unrelated large exposures. The purpose of large exposures regulation is to reduce the risk of an unexpected event imperilling the continued existence of the institution. In practice, a bank will have more information on connected counterparties than unrelated obligors. It should therefore be in a stronger position to monitor and control credit risk and to prevent unexpected events triggering a collapse of the banking group.

Paragraph 197 states that "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".

We accept that there are differences in national insolvency laws, with the result that the insolvency of a banking group may result in the application of different insolvency laws to different parts of the group. However, we doubt that such differences justify preventing the recognition of diversification benefits to subsidiaries incorporated within different Member States.

Firstly, there has been considerable convergence in the rules applicable to international insolvencies. The EC Insolvency Regulation, the Credit Institutions Winding Up Directive and the Insurers' Winding Up Directive have harmonised the conflict of law rules applicable to cross-border insolvencies within the EC/EEA to the degree considered necessary by the Community legislator. Several Member States (including the UK) have also adopted the UNCITRAL model law. The Community institutions could encourage further Member States to do so.

Secondly, an approach that distinguishes between groups that operate in a single member state, and those that operate in more than one Member State, is inconsistent with the aims of the Single Market. It does nothing to facilitate greater integration in the banking sector or to enable consumers to benefit from a single market for financial services.

Thirdly, as mentioned above, disputes as to how the burden should be shared between creditors can arise within a single member state where national insolvency law is focused, as in the United Kingdom, on each company as a separate entity. If a banking group includes

regulated and non-regulated entities then different insolvency procedures may apply to the regulated and unregulated companies.

Fourthly, in the case of BCCI, which was subject to concurrent insolvency proceedings in Luxembourg, England and the Cayman Islands, the existence of significant differences between English/Cayman insolvency law and Luxembourg insolvency law did not prevent the courts from co-operating together and achieving a result that was broadly equitable to all creditors. A similar result, albeit not involving a banking group, was achieved between the English and US courts following the collapse of the Maxwell group.

Finally, the main sources of group support (capital injection by a parent undertaking, the payment of dividends, and the return of capital on a winding up), are available in all developed legal systems. We see no reason why the provision of group support when required should be regarded as inherently more risky when provided across national borders.

We suggest that the recognition of group support, and a corresponding exemption from large exposure limits for intra-group exposures, should not be restricted to banking groups or sub-groups that operate in a single Member State. We would invite CEBS to establish objective criteria for the recognition of group support on a cross-border basis. Such criteria should be realistic and focus on legal and practical impediments to the provision of support in a stress situation. Differences in national insolvency laws should only be used as a reason to deny recognition if there is clear evidence that such differences prevent the transferability of capital.

We question whether the absence of cross-border institutional arrangements for providing emergency liquidity assistance is significant in this context. Emergency liquidity support is, by definition, an exceptional situation, and will only be provided where the failure of an institution or group gives rise to systemic risk (the provision of support in other circumstances raises issues of competitive equality and, potentially, unlawful state aid). **Banks and banking groups should be in a position to meet their requirements in all realistic scenarios without reliance on emergency support from national authorities.** To the extent that current rules do not require this, there may be a case for existing requirements to be reviewed and tightened.

We also question whether extending recognition of group effects beyond a single Member State would result in increased risk for depositors as suggested in paragraph 198. Cross-border exposures are not intrinsically more risky than exposures that arise within a single Member State, not are we aware of evidence suggesting that such exposures are more likely to lead to the failure of a bank or its group.

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

We have no substantive comments on the analysis. We also refer to our answer to question 19.

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

We agree that subsidiaries that meet the criteria in Article 69 should continue to benefit from an exemption from large exposures limits.

We favour an approach to intra-group large exposures that recognises that the group may be a source of strength as well as weakness. In terms of the approach to be adopted, we invite CEBS to consider establishing realistic criteria for the recognition of group support based on the willingness and ability of banking groups to transfer capital in a financially stressed situation. Where capital is freely transferable, and the members of the group demonstrate the willingness to make capital available where required, we consider that there is a case for exempting intra-group exposures from large exposures limits.

