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The voice of banking & financial services

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Joint Trade Associations' Response

CEBS Consultation Paper (CP16) – Second consultation paper on CEBS' technical advice to the European Commission on the review of the Large Exposures rules

Executive Summary

The London Investment Banking Association (LIBA), the International Swaps and Derivatives Association (ISDA) and the British Bankers' Association (BBA) welcome this opportunity to comment on CEBS thinking on the second part of the European Commission's call for advice on large exposures. Our combined membership represents a diverse group of financial institutions incorporated in a number of states both within and outside the EU and operating across the broad spectrum of European and international capital markets. As with our previous survey on industry practice, the responses to this consultation mainly represent the views of a sub-section of our members made up of large internationally active financial institutions. However, in the area of inter-bank exposures we have also included the views of smaller banks.

In the first section of our response we set out our key messages. The following section addresses the questions in detail. We have also appended, in Annex 1, our suggestion for an internal limits based regime and in Annex 2 some further analysis on the potential impact of imposing limits on intra-group exposures

Key messages

We are pleased to note that CEBS has taken on board many of our suggestions with regard to the development of the market failure analysis and has put significant effort into considering cost benefit analysis regarding part 1 of the call for advice (and in relation to part 2 more generally) . However, we remain unconvinced by the analysis and still **believe that an Internal Limits Based Approach (ILBA) using the tools available to supervisors under Pillar 2 is the most appropriate regulatory response**. We think that the ILBA would be credible, proportionate, clear and transparent, and is in line with the Better Regulation agenda. We believe that, in meeting the supervisory objective, a large exposures regime should target the issues that are not already addressed by the regulatory framework and encourage firms to manage the risk appropriately. It is questionable whether a supervisory limits based regime, because of its backstop nature, will achieve these aims. Our thoughts on the ILBA are set out in more detail in Question 1 and Annex 1. We acknowledge that CEBS has decided that it does not wish to pursue this option, but we think that it is important that it is given proper consideration once experience has been gained of the implementation of the Capital Requirements Directive (CRD), and in particular Pillar 2. As a result **we recommend that any proposed legislation contains a sunset clause**.

Our response to CP16 is therefore predicated on the basis that the optimal solution to the issues raised would, in our view, be the ILBA. Therefore our comments and suggestions regarding the amended limits backstop regime are designed to make it more risk focussed and workable for firms. Members have identified three main areas where they have serious reservations about the direction of policy – intra-group, inter-bank and the trading book. In our view, the significance of these issues, combined with the other unresolved points we identify in the main body of the response, mean that the timetable should be revisited. These issues are considered in more detail below:

<u>Intra-group exposures</u>
Members disagree with the focus and conclusions of the market failure analysis for intra-group exposures and with the options for a regime presented. A preferential treatment for intra-group exposures should be generally available and the criteria for their use should be based on the aspects that make being part of a group a source of strength.

Intra–group exposures play an important part in reducing the risk of failure because they are the means by which funding is channelled around the group in an efficient manner. If intra-group exposures are limited then firms will have to turn to the inter-bank market for funding. In times of trouble (for a particular firm or the market more generally, as we have seen recently), inter-bank funding becomes much harder to obtain. Therefore restricting intra-group exposures is likely to increase the risk of failure in the financial system. Risk is also channelled around the group to allow more effective risk management. Intra-group limits would inhibit this process, thereby concentrating risks in entities where it can be less effectively mitigated.

The major problem with the market failure analysis, therefore, is its focus on post insolvency issues. **Financial stability, maintaining confidence in institutions and protection of consumers are best served by reducing the likelihood of needing to address the post insolvency issues in practice.** Therefore in keeping with the rest of the consultation, and with the focus of prudential regulation in general, we think that **the primary objective of the large exposures regime should be to reduce the risk of firm failure resulting from tail event idiosyncratic risk to an acceptable level**.

That said, we do agree that post insolvency issues are important, but do not think that regulatory limits are the appropriate tool to address them. This is because intra-group limits are likely to make the relationships between firms more complex not less. In the context of a simple, backstop regime it does not seem possible to address such contingencies without introducing distortions and perverse effects. The most appropriate solutions to these issues appear, to us, to lie outside of the scope of this consultation.

In addition, information asymmetries for group entities are also much lower than for third party exposures, particularly where there is integrated risk management, regardless of geographic location. It is erroneous to suggest that control ceases to exist just because group entity is cross border. Additionally we believe that market discipline is also a significant mitigant, because the failure of a group entity would have serious consequences for a firm's business.

We therefore contend that it is inappropriate to limit all intra-group exposures. However, rather than distinguish between intra-group exposures on the basis of geography we think that it is more appropriate to focus on the criteria that make a group a source of strength rather than weakness. To that end we would propose the following, generally applicable, high level principles.

Intra-group exposures should be included within the requirements of the large exposures framework except where:

- **The exposures are between companies that are part of the same consolidation on a full basis, conducted either by a Member State or equivalent third party supervisor;**
- **Risk evaluation, measurement, and control procedures are materially the same across the group entities concerned; and**
- **There is no current or known, future material practical or legal impediment to the prompt transfer of surplus own funds or repayment of liabilities.**

Such an approach is proportionate and risk focussed, clear and transparent.

To the extent that limits are imposed on intra-group exposures, the regime should reflect the significant reduction in the market failure associated with the features above.

<u>Inter-bank exposures</u>

Although we agree that tail event idiosyncratic risk is relevant to banks and investment firms, **we do not believe the market failure analysis justifies regulatory intervention in the form of limits for all exposures**:

- Inter-bank contagion is a very low PD/high LGD event. Banks are different to other third parties, not least because they are subject to prudential requirements and regulatory scrutiny.
- Access to liquidity is vital to banks and investment firms in a way that it is not to other entities. Failure is far more likely to result from a liquidity shock than the failure of another firm for idiosyncratic reasons.
- The moral hazard of an implicit state guarantee is negative externality but a limit will not cause firms to internalise the cost of systemic risk. We would contend that the PD floor and the conservatism in the capital requirements address these issues already.
- Mitigating management action is ignored.

We also think that the cost benefit analysis relating to the imposition of limits significantly under-estimates the costs and over-estimates the benefits. Diversification of counterparties and increased use of collateral will not be as easy or costless to achieve as suggested. There will be a significant impact on smaller firms. The interplay between restrictions on intra-group and inter-bank will potentially increase the risk of failure. The risk of contagion due to local shocks will be significantly increased because of a likely increase in geographic and sectoral concentrations. Restrictions on inter-bank are also likely to have a disproportionate effect on some jurisdictions.

As a result we think that it would be inappropriate to limit all inter-bank exposures. We would recommend that a preferential treatment should

be made available based on maturity to reflect the lower information asymmetry attributable to exposures, particularly at the shorter end. We would recommend that inter-bank exposures with a maturity of less than one year should be subject to a general exemption. One year is an essential planning horizon and in firms risk management and is the longer end of the repo market, which is used extensively for funding. Conversion factors should be applied to inter-bank exposures with a maturity of greater than one year, 20% for maturities between 1 and 3 years, 50% thereafter.

Trading book

While tail event idiosyncratic risk is relevant to trading book exposures a differentiated approach is vital. Trading book exposures are of shorter maturity than those in the non-trading book and are managed on day to day basis. Therefore the information asymmetry is lower in the trading book. While CEBS has concluded that credit risk should not be incorporated in a mechanistic regulatory regime (although firms undoubtedly take account of credit risk within their own systems), **we recommend that the current regime of capital charges remains** because the timetable is such that it is not possible to identify a viable alternative. Deduction of all exposures above 25%, while it might appear to have the virtue of simplicity would have a significant negative impact on the ability of firms to do business (Anecdotal evidence suggests that the capital charge could increase by a multiple in excess of three times), thereby putting EU firms at a competitive disadvantage. **We would also note that intra-group and inter-bank exposures are often trading book exposures. It is therefore necessary to consider the inter-relationships with these issues when developing a proposal for the trading book.**

Timetable

We continue to believe that the timetable for the review is too tight and should be extended. It is clear that intra-group, inter-bank and trading book are not only significant issues, but they are also highly inter-dependent and complex. It is essential, in the interests of better regulation, that sufficient time is invested in ensuring that an appropriate outcome is achieved for these issues and that the full implications of any policy proposals are thoroughly thought through to avoid unintended consequences. Not only is further review required of the analysis in CP16 on a stand alone basis, but the inter-dependencies also need to be fully investigated. In addition there are a number of other areas of the consultation where we believe that there are still issues to resolve and where further review is required (for example in relation exposure value and CRM). Such work will take time to do properly. Members do not see the value in pressing ahead if the end result either creates new problems or fails to improve those of the existing regime. **While we appreciate that the timetable is not within CEBS gift, it is in the interest of both supervisors and the industry that a prudentially appropriate and workable solution is achieved. If the current timetable is maintained we think that it is vital that a sunset clause is inserted into any Directive proposal.** A call back provision of this nature would allow the consequences of the current review to be re-visited, proper consideration of an internal limits based approach and the impacts of other relevant reviews (such as liquidity and the Winding Up Directive) to be taken into account.

If you have any questions in relation to any aspect of this response please do not hesitate to contact Diane Hilleard (diane.hilleard@liba.org.uk), Ed Duncan (eduncan@isda.org) or John Thorp (john.thorp@bba.or.uk).

Questions

Chapter 1 – Summary of CEBS' key findings in Part 1 of its Advice

Q1 CEBS would welcome respondents views on the high level impact assessment of the policy options (please see Annex 1).

In our response to CP14 the industry commented on the absence of any material market failure resulting from tail event idiosyncratic risk. However for the purposes of this consultation we recognise that this view has not prevailed and do not pursue it further.

We assess the policy options presented in Annex 1 of the CP in relation to our view of the regulatory objective (to provide an appropriate degree of protection against firm failure arising from tail event idiosyncratic risk in the credit portfolio) and in line with the principles that we defined in our earlier paper (necessity, suitability, proportionality, clarity and transparency and the competitive position of the EU industry). Our view remains that an internal limits based approach is the most appropriate policy response and that the amended limit backstop regime is an inferior solution (albeit one that firms will be prepared live with provided there is a tangible improvement on the existing regime).

<u>Option1 – No specific regime</u>
In considering this option we think it is important to remember that 'no specific regime' does not mean that there are no aspects of the regulatory framework that are relevant to the risk inherent in large exposures. While Pillar 1 is calibrated on the basis of a well diversified firm, there is a significant amount of conservatism embedded within the framework that goes some way to addressing tail event idiosyncratic risk. For example we think that the floor on probability of default, as noted in our response to CP 14, does provide a measure of protection against moral hazard issues. In addition, for those firms that are on IRB, the Pillar 1 regime provides supervisors with an understanding of significant elements of the way that firms manage their single name exposures – in particular how exposures are allocated to rating grades (credit risk is a key input into firms' own limits), and of systems and controls around credit assessment more generally. There are also aspects of the Pillar 1 regime that explicitly take account of concentration risk – for example the risk weights for securitisation take account of different granularity assumptions. In addition, concentration risk is already addressed in Pillar 2 and CEBS provides quite extensive guidance on the limit setting process in the guidelines.

As a result, we think that it is important that the review of the large exposures regime focuses on the gaps in the current CRD framework that need to be addressed. These would seem to be:

- An explicit limit setting requirement (where we obviously favour use of firms own systems – see option 2 below);
- supervisory reporting to supplement what is obtained through other parts of the framework (to ensure that supervisors have the requisite understanding of the risks a firm is running), and,
- Possible refinements to CEBS guidance on Pillar 2 (if firms are allowed to use their own systems).

Having established the gaps and therefore necessity, we agree that this option would not be a suitable approach to meeting the regulatory objective.

As regards the impact analysis we agree that the reduction in costs associated with the removal of the existing provisions would be partly or wholly offset by the likely intervention of regulators at a firm/national level. However, we disagree that the existing regime provides a meaningful degree of protection for this risk for our larger members. As noted previously firms have good incentives to manage this risk for themselves and do so to a much lower loss severity than that implied by the large exposures regime. We agree that loss of all supervisory information in this area would have a negative impact on regulators.

We are not convinced that market confidence would be reduced by the removal of the existing regime. There would appear to be no clear evidence either way as to the role that the existing regime is playing in enhancing market confidence in the current market conditions. A backstop regime does not, in our view, provide the level of comfort that CEBS ascribes to it. Rating agencies are unlikely to stop focussing on concentration risk in the absence of a large exposures limits regime, and will continue to look beyond the regulatory considerations. Similarly Members will continue to analyse their CRD firm counterparties.

We agree that such an approach would allow firms to manage their risk more flexibly. In related work that we have undertaken in the UK regarding the treatment of members of financial groups, firms have cited the intra-group large exposures treatment as a constraining factor in competing for business cross border and therefore we do believe that the existing regime, as implemented in the UK, does restrict competition.

<u>Option 2 – Large Exposures dealt with under pillar 2</u>
The CEBS proposal for a pillar 2 regime relates to the capital planning and assessment processes. Our proposal, although we have previously labelled it 'Pillar 2', is actually an internal limits based approach that uses the tools available to supervisors under Pillar 2 to focus on systems and controls. An outline of this proposal is set out in Annex 1.

We agree that an approach that relies entirely on internal capital to mitigate the risk is unlikely to be suitable in addressing the regulatory objectives. As outlined in our survey of industry practices, firms indicated that they use limits based systems to manage single name risk. The ILBA therefore builds on the gaps identified in option 1. It provides firms with the incentive to manage the risk. And, since it would provide regulators with a fuller understanding of the firm's risk management capabilities, it would provide a level of comfort that simply can not be obtained from a backstop limit. We accept that this approach might result in a change in focus in the supervisory effort, but we do not anticipate it being taken up by all firms, since we would envisage that it would sit alongside a supervisory limits regime. As such, we think that the ILBA would be proportionate policy response, for those with the appropriate risk management systems. We would envisage that the ILBA would be supplemented by supervisory reporting. We therefore think that it would also meet the principles of clarity and transparency and would remove competitive distortions introduced by the existing regime.

In relation to the impact analysis set out, we question whether our 'Pillar 2 approach', the ILBA, would necessarily result in a loss of information to supervisors. In fact, we would contend that the supervisory review of firms' own systems and controls would actually improve regulators' understanding of the risks being run by a firm and how they are managed, thereby providing greater comfort. We do not believe that it would result in an increase in capital compliance costs, as its focus would be systems and controls not purely capital. We question whether more senior management would indeed be required, since firms already include this risk within their internal governance procedures. While it is true that firms would be operating with different limits, we do not believe that this represents a change to the current position. Our larger firms already set limits well within the 25% for most exposures and the differing implementation of the existing regime across Member States means that there is currently very little comparability. We agree that such an approach would allow firms to manage their business more flexibly.

We therefore believe that the ILBA continues to have merits and we think that it should not be entirely discounted. If it is not thought appropriate to include this option at this stage, then we strongly believe that a sunset clause should be included within the legislation (to allow time for supervisors to gain experience of Pillar 2) so that it can be revisited.

<u>Option 3 and 4 – Market discipline through Pillar 3, or rating agencies</u>
While we think that market discipline obviously has a place to play in providing the correct incentive structure for firms to manage unforeseen event risk we would agree that an approach that relies entirely on Pillar 3 and/or rating agencies would not be suitable.

<u>Option 5 – Current regime</u>
As outlined in our earlier submissions to you and the Commission, the existing regime has a number of problems, which are accepted by all parties. We agree that such an approach is not suitable.

<u>Option 6 – Amended limit backstop regime</u>
This option is the subject of this CP and the impact will be driven by the detailed consideration of the various issues outlined. We therefore do not comment on the impact assessment in this section of this response. However, we highlight our key messages:

- We continue to believe that an internal limits based approach should be incorporated into the regulatory framework. One size definitely does not fit all
- Restrictions on intra-group and inter-bank will have a significant negative impact on our Members and exacerbate some of the problems of the existing regime.
- It is essential that a differentiated approach is taken to the trading book because of the shorter term nature of these exposures and the fact that they are managed on a day to day basis.

Chapter 2 - Definition of large exposures (connected clients)

Q2 Do you agree with the proposal and suggested interpretation of 'control' and of 'interconnectedness'? Do you find the guidance/examples provided in both cases useful? Please explain your views and provide examples and where relevant provide costs and benefits.

Members agree with the high level principles for control and inter-connectedness outlined in the bullets above paragraphs 85 and 91. As noted in our survey of industry practice, Members use similar definitions in their own risk management. However, we question whether it is CEBS intention that these be included within the revised Directive or whether they would be incorporated in a CEBS guideline.

While examples are usually considered helpful by firms, as they give insight into supervisory intentions, Members believe that many of those provided in the CP, particularly relating to interconnectedness, are simply unworkable in practice and verge on delivering groupings that would be addressed by Pillar 2 concentration risk. For example, while in certain circumstances the credit analysis of a counterparty is able to identify dependence on buyers, in other circumstances it is not (where the counterparty is privately owned the information may not necessarily be available). To the extent that firms' credit systems already pick up the information in paragraph 92, it will feed into the limit set, but may not result in aggregation. To achieve the level of aggregation CEBS is suggesting would require extensive further manual review, purely for regulatory reasons. The resources required to do so on a regular basis would be enormous and the cost would be a significant burden on the industry (even if it were possible to find the number of analysts necessary to undertake the task).

In our survey of industry practice we noted that: 'Each firm sets down policies on third-party connectedness (typically at a group level). It seems that these policies differ substantially across firms. What seems to be universal, however, is that connectedness policies cannot be followed automatically or rigidly. Neither ownership nor control are 'either/or' concepts. Each counterparty will often require a case-by-case evaluation. In most cases the independence of the group function guarantees a neutrality in the decision making process and ensures a conservative approach to "connectedness". In one case they identified "an independent data management team" as responsible for managing and documenting linkages between customers forming larger groups.'

Therefore it is clear that firms already take account of inter-connectedness but that it is extremely difficult to produce a one size fits all answer. We therefore recommend that the bullets in paragraph 92 be deleted.