Any decision on whether to allow group support should be taken by the EEA supervisor responsible for the consolidated supervision of the banking group as well as any EEA sub-group at which consolidated supervision is carried out. The burden of proof should be on firms to satisfy their supervisor that the criteria for the recognition of group support are met. The supervisor should also be under an obligation to consult with other EEA supervisors and, where appropriate, and if it is practical to do so, with non-EEA supervisors. If a banking group is subject to consolidated supervision at more than one level we would invite CEBS to establish mechanisms for consultation between the relevant supervisors to ensure consistency.

We agree with CEBS that any exemption should not be automatic. If the members of a group are unwilling to support other group companies in times of financial stress then exemption is not prudentially justified. The same applies if the legal or regulatory environment in an EEA or third state acts as an obstacle to the provision of group support.

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.

(i) *intra-group exposures to entities within the same Member State*.

Group entities that are not subject to sub-consolidation should be eligible for exemption on meeting strictly defined criteria. Exemption should be at the discretion of the national supervisor and on satisfaction of objective and public criteria relating to the transferability of capital. If such criteria are met we do not consider it is necessary to distinguish between regulated and non-regulated entities.

(ii) *intra-group exposures to group entities in different Member States.*

In our view, the same approach should be applied. Exemption should be based on satisfaction of objective and public criteria. There should be no automatic exemption. Supervisors should have the right to withdraw exemption if the requirements cease to be met.

(iii) *exposures to group entities in non-EEA jurisdictions*.

We do not consider it appropriate to distinguish between exposures to group entities in EEA and non-EEA jurisdictions *provided that the criteria for exemption are met*. This would include a

review of the third country's insolvency and company law, as well as any restrictions on the free transferability of capital (taxation, exchange controls, etc.).

Paragraph 226 suggests including of a "safety valve" permitting authorities to relax or remove intra-group limits in exceptional circumstances. We consider that such a power could be helpful in enabling competent authorities to address sudden liquidity or banking crises.

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

We agree with factors I, IV and V.

Factor II refers to exposures between entities or closely related groups unduly prejudicing the ability of a liquidator to dispose of an otherwise fundamentally sound part of an insolvent group. We question why intra-group exposures should be treated differently from other exposures. Save in exceptional situations banking group operate on a going concern basis. Regulation should reflect this, and not seek to constrain a group's business model by reference to the possible hiving down of its business should it become insolvent. Such an approach could affect the ability of a firm to run its business in a commercially appropriate manner and would introduce a distinction between banks that operate through a network of branches and those that rely on subsidiaries.

To the extent that CEBS is concerned that applying normal insolvency laws may frustrate the transfer of retail deposits, and consumer accounts, to a successor firm, or to a bridge bank, the solution lies in a tailored insolvency regime that ring-fences retail accounts and facilitates their transfer. This is a matter currently being consulted on by the UK government[3]. However, this issue, which concerns the protection of retail banking customers, raises separate issues from large exposures regulation.

Factor III states that 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.

We do not see why intra-group exposures should compromise the credibility of national depositor protection schemes or place depositors in one Member State at a disadvantage compared with depositors or creditors in another Member State. The level of depositor protection is set by the home Member State subject to meeting an EU minimum. It is the for Member States to ensure that the scheme(s) established by it are adequately funded and are not exposed to bankruptcy or default in the event of the failure of an individual bank.

The possibility of depositors being placed at a disadvantage compared to the position in other Member States exists today as the Deposit Protection Directive is not a maximum harmonisation directive and leaves the level of protection to be determined by individual

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[3] Financial Stability and Depositor Protection: Strengthening the Framework, January 2008, Cm 7308.

Member States. To the extent that CEBS is concerned that the consolidating supervisor may permit inappropriate levels of risk taking in a banking group, the solution, in our view, is to be sought in effective co-operation between banking regulators, leading to a model of supervision of the group that is tailored to the risks run by individual firms in the group, and the group as a whole. Banking supervisors are, in any event, required to ensure that institutions authorised by them meet the criteria for authorisation on a stand alone basis. Pillar 2 is also available on both a solo and a consolidated basis.