In addition we do not believe that the connectedness requirements in the large exposures regime are the most appropriate tool for dealing with the regulatory concern regarding the drawing of multiple liquidity facilities to special purpose vehicles at the same point in time. In the analysis of the Rhineland funding example, CEBS indicates that the vehicles were legally independent and did not invest in the same assets. As the risk of loss on a liquidity facility is related to the underlying assets, the fact that they were funded in the same way, i.e. through the CP market, should not automatically mean that they should be aggregated for large exposures purposes. Provided the assets in the underlying vehicles are good and the requirements of the CRD are met with regard to the prohibition of funding impaired assets, there is a risk of liquidity draw, which should be dealt with as part of the firm's liquidity risk management, and there may be geographic or sectoral risks associated with the underlying assets, but these should be picked up in Pillar 2. In addition, the specific requirements, now included within the CRD, mean that liquidity facilities to such vehicles are more likely to receive a 100% conversion factor and will therefore be more visible to supervisors. Therefore we think that the concerns regarding liquidity facilities should be addressed through use of supervisory tools in Pillar 2.

Members are also concerned by the proposed inclusion of a supervisory override contained in paragraph 94. We do not believe that this is a practical proposition and would constitute supervisors taking management decisions for the firm. We think it would be more appropriate for supervisors to focus their attention on whether firms have an appropriate policy/procedures in place for determining connectedness. Obviously this would not preclude the option firms have of approaching supervisors for advice where they consider that there may be ambiguity.

Chapter 3 – Definition of exposure value

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.

Logically, on-balance sheet exposures should be recorded net of accounting provisions and value adjustments for the following reasons:

- Writing off an amount of an exposure already assumes that the money has been lost. It therefore cannot be lost twice.
- A write-off has a double impact because it reduces the capital base against which exposures can be measured, thereby reducing the limit that can be set.

Since the majority of limits set by our larger Members are significantly below the current 25% limit, any benefit perceived in restricting firms from lending further to a distressed entity would be minimal. The costs associated with such a proposal would therefore be predominantly systems related. We think that the reduction in the capital base, upon which limits are calculated, already addresses the perceived risk that net amounts increase the limit available to deteriorating counterparties. In addition, where provisions have been raised against counterparties, these entities will already be the subject of increased management scrutiny. We believe that appropriate systems and controls are a more effective way of addressing this risk.

However, we think that the gross/net of provisions issue may require further consideration because of the different supervisory approaches available. In the capital framework standardised firms will record their on balance sheet exposures net of provisions. However, for IRB firms the calculation is done on a gross basis and provisions are dealt with in the comparison to Expected Loss, which goes into the own funds calculation.

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

Most of our larger more sophisticated Members will be using the Advanced Internal Ratings Based (IRB) approach and are therefore supportive of CEBS proposal that internal estimates should be used. However, some Members, notably those who are subsidiaries of foreign entities may be using the standardised approach for entities in Europe for their capital requirements (although they have IRB approval at the home level). As we noted in our survey of industry practice, firms do not necessarily use a 100% conversion factor in their own internal risk management because this is considered to be overly conservative, implying, as it does, not only that the full 'commitment' will be drawn but that it will also be lost. We think that it is inappropriate to make that assumption for all medium and low risk facilities. Firms actively manage their credit exposures, including the level of undrawn facilities, the levels of facilities will be reviewed and reduced if a counterparty is evidencing difficulties. The conversion factors also take account of the reduced information asymmetry inherent in shorter maturity exposures and the extent to which mitigation will impact the level of risk in the exposures. We therefore think that it is appropriate for the large exposures framework to be consistent with the capital requirements as to the level of the conversion factors.

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 to 100%, and for which reasons? Please explain your views and provide feedback on the costs and benefits of such an approach.

In general we support an alignment between the calculation of exposure values for large exposures and capital requirements purposes. We think that conversion factors of less than 100% should be available within the framework because the conversion factors used for capital requirements purposes are intended to recognise the uncertain nature of drawdown or the mitigations built into these facilities. There appears to be recognition of this principle in the proposal for the use of own estimates by AIRB firms. Provided that the conversion factors are appropriately conservative in the capital framework, which we believe they are, we see no reason why they should not be used

We therefore believe that the new framework should align the conversion factors with those in the capital framework.

Q6 In your opinion, how can a large exposures regime address the risk that credit institutions may not be able to exercise their legal right to cancel an undrawn credit facility?

We appreciate that supervisors may have had concerns over the treatment of liquidity facilities to certain off balance sheet structures, which may, in form, have qualified for a 0% conversion factor under the pre-CRD regime. However, we would like to remind CEBS that a specific treatment for these facilities is now included within the CRD and it is likely that extremely few would now qualify for 0%, as the criteria have been made much clearer. Even the criteria for the 20% conversion factor are quite stringent and therefore more facilities receive a 100% conversion factor. In addition, the 0% conversion factor is not available for IRB firms (with the exception of servicer cash advances, which we do not believe are the focus of CEBS' concern). Therefore we consider concern to have already been addressed.

In addition we believe that that those cases where unconditionally cancellable facilities are not cancelled for reputational reasons are extremely rare.

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.

Our understanding CP16 is that, for large exposures, AIRB firms would be allowed to use EAD for unsecured exposures and that any firm (whether IRB or not) would be able to use IMM for securities financing and derivatives, provided that they have been approved for its use for capital purposes.

Members support the use of internal estimates and a more principles based approach. We are pleased to note that CEBS has decided to remove principle 4 that was contained within CP14 (providing further detail on supervisory expectations with regard to the use of internal estimates), which we had found confusing. However, we remain unclear as to the intended purpose of Principle 2. As we indicated in our response to CP14, if a firm has already demonstrated that a measure is acceptable for capital purposes then we fail to understand why further tests are necessary, or even what they might be. Therefore, we also question the purpose of principle 3.

We seek further dialogue with CEBS on the circumstances that would cause supervisors override the use of internal estimates and require standard conversion factors to be used. We do not understand why this would be necessary.

The use of the capital calculation exposure values will be beneficial in terms of the reduction in costs associated with multiple exposure calculations. Consistency of exposure calculation should also be of benefit to supervisors in assessing the information provided by firms and facilitate improved dialogue between firm and regulator. We do not envisage material costs arising out of this proposal.

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?

Yes. Such an approach accords with the way that Members currently manage this business. However, we do think it would be helpful if there the scope of these requirements were clarified. We recommend that a definition is tied to the CRD - i.e. securitisation transactions within the scope of Consolidated Banking Directive Article 78 (1) (m), CIUs in Article 78 (1) (o).

Do you agree that the proposed principles are appropriate to identify the relevant risk in a large exposures backstop regime?

Yes. We are pleased to note that CEBS has taken on board our suggestion, in our response to CP 14, to give examples of the factors that firms take into consideration in determining where the risk resides. We think a key benefit of such an approach will be to align the regulatory requirements with the way these exposures are managed.

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.

One additional factor that has been suggested by members as follows:
Position in the payment waterfall – As we noted in our response to CP14, where transactions are tranched, the resultant risk will be a blend of the underlying exposures resulting in a given risk level dependent on the position in the structure. As a result the more senior the position in the structure the less relevant the default of an individual asset will be to the risk.

As indicated in our response to CP14, we do not support the further development of a harmonised guideline based on Annex 3.

Chapter 4 - Credit risk mitigation

We are pleased to note that CEBS is proposing that exposures covered by netting agreements should be treated consistently with the capital framework. As a general principle we think that the large exposures framework should encourage the use of credit risk mitigation and this is a welcome precedent.

We assume that where firms are using the approaches in Annex III for securities financing transactions the requirements for collateral are not relevant.

We seek confirmation that it is not CEBS' intention to require AIRB firms to meet the operational requirements of the comprehensive approach as well as those relating to eligibility. Running a further set of operational requirements, beyond those necessary to meet the AIRB, and purely for large exposures purposes, would impose an additional burden that would not be justified.

It is our understanding that CEBS proposes that exposure value for AIRB firms should be measured as EAD for unsecured exposures but that the requirements of Article 114(2) would be retained for exposures mitigated by funded or unfunded means where the adjustment has been made through LGD. Although we strongly support the intention to recognise the effects of credit risk mitigants in exposure value, the clarity, in terms of expected outcome, of Article 114(2) could be improved. We think that this provision requires further consideration.

As regards unfunded protection, members believe that the recognition of double default should be given further consideration. Where a guarantee or credit derivative is used as protection both counterparties have to fail before the firm loses money. The substitution approach will not recognise the loss mitigating effects of unfunded protection. It is our view that the large exposures regime should reward good risk management practice and give greater benefit to exposures that are mitigated in this way. One way of giving benefit to protection where the provider is of good quality and sufficiently uncorrelated to the underlying exposure might be to use an exposure valuation based on the replacement cost for these transactions, in line with counterparty risk measurement in the capital framework. We would be happy to discuss this further with CEBS.

Also in relation to unfunded protection, we seek further clarity in relation to the removal of the discretion alluded to in paragraph 157. If the intention is to require firms to substitute their underlying exposure with their protection counterparty (if standardised, foundation or where PD is amended for AIRB), then we think that further consideration of this issue is necessary. Where firms are using portfolio protection to reduce sectoral or geographic concentrations on what would otherwise be immaterial exposures, such a proposal has potentially negative consequences. By requiring the exposure to be recorded to the protection counterparty, firms could face a disincentive to undertake risk mitigating behaviour because of the potential large exposure and would not be reflective of the risk of loss (see also double default above).

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 feedback on the costs and benefits.

We disagree with the market failure analysis. Market failure analysis is intended to identify issues of relevance to regulatory objectives where firms do not have the incentives to address them appropriately. One way of minimising tail event idiosyncratic risk is to use credit risk mitigants. Taking collateral delivers a more timely and certain recovery than would be the case in an unsecured situation. Conventional work-outs on unsecured exposures can take a year or more. However, financial collateral can be liquidated in a matter of days; even physical collateral can be liquidated in a few months. As a result we believe that the large exposures framework should encourage the use of mitigants.

The costs associated with a differentiated approach will be an increase in the cost of doing certain types of business, systems costs associated with running a parallel set of valuation calculations (and holding two sets of CRM data), restriction of the types of collateral that firms will accept (thereby undermining the expansion of CRM techniques in the capital framework) and a potential increase the risk of firm failure. The benefits in terms of increased certainty and timeliness that CEBS appears to be seeking would, in our view, be minimal.

As we regard the credit risk mitigation requirements in the capital framework to be conservative, we believe that large exposures regime should not provide disincentives for the use of these techniques. We therefore do not agree with the suggestion that it is necessary to be more conservative in the large exposures regime. For example the comprehensive approach already sets conservative haircuts for collateral that are beyond what firms regard is necessary for normal margining re-sets, to take account of possible negative movements in value.

We also see no reason for excluding physical collateral. It provides a mitigating effect and therefore if ignored, the regime would systematically over estimate the risk to the firm. We would also highlight that the exclusion of physical collateral would be a significant issue for commodities firms and that this issue should be co-ordinated with the Commodities Review.

Q10 Do you agree that the three alternatives set out for the recognition of CRM techniques are the relevant ones? Please explain your views and provide examples. And, where relevant, please provide feedback on the costs and benefits.

Given CEBS' view of the market failure analysis, the alternatives outlined would seem to be relevant ones. However, we do not believe that it is necessary to consider options 2 and 3 for the reasons outlined in our assessment of the cost benefit analysis outlined in Q9 above. They will increase cost, with no perceivable benefit accruing.

In addition, we would note that Article 114 of the current Directive requires stress testing of collateral values and where those tests indicate a lower realisable value the value of the collateral should be reduced. In the negotiations of the CRD, we argued that this requirement should not be inserted - Firms using the comprehensive approach and own haircuts are already required to stress test them under Pillar 1. Furthermore stress testing is an input into the Pillar 2 dialogue and it is there that these issues should be addressed. Firms already have incentives to value collateral appropriately, as it not in their interests that such mitigants do not protect against losses.

In addition we also indicated that, since the change was not consulted upon as part of the CRD process, it should be as part of the large exposures review if policy makers wish to retain the requirement. No rationale has been provided for its inclusion and we believe it should be removed.

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 in the institutions' and collateral market's behaviour?

We set out our analysis of the costs and benefits of the various options below. In our view option 1 should be adopted since it addresses prudential concerns regarding risk management and imposes the least burden on the industry.

Option 1 – accept the same protection treatment in both the large exposures and minimum capital frameworks

We do not believe that the protection requirements are less conservative; in fact the requirements for mitigants are much more explicit and rigorous in the CRD than in the existing Directive. We agree that this option would be better for business than the other two and would interfere less in the workings of the collateral market. Since we regard credit risk mitigation as something that should be encouraged this option would be a significant benefit; as would the reduction in costs of running a single system. In addition we do not regard the inclusion of a broader range of mitigants as being less conservative given the benefits of encouraging this behaviour for the regulatory objective. In fact we regard all the reductions in costs listed as benefits. We do not think that there are any real costs associated with this option.

Option 2 – accept the same treatment as for the capital requirements for only those instruments deemed liquid enough

We assume from the content of the concrete proposal that this implies financial collateral eligible under the comprehensive approach and excludes all physical collateral. Such a proposal will encourage firms to take only eligible financial collateral under the comprehensive approach and therefore increase the cost of doing business.

Option 3 – accept the same eligibility list as in the CRD but adopt a more conservative calculation of the protection effects

We do not believe that this option would result in significant benefits because we regard the capital framework as already conservative. It will however increase the cost of doing business, in terms of opportunity costs and the cost of running two systems

Q12 Do you support CEBS' proposal that institutions that use the simple method should follow the minimum capital rules (substitution approach) instead of applying haircuts included in the current large exposures rules? Please explain your views and where relevant provide feedback on the costs and benefits.

Our larger sophisticated members will not be using the simple approach and therefore this question is not relevant to them. However, smaller banks, who are participating in our discussions on this consultation, have indicated that the substitution approach would be appropriate.

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.

No. As noted earlier we believe that physical collateral should be eligible. It provides mitigation against tail event idiosyncratic risk and we believe good practices should be rewarded rather than penalised. It would be a significant issue for commodities firms. It will increase cost, both of doing business and in systems terms. We struggle to identify any benefits of this approach. Recognition for all physical collateral should be given in line with capital framework (see comments regarding clarity of Article 114(2) above Q9).

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 any suggestions for possible principles? Please explain your responses and provide feedback on the costs and benefits where relevant.

We assume that by 'indirect exposures' CEBS merely refers to the situations where collateral has been used (see comment above Q9 regarding unfunded protection) rather than other situations where firms might look through to other parties, for example where firms may look to fund managers as well as the scheme, or a servicer related to a securitisation transaction.

We would agree that aggregating exposures to collateral issuers with other direct exposures to that entity would be inappropriate. Such an approach would be in direct contradiction to the CRM proposals. It would also impose a significant additional administrative cost on firms. We note that the national discretion in to analyse and report collateral was not implemented in the UK after representations that the requirement could not be justified on cost benefit grounds.

However, as noted in Q10, we do not believe that stress testing collateral values and further haircutting them as a result (per Article 114) is an appropriate solution either. Stress testing, as we outlined in our survey of industry practice, is used increasingly by management as part of their overall governance policies. However, it is less common for stress tests to be designed to capture a single specific risk such as the indirect risks resulting from collateral. The macro economic scenarios tested will often result in reports covering a variety of increased sensitivities to a range of different risks, not just credit risk. Where used at a single name level, the stress/scenario tests tend to be 'what if' analysis applied to the largest counterparties. Stress testing is an area that is still evolving and while we believe that it is a very useful risk management tool, we think that the haircutting approach already embodied in the capital framework already addresses the risk that CEBS cites as a concern and does not need to be supplemented by further requirements here.

Chapter 5 – Trading book issues

Q15 Do you consider that two different sets of large exposures rules for banking and trading book are necessary in order to reflect the different risk in the respective businesses? What could be the costs/benefits of this? Please explain your views and provide as appropriate feedback on the costs and benefits of this.

Members agree that it is necessary to take a different approach to large exposures in the trading book to that of the non-trading book. Trading book exposures tend to be of shorter maturity, thereby reducing the information asymmetry (a concept that CEBS appears to acknowledge in paragraph 110). The exposures are also managed in a more active way than those that held to maturity.

From a CBA perspective, a restriction on firms' trading book exposures to 25% of capital base would have a significant adverse effect on their ability to do business; i.e. increased direct costs in the form of re-structuring transactions, require more collateral, more management time and the opportunity cost of lost business. As noted in the CP, a limit would be a particular concern for investment firms, whose business is predominantly trading book.

We accept that unforeseen event risk is also relevant in the trading book; indeed firms monitor these exposures as part of their single name credit risk systems.

However, we can think of no benefits, other than simplicity (which is more than offset by the costs outlined above), of requiring trading book exposures to be managed to the same rules as the non-trading book.

Q16 Since the boundary between trading and banking book exposures is increasingly blurred, do the current large exposures rules create an incentive to book business in the trading book (which would otherwise be disallowed in the banking book)? Please explain your views and provide feedback on the relevant costs and benefits.

We are concerned by the suggestion in the CP that the large exposures rules create incentives to arbitrage the trading book boundary. We would note that the CRD incorporates a revised and expanded boundary definition and requirements for prudent valuation. These requirements were intended to address regulators concerns about arbitrage and in particular the inclusion of credit related instruments. We believe that the revised requirements have clarified the boundary and that if supervisors have concerns about application of these requirements at individual firms these should be the subject of bilateral discussion between firm and regulator. We would also note that the discussions surrounding the implementation of the incremental default risk charge suggest that there are also incentives in the framework that work in the opposite direction. Therefore, we do not believe that arbitrage is a general issue and in particular do not think that applying the non-trading book rules to the trading book is an appropriate or proportionate way of addressing such concerns.

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 backstop regime? Please explain your views. Please provide examples and feedback on relevant costs and benefits.

No. The imposition of deduction for exposures in excess of 25%, while undoubtedly simpler than the current regime, would overstate the risk of these exposures and impose an enormous cost on the industry. We do not believe this is justified by CBA.

Since trading exposures tend to be of shorter maturity and actively managed day to day the information asymmetry is significantly less. We therefore believe that a deduction approach would be a disproportionate way of delivering the regulatory objective of reducing the risk of firm failure from tail event idiosyncratic risk to an appropriate level.

In terms of the perceived benefits it might be argued that a deduction approach would make the regime internally consistent with the conclusion to disregard credit risk in the regulatory backstop limit. We acknowledge that the current trading book requirements take some account of credit risk by relating the charge to the capital requirements. However, while we agreed CEBS' conclusion with regard to the backstop limit, we continue to disagree that taking account of credit risk is entirely inappropriate. In firms own limit setting processes credit risk is a significant input, along with such factors as tenor, product counterparty type and sector. In addition, the proposals in this consultation also effectively acknowledge the need to take account of credit risk in certain circumstances (for example the proposal to exempt sovereign exposures). We believe that this is one of those areas where exceptions should be made.