We were surprised to see creditors being referred to. Banking regulation exists to protect depositors and, more generally, the banking system. Under the Credit Institutions Winding Up Directive creditors are entitled to participate in the assets of an insolvent bank regardless of their nationality or the place where the debt was incurred. If the assets of an insolvent bank have been wrongfully dissipated all creditors are entitled to benefit from collective procedures available under national law for challenging preferences, transactions at an undervalue and transactions in fraud of creditors. The same applies to misfeasance proceedings against directors.

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.

We regard this as a beneficial change but do not propose to comment in detail.

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

We agree that financial institutions not subject to the CRD should not be subject to large exposures limits on a solo basis but that parent institutions should include their exposures on a consolidated basis. Such firms present a risk of loss to the group on a consolidated basis, and may trigger the need to raise additional capital on a group-wide basis. It is therefore prudent to take such exposures into account.

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?

We agree with CEBS that the risk of default of such sovereigns falls outside the plausible unforeseen risk that the large exposures regime seeks to cover (paragraph 252). **We therefore regard exemption as justified. We do not oppose the removal of this national discretion**, however we assume that national supervisors will continue to have the means to monitor excessive risk exposure to particular sovereigns under Pillar 2.

In terms of local and public authorities some caution may be appropriate. Although local authorities in the United Kingdom have revenue raising powers, their ability to raise additional revenues may be capped by central government, in which case default cannot be excluded. Moreover, there have been a number of cases were local authorities with revenue raising powers have become insolvent (e.g. Orange County, California; insolvency triggered by speculation in derivatives). We would suggest that whether local authorities should be treated as sovereign risk should be a matter for assessment by the competent authorities in the state

where the authority is located. While local authorities may not be subject to formal insolvency proceedings, this does not mean that they cannot default, and that default may not be an unforeseen risk that a large exposures regime should address.

There may also be a higher level of legal risk on exposures to local authorities than sovereign borrowers due to limitations on their capacity. For example, in *Hazell v. London Borough of Hammersmith and Fulham* [1992] 2 A.C. 1 the House of Lords held that local authorities had no capacity to enter into transactions in derivatives. In *Crédit Suisse v. Allerdale Borough Council* [1997] 1 Q.B. 306 the Court of Appeal held that the establishment of a company and the giving of a guarantee by the defendant council as part of a scheme designed to circumvent controls on local authority borrowing were ultra vires acts. While there have been changes to the legal regime applicable to English local authorities since these cases were decided we consider they suggest that there may need to be a mechanism to take account of such risks.

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

We have nothing to add to the analysis in paragraphs 256 and 257.

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

We do not have any suggestions for further exemptions.

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

We agree with CEBS' conclusion that regulated institutions are susceptible to unforeseen event risk. The experience in the United Kingdom with the secondary banking crisis, and the failures of Johnson Matthey, BCCI and Barings, as well as the recent difficulties at Northern Rock demonstrate that credit institutions can fail. This phenomenon is not restricted to the United Kingdom as shown by the Scandinavian banking crisis, as well as the failure of Bankhaus Herstatt and recent difficulties at Société Général, IKB and Sachsen LB.

We also agree that large inter-bank exposures may be associated with the market failures referred to in the CEBS paper. We would, however, add the following observation. While the possibility of market failure exists for exposures of all maturities, we consider that recent market events demonstrate that such risks are significantly attenuated in respect of short-term exposures which should be reflected in a large exposures regime. Unforeseen events are unpredictable. However, it does not follow that they are instantaneous, and the unfolding of the market disruption events in August and September 2007 demonstrated that banks can respond quickly to changes in perceived creditworthiness through rapidly adjusting the counterparties with whom they are willing to do business. While a particular event may be unforeseen, once it occurs banks reassess the conditions in which they operate, which may make foreseeable subsequent events that previously would have been unforeseeable. We would express our agreement with CEBS that it is important to ensure that any large exposures

regime does not aggravate market failures associated with conditions such as those observed over the summer (paragraph 278).

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

We do not propose to comment on the cost/benefit analysis.

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

Given the competing factors identified in CEBS' cost-benefit analysis we question whether the case has been made for a quantitative regime at this stage, particularly, given differences between Member States, and the need to avoid imposing undue restrictions on smaller institutions. We recognise, however, that the existence of large inter-bank exposures could present a risk of unforeseen loss which, ideally, should be captured by a large exposures regime. We also believe that the level of such unforeseen events is greater at longer maturities as institutions are unable to re-evaluate their analysis of the situation as a result of new data. We would therefore tentatively suggest that the following principles may be relevant for the treatment of inter-bank large exposures:-

First, all large inter-bank large exposures should be reported to national authorities;

Second, competent authorities should have the power to set quantitative limits on such exposures, and should be encouraged to do so if a bank is large, or where its failure presents systemic risk. Given the differences between Member States identified in the CEBS paper we consider that this is a suitable case for the retention of national discretion.

Third, 25% would seem to be an appropriate place to start if a quantitative regime is applied.

Fourth, we consider that there is a case for exempting short-term exposures from the 25% limit.

Finally, competent authorities should have the ability to waive quantitative limits in situations such as those which prevailed last summer. The ability to waive large exposure limits, either on an institution by institution basis, or across the board, would be an additional tool for authorities to manage disruption in the inter-bank or credit markets.

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).

See above.

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

See above.

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

The consultation paper puts forward three options:-

> 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).
>
> 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.
>
> 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.

We regard the first option as unrealistic. A breach of the limit may occur for a variety of reasons, including as a result of a failure of a counterparty to provide collateral, or a default by a clearing or settlement system. If the breach is temporary and is not attributable to failures at the institution, there may be no need for regulatory action. A breach of large exposures limits is not different in kind to any other rule breach, and competent authorities should have the power to respond in a proportionate manner.

If the breach is temporary, and is corrected, there does not appear to be any need for the institution to raise additional capital. Nor do we see the need for "punitive" raising of capital: a requirement to raise capital may be justified where the firm is unable or unwilling to reduce the size of its exposures. However, we do not understand the justification for requiring the firm to raise four times the amount of capital required to cover the breach. If the breach is deliberate, or if it is the result of fundamentally inadequate systems and controls, then there are likely to be other, more appropriate regulatory actions, for example, by requiring improvements in the systems and controls, or placing limits on the types of business that the firm may undertake. In exceptional cases, restriction or withdrawal of authorisation might be appropriate.

Option 2 is likely to be the most suitable response in many cases. However, there exists a wide range of situations in which a breach can arise, and authorities need to retain discretion in dealing with the breach. We would suggest that CEBS formulate a set of principles that may assist competent authorities in taking action. However, we do not believe that CEBS should seek to define, in advance, the measures that should be taken by national regulators, or place

limits on the timeframe for a firm to rectify the situation. For example, a breach may be more acceptable if it arises within a small firm with a limited base of customers and counterparties than with an internationally active bank that poses systemic risk.

Option 3 is unlikely to be appropriate, save in limited situations where competitive and systemic concerns do not arise. It would be a matter of concern if a banking regulator systematically tolerated excesses on the part of institutions authorised by it, although we assume that peer review within CEBS will prevent such a situation arising in practice. There may, however, be exceptional situations where option 3 is appropriate.

We consider that option 2 is likely, in most cases, to represent the appropriate response, particularly in the case of larger institutions, or where an institution raises potential systemic concerns. However, given the wide range of situations in which an excess can arise we do not consider it appropriate to seek to limit possible responses in advance.

Reporting Questions (Q 35-37)

We have no views on these questions.

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

We share CEBS' conclusion that the market failure analysis does not justify exempting advanced institutions from large exposure requirements even where they have sophisticated systems and controls.

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