Deduction above 25% could be regarded as introducing simplicity. However, firms' systems are already set up to address the current requirements and therefore a change would involve additional cost.

The costs associated with a policy of deducting all trading book excesses would be enormous.

- It would increase the cost of business significantly through the increase in the capital charge. Anecdotal evidence from some firms indicates that the increase in capital requirement could be a multiple of in excess of 3 times.
- By deducting, there would be a double impact by further decreasing the capital base against which other exposures would be measured, (If this treatment is combined with a restriction on inter-bank exposures the increase in the capital charge would be significantly higher).
- The changing nature of the trading book would mean that capital charge would be volatile and harder to manage requiring firms to hold a higher capital buffer.
- It would require increased use of mitigants that firms currently do not consider are warranted and therefore increase cost.
- Transactions would have to be restructured which would increase costs (e.g. cost of the restructuring itself, associated management time required and the increased operational risk that would result).
- The increased opportunity cost of lost business. It would likely have a negative impact on the real economy as a result.

Therefore in the case of the trading book we believe that it is imperative to give recognition to the shorter time horizon and active risk management. While we believe it might be possible to devise an alternative approach to that contained within the CRD, the tight timetable does not permit such discussion. We would therefore recommend a continuation of the existing regime

We also note that there is an error in Article 31(b) of Directive 2006/49/EC, whereby it refers to the calculation of capital requirements for trading book excesses by reference to Annex VI of Directive 2006/48/EC, when it should refer to Annex VI of Directive 2006/49/EC, which applies a factor to the specific and counterparty risk capital requirements.

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.

We assume from the content of the consultation that there are three issues that CEBS seeks to address with this question:

- The treatment of instruments it regards as being less liquid;
- Whether look through would be appropriate; and
- Whether protection offered by such products should be recognised.

We do not believe that the liquidity of credit derivatives and structured products is germane to the supervisory objective of providing an appropriate level of protection against tail event idiosyncratic risk. Lack of liquidity in these products can either be a result of general market conditions for these products or specific to the individual names referenced. Both of these aspects are already tackled by the CRD – Annex VII of the recast CAD imposes standards for the valuation of less liquid positions; and, liquidity is an aspect that must be considered under

Pillar 2. We are obviously aware that both funding and market liquidity are the subject of intense regulatory scrutiny in light of recent events. However, we would note that the market for single name credit derivatives has stood up well (and has actually been more liquid than its cash counterpart in some areas) and that valuation is a major focus for firms. We do not, however, believe that a large exposures regime should address the liquidity of these instruments.

As regards look through, some Members have indicated that they look through their trading book structured product exposures, where it is appropriate to do so from a risk management perspective.

We believe that the large exposures regime should provide positive incentives to firms to mitigate their risks and therefore these products should be recognised. In line with the approach taken in other areas of the CP, we believe that this should be aligned with the capital framework. Therefore these products should be allowed to offset the issuer risk and reduce counterparty risk.

Chapter 6 – Intra-group exposures (scope of application, specialised institutions)

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

With the exception of CEBS' statement that intra-group exposures are lower risk than third party exposures, we do not agree with the market failure analysis.

The major problem with the market failure analysis is its focus on post insolvency issues, which we consider to be a secondary rather than primary objective. CEBS states in paragraph 56 that the objective of the large exposures regime is to keep risks arising from large exposures are kept to an acceptable level following from the overarching principles of prudential supervision to ensure continued financial stability, maintain confidence in the financial institutions and protect consumers and in particular depositors. We believe that in this, as with prudential regulation in general, and indeed the rest of the consultation, the primary objective is to reduce the risk of failure of firms to an acceptable level. Financial stability, market confidence and the protection of consumers are best served by reducing the risk of failure rather than by limiting the loss to consumers, and any drain on the public purse, when an institution actually fails.

Intra-group exposures play an important part in reducing the risk of failure of a group because they are the means by which funding is channelled around the group. If intra-group exposures are severely limited, firms will have to rely on the inter-bank market for funding. In times of market turbulence or where the market has a negative view relating to a particular firm, inter-bank financing is more difficult to obtain. Therefore the risk of failure will increase. We accept however, that while reducing the probability of default of group companies, the loss if a default happens may be higher. There is a trade-off to be balanced (see annex 2 for further detail). However, we strongly believe that it is more important to reduce the risk of failure in the first instance. Therefore, the large exposures regime should create an incentive for firms to manage the risk inherent in these exposures (which is the risk in the external exposures of the group entity) rather than to limit intra-group exposures themselves.

That said, minimising losses to consumers and the cost to the taxpayer are obviously also important, but we do not think that a large exposures limit is the best way of resolving these issues because it can not address the causes of the problems and will potentially increase the frequency of them being faced. A limit could also have the effect of making the inter-relationships between group entities more complex as firms find other ways of channelling funds/risks around the group, thereby making any failure a much more complex task to unravel. In the context of a simple backstop regime it does not appear possible to address all the contingencies without introducing distortions and perverse effects. As such we think the solutions to these issues to lie outside the scope of this consultation.

We note that some of the concerns raised in the CP are being addressed elsewhere. Since the publication of this consultation, the European Commission has published its summary of the public consultation on the reorganisation and wind winding-up of credit institutions. We highlight several key issues from that document below:

- ECOFIN has asked the Commission to assess the possible extension of scope of the present EU directive on winding up and reorganisation to include insolvent subsidiaries to increase the efficiency of winding up cross border banking groups. The Commission also been asked to perform a feasibility study on reducing the barriers for cross border asset transferability with the objective of reinforcing the primacy of private solutions, avoid the counter-productive ring-fencing of assets and facilitate the smooth management of a crisis.
- The majority of respondents to the consultation favoured a winding up directive for investment firms; they are currently not specifically covered.
- The majority of respondents favoured a legal framework tailored to the winding up and re-organisation of cross border banking groups.

It would appear from the mandate given to the Commission by ECOFIN and the responses to the consultation received, that some of CEBS concerns (including deposit guarantee, which is also the subject of review following recent market events) are likely to be actively addressed at the EU level. Although any resultant legislation will not be available for some time, and will only address EU entities, we believe it is inappropriate to attempt to address these issues in the short term through the large exposures regime.

The CP recognises that information asymmetries are lower for intra-group than for third party exposures. However, the consultation only seems to accept that this is the case in those entities that are within a sub-consolidation (or for branches). This analysis seems to be based on the premise that outside the sub-consolidated group (in paragraph 192) a relationship of control only ‘may’ exist. Our Members disagree strongly with this analysis and that in paragraph193. Sophisticated cross border groups manage their risk on an integrated basis with common risk policies (although obviously such policies may have to be tailored slightly to meet local circumstances – e.g. consumer laws). Firms will obviously have considerably more risk information available about group companies than third parties, and because of the group structure they are able to take positive action to address any issues identified from management information. Such action could include the replacement of management, the winding down or sale of external exposures, or the transfer of exposures to other parts of the. Management action would not automatically result in an injection of capital or liquidity. However, we accept that where common risk controls are not evident it would be inappropriate to relax the large exposures treatment

We also disagree that capital cannot be moved cross border. Surplus capital undoubtedly can be moved around a group quite easily. However, a focus on capital misses the main reasons for intra-group exposures, which are the day to day funding needs of the group entities and centralised risk management.

Treasury functions are run centrally for a reason – some entities generate surplus cash; others do not. It is simply more efficient to fund group entities through intra-group exposures than it is to fund them through the inter-bank market. Intra-group exposures are therefore vital to the functioning of the financial markets as well as to the group's own management of liquidity. It essential that firms are allowed to continue running their business using intra-group funding, but it is also important to understand that the issues of intra-group exposures and inter-bank exposures are inextricably linked. Policy makers must consider these two issues together when designing the future large exposures regime.

Large groups also manage risks centrally. This requires the transfer of risks from local entities to the group entity responsible for the central risk management. This is an important feature of integrated risk management and allows the group as a whole to work more efficiently and effectively. Restricting such back-to-back transactions will make it significantly more difficult to run a global risk management strategy and will also increase costs as it will be necessary to set up local risk management functions

We also believe that market discipline provides a mitigant against market failure in this area. Firms take their reputation very seriously because allowing a subsidiary to fail would have a serious impact on their business. Therefore, industry and regulatory incentives are aligned in this area. The actual risk is consequentially much smaller than that implied by the consultation.

We would therefore conclude that, for all intra-group exposures, the market failures of information asymmetry and negative externalities are significantly lower than for other third party exposures. We also think that market discipline provides a mitigant. Our Members strongly believe that being part of a group, where there is integrated risk management, is a source of strength rather than weakness (as suggested by this consultation). Therefore we consider that the case for limiting all intra-group exposures has not been made.

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

We set out below our view of the costs and benefits of limiting intra-group exposures:

Costs

- Increased cost to depositors and the public purse resulting from increased firm failures due to illiquidity.
- Restriction on groups' ability to manage their liquidity needs efficiently – funding will cost more through the inter-bank market than through the intra-group route (direct cost and increased use of collateral).
- Further contraction of liquidity in a market crisis.
- Increased operational risk resulting from the need to funnel funding through the inter-bank market.
- Opportunity cost of lost business where funding can not be arranged through other means in the time available.
- Disproportionate impact on smaller firms with EU parents on whom they rely for funding to compete with the larger firms.
- Disproportionate effect on those countries where cross border firms are prevalent, or where the existing regime is more favourable than that proposed, or where host country firms rely on intra-group funding.
- Hindering progress toward a single European market.

- Increased liquidity risk for affiliates – where a failure rumour hits an affiliate its inter-bank funding is likely to be cut or increased collateral is likely to be required.
- Increased geographical concentrations are likely.
- Increased sectoral risks are likely for the banks that are funding.
- Increased direct costs due to the need to set up local treasury operations (both in terms of systems and the staff required to run them).
- Increased cost of running localised risk management functions, not only resources and systems but also increased hedging costs.
- Increased cost of capital because firms will have to fund themselves locally and will probably have to hold more capital locally as a result.
- Restrictions on financing across borders resulting from these proposals will make the EU a far less attractive proposition for non-EEA parent firms, where the EU firm is the cash generator.

Benefits

- Possible reduction in the loss given default of intra-group exposures.
- Reduced risk of contagion across a group, because each entity will essentially be required to be able to stand alone.

It would appear to us that the costs of limiting intra-group exposures far outweigh any benefits that might accrue.

Q21 What are your views on the proposals/options for the scope of application of the large exposures regime
And
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; to group entities in non- EEA jurisdictions? Please explain your response.

Firms do not think that a case has been made for applying limits to all intra-group exposures, and certainly not for the reduced 20% limit as per Article 111(2). However, we recognise that all firms are not managed in the same way. Therefore, Members consider that the most appropriate starting point for developing options for the treatment within a regulatory limits based regime is not whether supervisors should have the ability to exempt such exposures on a case by case basis or the geographical location of the entities within the group but on the criteria that make a group a source of strength rather than weakness. The large exposures regime should encourage the appropriate management of the risk that is inherent in these exposures. As a result we recommend the following alternative approach.

Intra-group exposures should be included within the requirements for large exposures except where:

- They relate to exposures that are between group companies that are part of the same consolidation on a full basis, either conducted by a Member State or equivalent third country supervisor;
- Risk, evaluation, measurement and control procedures are materially the same across the entities in the group concerned; and
- There is no current or known future material practical or legal impediment to the prompt transfer of surplus own funds or repayment of liabilities.

In our view this would be an appropriate principles based approach (in line with the better regulation agenda) and therefore is the best way of ensuring that any concessionary treatment is applied in an appropriate way. It correctly puts the onus on senior management to satisfy themselves that there is integrated governance and controls. It is also risk based because it excludes group entities that are not part of the integrated risk management system and where, therefore, less reliance can be placed on the control and management.

We recognise that exempting intra-group exposures in this way, without giving supervisors the tools to understand the risk involved, would be inappropriate. We would therefore recommend that such a proposal would be supplemented with supervisory reporting of material exposures. Supervisors would therefore be able to discuss the risks and how they are mitigated as part of Pillar 2.

To the extent that any limits are imposed on intra-group exposures, the regime should reflect the significantly reduced market failures associated with the features of intra-group exposures. We make the following observations in respect of the scenarios outlined in the consultation:

(i) Intra-group exposures within a member state

The proposal to exempt intra-group exposures within a member state requires the provisions of Articles 80.7 or 80.8 to be met. However, these requirements are slightly different to the requirements in Article 69, which were considered appropriate for exempting exposures in the market failure analysis. We question CEBS intentions in this regard. We also note that both these Articles contain provisions that are more restrictive than the current discretion in Article 113.

In line with our thinking above, we believe that intra-group exposures within the same member state, where the entities are part of the same consolidation, subject to the same risk controls, and where surplus capital and other funds are capable of moving without material impediment should be exempt. To ensure that supervisors have sufficient information, this solution could be supplemented by reporting of the material intra-group exposures.

(ii) Intra-group exposures to entities in a different Member State

As noted above we fail to understand the view that firms will be less willing or able to support group entities in other Member States and would re-iterate that it is not in firms' interest to allow a group entity to fail. The purpose of integrated risk management is to identify problems early and address them using all the management tools available. This applies equally to foreign entities as it does to domestic ones.

Restrictions within the EU will also frustrate competition and will therefore run counter to the development of a single market. For similar reasons we do not believe that it is helpful to include national discretions, or for regulators to exempt firms in exceptional circumstances, as such approaches will re-create the current inequalities and increase the complexity of implementation for firms. We believe that it is inappropriate to limit these exposures to 25% and that tighter limits should certainly not be applied. Exemptions should be based on clear criteria along the lines of the principles outlined above. Such an approach would be proportional and clear and transparent and minimise competitive distortions. If it is concluded that limits for intra-group should be included, then these should be set against group capital.

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

Our comments for (ii) also hold for this scenario. As many of our Members are global operations, we are concerned that limiting intra-group exposures to entities outside the EEA will make EU firms less competitive. However, it is a well-established precedent in the CRD and other Directives that the same treatment should be given to equivalent third country nations. We therefore believe that exemption based on clear criteria should be available to non-EEA group exposures. As with (ii), if limits are taken forward into the proposed regime these should be set against consolidated capital.

Interdependencies

Regardless of the final outcome of the consultation with respect to intra-group exposures, we think that it is not possible to arrive at a final conclusion without taking account of the outcome of the Liquidity Review, which is also underway. These two aspects of the regulatory framework are deeply intertwined and we therefore think that a sunset clause should be included within any proposed legislation to ensure that the complementary aspects can be picked up.

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

As noted in Question 22 we think that the focus of the principles should be on the criteria that make a group a source of strength rather than weakness and to encourage the appropriate management of the risk that is inherent in these exposures (i.e. the external exposures of the group). We therefore think that the following principles should be applied:

Intra-group exposures should be included within the requirements for large exposures except where:

- o They relate to exposures that are between group companies that are part of the same consolidation on a full basis, either conducted by a Member State or equivalent third country supervisor;
- o Risk, evaluation, measurement and control procedures are materially the same across the entities in the group concerned; and
- o Where there is no current or known future, material practical or legal impediment to the prompt transfer of surplus own funds or repayment of liabilities

As regards the principles in paragraph 230 we have the following comments:

I	This is not a principle but the base case situation from which an exemption is granted.
II	This is a post insolvency issue and is in our view irrelevant to the primary objective of reducing the risk of failure to an acceptable level.
III	As per principle 2
IV	As per principle 2
V	We do not understand what this principle is trying to achieve.

Paragraph 227 raises some interesting issues as to the level at which the calculations should be performed (and consequentially, the capital base to be used), but CEBS orientation on this issue is unclear to us. As noted above we think that if a limit is imposed it should be set against the consolidated capital base.

Members would contest the statement in paragraph 228 that firms have demonstrably weaker incentives to limit intra-group exposures. While the intra-group exposures themselves are essentially a by-product of the process, and tend to be managed within the treasury function rather than the credit risk area, this does not mean that there is no management scrutiny. Firms have policies and processes to determine, monitor and manage the level of intra-group exposures; a fact which has been borne out in both our survey of risk management (previously submitted) and the more recent work undertaken by the LIBA and the BBA in respect of the UK project to examine the treatment of members of financial groups. The focus of risk management, however, is on the external exposures of the group entity because it is those exposures that will cause the group to either make or lose money.

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.

It is not clear to us whether CEBS is proposing a general exemption for investment managers or just for their exposures in an intra-group context. Our Members have no strong views on any proposed exemption.

Q25 Do you agree with the proposal on the treatment of other financial institutions for large exposures purposes? Please explain your response.

Members agree that applying the large exposures regime at a consolidated level to these entities (rather than imposing solo requirements) is appropriate since the external exposures of the group as a whole are the most relevant to tail event idiosyncratic risk. Since this approach accords with the current approach the impact should be minimal.

Chapter 7 – Sovereigns, international organisations, multilateral development banks and public sector entities

Q26 What are your views on the proposal to remove the national discretion and to automatically exempt exposures to sovereigns and other international organisations (within Art 113.3 (a-f)), as well as some regional governments and local authorities? Please explain your views.

We agree with CEBS proposal to automatically exempt exposures to sovereigns and other international organisations, as well as some regional governments and local authorities, in accordance with the discretions contained within Article 113.3 (a –f). We believe that all exposures to central governments and central banks that attract a 0% risk weighting should be exempt (including those that are denominated in local currency and are attributed a 0% risk weight by the third country CRD equivalent local regulator). We note that any residual country risk, associated with these exposures, will already be picked up by firms in their concentration risk management under Pillar 2.

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

The direct costs and opportunity costs associated with this proposal would appear to be zero, since these discretions are by and large already adopted by all Member States and are therefore already implemented by firms and supervisors. The benefits would appear to be the recognition of low credit risk and the smooth running of international markets. In particular it will be important for the use of collateral, where sovereign exposures are used extensively.

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.

Provided that the intra-group treatment is resolved satisfactorily we think that the exemptions in Article 113 (3) (g) and (h) and (o) will have been appropriately addressed through either the CRM proposals and/or intra-group.

Article 113(3)(i) and (k) are considered as part of our answer to question 29.

Since discount houses no longer exist in the UK, Members do not see the need for the exemption in Article 113(3)(j).

Members have no strong views on the remaining exemptions covered by Article 113(3) (l) to (n) and (p).

Chapter 8 - Inter-bank exposures

Q29 Do you consider that large inter-bank exposures of all maturities are associated with the market failure identified?

We agree that in terms of the perfect market assumption that underpins all MFA, banks and investment firms could be the subject of tail event idiosyncratic risk and that it is relevant to consider exposures between these entities when developing the large exposures regime. However, we do not think that the market failure analysis holds in the same way as for other types of entities.

Although the consultation states that the level of bank failures (after taking out the impact of regulatory interventions) is not significantly different to that of corporates there is no evidence that large exposures, and in particular inter-bank exposures, have been the cause of any bank failures. In CP 14 CEBS acknowledged that the studies performed by Basel and the Group de Contact found that most failures were the result of internal control problems. We note that CEBS views Rhineland funding as an example of a large exposures failure related to connected exposures. However we regard the drawing of multiple liquidity facilities to be an issue of liquidity and concentration risk not of tail event idiosyncratic risk. In the case of Northern Rock, it was the absence of funding available in the market that caused problems. Since the large exposures regime (including its exemptions for certain inter-bank exposures) has been in place for 15 years without evidence of a problem, we see no evidence for limiting all such exposures.

We agree that the negative externalities of failing to internalise the cost of systemic failure and the risk to consumers are the relevant market failures and that the relevant consideration is contagion. However, the analysis fails to take account two things:

- The proposed approach to intra-group when considering the risks regarding inter-bank. If intra-group exposures are restricted, then firms will have to rely much more heavily on the inter-bank market for funding.
- The speed with which the inter-bank market reacts to perceived problems at an individual entity or within the market more generally. The market therefore addresses the risk itself by reducing the funds it will make available and/or increasing the cost.

There is, therefore, a potentially increased risk of failure of banks and investment firms, not as a result of the large exposures contagion that CEBS envisages, but because of the absence of liquidity. In our view BIS working paper 234 supports this conclusion. The studies that have been conducted indicate that the bank contagion is a low PD/high LGD event and would support the conclusion that banks are different. It highlights illiquidity is a significant risk for contagion - 'illiquidity may not only amplify contagion, it may even cause it'. The Muller study analysed how the ability to draw credit lines affected the scope for contagion. This study concluded that there were two effects of liquidity lines:

(a) Providing a source of liquidity thereby reducing the risk of banks not being able to meet their commitments; and
(b) Draws on liquidity lines introduces a liquidity shock at banks that have to provide the liquidity.

Of these two effects the study indicated that (a) was by far the more important. In other words restricting liquidity in the inter-bank market is likely to have the opposite effect to that intended by CEBS and exacerbate liquidity problems in a market shock.

As regards the regulatory failure of moral hazard, we indicated in our response to CP 14 that any failure to price in an implicit government guarantee is not addressed by setting a regulatory backstop limit but by making firms internalise the cost. This has already been addressed by the incorporation of a floor to PD and the conservatism already built into the capital framework.

The market failure fails to take account of the mitigating actions of management. Stress/scenario testing is used by firms to address concentration risks and firms indicated that they use scenario analysis on the top twenty exposures. Since other banks and investment firms are likely to be within these scenario analyses, this risk is addressed. Risks identified from scenario testing results can lead to a change in limits set or increased use of credit risk mitigants. In paragraph 275 CEBS notes the findings of the IMF's FSAP reports, which indicate that stress testing can contain or eliminate the risk of contagion. CEBS references to these reports, however, do not indicate that setting a regulatory limit is the appropriate way to address the risk.

We find it odd that CEBS concludes that shorter maturity does not reduce information asymmetry, when in paragraph 110 there is acceptance that it does. We would contend that maturity is a factor in reducing information asymmetry and that it should be taken into account in developing the large exposures regime.

Finally we would contend that it is not possible, nor is it necessarily desirable to address all market failures. The inter-bank market is of vital importance to the smooth running of the financial system. Restricting it unduly will have a knock-on impact to the competitiveness of the EU as a financial centre.

We therefore conclude that although there is evidence of some market failure, it is not clear that it is material. And for shorter maturities we believe that the market failure is further reduced. As a result we do not believe that it is clear that a regulatory limit is necessarily appropriate. In the case of shorter maturities we think that there is definitely a case for exemption.

Q30 What do you consider to be the implications of the caveats set out above to the conclusions of the cost/benefit analysis? Do you have any comments on the cost/benefit analysis?

Rather than merely comment on the caveats, we provide our comments on the cost benefit analysis as a whole.

We question the assumptions that underpin the cost benefit analysis and believe that the costs are understated and the benefits are overstated for the following reasons:

- It will be difficult for smaller firms to diversify without reducing the credit quality of their counterparties because the size of the funds they place will fall below the limits set by the larger higher credit quality firms. There is therefore a potential increase in the risk of failure for smaller firms that has not been accounted for. This may have implications for the amount of capital they will need to hold and therefore increase the cost of business.
- Smaller firms have indicated that the numbers of counterparties that they would have to deal with would also increase significantly. Given the likelihood that they will have to deal with lower quality counterparties this will have implications for the amount of resource both human and systems required to perform the credit analysis. If intra-group restrictions are introduced this will also impact the subsidiaries of larger firms. (The separate BBA paper includes further analysis of the issues faced by smaller banks in relation to the inter-bank section of the consultation.)
- If smaller firms are able to place funds with better quality counterparties it is likely that they would have to do so on the basis of longer maturities, thereby reducing flexibility in their own liquidity planning. This may increase the risk of liquidity problems.
- Restricting inter-bank funding will mean that larger firms will find it more difficult to obtain the funding of the size required and therefore costs are likely to increase as they will have to deal with more counterparties.
- We do not believe that the collateral markets are sufficiently liquid and therefore we believe that the assumptions of efficient markets and zero price elasticity are unrealistic. We believe that the costs of collateralising should be higher. If eligible collateral is restricted then the costs are likely to increase still further. (We are also surprised by the basis on which the cost is calculated, i.e. collateral is used to reduce exposures to below the 25% limit. In the UK such 'top slicing' has been frowned upon.)
- Increased collateralisation would also have systems and resource implications for all firms.
- Restricting inter-bank limits may also result in smaller firms finding it more difficult to access good quality collateral, thereby increasing their risks, with the implication of increased capital.
- The cost benefit analysis does not take account of the implications of restricting intra-group exposures. If larger firms are unable to access internal sources of funding then they will be forced to turn to the inter-bank markets. A combination of restrictions on intra-group and inter-bank will increase the likelihood of firms having to turn to the central bank for funding and increase the risk of failure. We therefore think that the risk neutral assumption is therefore inappropriate. The benefit of inter-bank limits is likely to be significantly overstated.
- The introduction of inter-bank limits is also likely to result in geographic concentrations and therefore increase the risk of failure due to shocks that affect localised regions.

- Increased risk of liquidity shocks is likely to undermine any perceived benefits in protecting against failure of banks that would not precipitate a systemic failure and therefore reduce the allocative efficiency associated with a reduction in moral hazard.
- We would agree with CEBS that the impact of inter-bank limits is likely to have a disproportionate effect on some jurisdictions. Since liquidity is vital to the smooth running of financial markets we think that further consideration is required.
- Restrictions on inter-bank liquidity in the EU could potentially result in a loss of business to EU firms and therefore have an impact on economic growth more generally.

We therefore conclude that the costs of introducing limits on all inter-bank exposures are likely to be significantly higher than the estimate produced and that the benefits are likely to be lower. We are therefore of the view that the case for limiting all inter-bank exposures has not been made.

Q31 – See Q33

Q32 Would a 25% limit on all inter-bank 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).

Yes. A 25% limit on all inter-bank exposures would unduly affect institutions' ability to manage their liquidity (see question 31 above). This impact will be more pronounced if firms are unable to fund group entities internally.

Yes. Maturity should continue to play a role. Information asymmetry is undoubtedly less and the 'less than one year' exemption is important to the smooth running of the repo markets which is an important source of liquidity.

Q31 Given the market failure and costs/benefit analysis set out, what treatment would you consider appropriate for inter-bank exposures?
And
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 inter-bank exposures?

The answer to these questions will in part depend on the decisions taken in relation to intra-group exposures. The need for liquidity in the inter-bank market will be more pronounced if constraining limits are placed on intra-group exposures.

In a limits based approach, we think that it is important to take account of the reduced information asymmetry inherent in short term exposures. We believe that the exemption for exposures of less than one year maturity should be made mandatory rather than a national discretion. Such an approach is credible, proportionate, clear and transparent and has regard to the competitive position of the EU. We believe, however, that the plethora of existing national discretions for exposures beyond one year should be simplified and that a mandatory rule should be adopted. We would recommend the following: A conversion factor of 20% should apply to exposures with a maturity of between one and three years and a conversion factor of 50% for exposures with a maturity of over three years. This would reflect our view of the market failure associated with these exposures and explicitly take account of the impact of maturity

We accept, however, that regulators need to understand the level of inter-bank exposures in order to supervise effectively. We would therefore suggest that inter-bank exposures in excess of 10% of own funds should be reported.

Chapter 9 – Breach of limits

Q34 Respondents' views on the approaches to non trading book breaches of limits would be welcomed. Please explain your views and provide examples and feedback on relevant costs and benefits.

Breaches of limits do occasionally occur and we think that CEBS rightly distinguishes between those that arise out of events that are outside the firm's control (such as a change in structure of a counterparty), those that result from changes to a firm's own structure and those that result from failures in a firm's systems and controls. As we regard systems and controls as central to the management of extreme idiosyncratic risk, we believe that breaches resulting from failures in a firm's systems should be the focus for regulators. Regular or persistent breaches in this category would, in our view, indicate more serious problems at the firm and should be a trigger for supervisory discussion under pillar 2.

An appropriate response to individual breaches would be for the firm and the regulator to agree an appropriate timescale for resolution. We do not believe that it is possible to hard code a timescale for resolution that would be appropriate for all such circumstances, particularly where the breach results from a major structural change to either the firm or the counterparty.

Chapter 10 – Reporting issues

Q35 What are your views on the 3 reporting options? Please explain and provide feedback on the costs/ benefits of CEBS' initial views.
And
Q36 Do you support CEBS' thinking on the purpose and the benefits of regular reporting using pre-defined reporting templates?

We agree that it is important for supervisors to understand the concentration risks being run by firms. We note CEBS objective in this regard, and that it also considers that peer group analysis and aggregation of exposures across the system to understand the impact of shocks. As regards the analysis of systemic issues arising from shocks, we seriously doubt it will be possible to devise a reporting system (without capturing the entirety of firms' data) that would permit regulators to identify potential shocks or to address issues during a crisis. We think this objective is best addressed by ad-hoc information requests as currently.

We think that the most appropriate and most proportionate response would be to rely on firms' internal management information. Our views on the three options are set out below:

<u>Pillar 3 reporting</u>
We agree that it would be inappropriate to address tail idiosyncratic risk through Pillar 3 reporting. Meaningful information would require disclosure of exposures that are commercially sensitive. Since Pillar 3 provides for the exclusion of information where it is commercially sensitive, this option will not credibly address regulators objective to understand the concentration risks being run. In addition, it is also likely that the information may be misinterpreted by other

users of these disclosures and therefore could therefore have unintended, undesirable consequences.

Reporting based on firm's internal reports

We think that using internal reports would address the regulatory objective to understand the concentration risks that are being run by a firm. We also think that this option is the most proportionate response of the three options, as it relies on the firms own systems. This option focuses on the firm's own risk management and therefore provides the supervisor with a better understanding of the risk management process, in line with the objectives of the CRD. We therefore think that supervisors will be able to ask more targeted questions rather than the suggested increase in questions/requests for additional information. We do, however, appreciate that it will be more difficult for regulators to automate the process of receiving and interrogating the data, and to undertake peer group analysis. However, we believe that convergence does not necessarily mean the same rules but achieving the same outcome. This option will not be without cost to firms, as additional management review processes will be undertaken as they are for any information submitted to the regulator

Regulatory defined reports

While regulatory defined reports will undoubtedly allow supervisors to automate the process of collection, interrogation and peer-group analysis, the success of this option in terms of meeting CEBS core objective of obtaining an understanding of the concentration risks being run will depend entirely on the information that is requested. In particular we think that the direction indicated by the CP in relation to intra-group and inter-bank exposures would result in reporting that does not focus on the risks that firms consider relevant but the consequences of the regulatory regime.

The cost to the industry in terms of the production of regulatory defined reports will be determined by the final content, frequency and submission times. We are concerned, given the size of the COREP package, that the level of detail will be significant. The COREP package also allows supervisors pick from the data fields and to supplement the requirements with additional information requests. It therefore does not represent a truly harmonised approach. We are therefore concerned that this option will involve significant cost to the industry. As regards frequency of reporting and submission times, we note that CEBS is currently consulting on CP04R. LIBA and the BBA will be responding jointly to that consultation.

We also note that CEBS does not discuss the reporting that might be required in event of a breach. We would recommend that firms notify their supervisor as soon as they become aware of a breach or likely breach outlining the size, nature and cause together with their plans to rectify the situation.

Q37 What is your opinion on CEBS' initial thinking regarding the elements to be reported under the Large Exposures regime?

We do not think that it is possible to comment on the detail of a reporting package until the regulatory regime is more settled in its design. We think that reporting should be the subject of further consultation with the industry at a later date.

However serious concern has been raised about two of the suggestions listed: the requirement to report all intra-group and inter-bank exposures; and, the requirement to report the composition of connected clients. Reporting of large exposures should only relate to those that are material. It would be a significant burden to produce reports covering all intra-group and inter-bank exposures. We do not believe that this approach is justified by cost benefit analysis. Similarly we do not consider it appropriate to disaggregate connected clients and we fail to understand the justification. We think that supervisors should focus on the systems and controls that are in place to ensure that connected clients are picked up. Without undertaking an analysis of the universe counterparties themselves, which would be a burdensome exercise, we do not understand how supervisors would be able to sensibly make use of this information. Obviously if there is a concern about a particular large exposure supervisors have the ability to engage in a dialogue with the firm about it on an ad-hoc basis, which could include discussion of its composition.

Chapter 11 – Credit risk management

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

No. We disagree with the analysis for the following reasons:

- We disagree with the market failure analysis outlined in part 1 of the call for advice. Regulatory and firm incentives are appropriately aligned in this area. Firms manage this risk to a much lower level of loss severity than that which would threaten solvency. In general the limits operating in large firms are significantly below the 25% limit.
- This analysis assumes that a 25% limit is the most appropriate limit. 25% is arbitrary; the only justification that has been provided is that it 'remains a large amount'. However, as we have previously indicated, a failure of a counterparty representing 25% of capital would still leave a firm with a minimum of 6% regulatory capital and does not necessarily imply insolvency (although we would naturally expect regulatory intervention).
- Exempting sophisticated firms from the limits does not necessarily imply that there should be no regulatory regime for these firms. We believe that the ILBA (as outlined in Annex 1), and incorporating supervisory reporting, would be a credible and proportionate response to the regulatory objectives.
- Merely recognising the impacts of credit risk mitigation does not help supervisors understand whether firms are managing the risks appropriately or allow them to understand the concentration risks that the firm itself thinks are relevant.
- The amended backstop limit regime provides no incentives for firms to manage tail event idiosyncratic risk better.

As a result we still believe that the option of a systems and controls based approach should not be ruled out entirely.

Annex 1 - Internal limits based approach (ILBA)

Our members continue to believe that an approach that focuses on firms' own systems and controls, using the tools available to supervisors under Pillar 2, is a viable and appropriate approach to deliver the regulatory objective for large exposures. In keeping with the Better Regulation agenda, we think that it is important to properly examine this option. However, to date there has possibly been a miscommunication, on our part, as to what such an approach would mean in practice. This Annex, therefore, aims to summarise the features of the ILBA, the costs and benefits, and implementation options

In developing the ILBA we have borne in mind the objectives and principles that we outlined in our first submission to you (summarised below).

The objective of the large exposures regime is to provide an appropriate level of protection against the risk of firm failure arising from tail event idiosyncratic risk. We note that CEBS supplements this initial objective with the following:

- Ensure that negative externalities arising from large single name exposures are contained to an acceptable level.
- Minimise the moral hazard arising from the existence of safety nets as it affects the management of large exposures.
- Ensure that public authorities have sufficient regulatory tools to monitor, on an ongoing basis the extent to which the overarching objectives of prudential supervision are being achieved.
- If intervention is necessary, ensure that it is effected using a tool that is appropriate and proportionate for achieving the stated objective.

The principles we outlined for assessing policy options are as follows:

- There is a sufficiently close and credible link between the requirements and the objectives.
- The rules should impose the smallest possible cost or burden consistent with the objective and should be capable of being applied by everyone without incurring disproportionate cost.
- The requirements should be clear and transparently applied.
- The requirements should be appropriate with regard to the international competitive position of the EU financial services industry.

The ILBA in practice

As noted above the ILBA would be a 'systems and controls' based regime, which relies on firms' internal limits where they can be demonstrated to appropriately manage the risk. The main features would be as follows:

- Firms would need to apply to their regulator and obtain explicit supervisory approval to use the ILBA (although we would not envisage this process to be as detailed and prescriptive as the IRB approach). It is not our intention that the ILBA would replace the amended backstop regime entirely. The ILBA would sit alongside it. Supervisory limits would remain available for those who want them.
- It would be a principles based approach along the lines of CEBS guidelines on concentration risk.
- The approach would apply at the group level not the entity level, as that is how firms tend to manage the risk. We recognise that such an approach would involve supervisory co-operation and reliance on other regulators, which would require further discussion.

- o It would be supplemented with supervisory reporting.

The criteria that we think should be applied to demonstrate firms' ability to measure and manage single name idiosyncratic risk, and which would inform the development of principles, are as follows:

1. Identification of risk appetite and governance of that process
   As outlined in our survey of industry practice risk appetite setting is addressed at Board level and will take account of the firm's strategy and desired risk profile. It is the basis for the delegation of authorisation to approve exposures or to sanction breaches across the group/firm. It also sets the high level limits for the business units. As such, it is the basis of the credit risk system.

2. The process for setting/changing limits and authority levels
   The limit system should encompass all exposures and operate firm wide. The limits should be documented. Any changes to limits should be decided at the appropriate level within the firm

3. Exposure measurement
   Exposure measurement methodologies should be documented and there should be a suitably rigorous process for approving any changes, which in turn should be documented.

4. Policies and procedures for monitoring exposures against the limits
   The firm should have a clearly documented policy for the frequency with which exposures are assessed against the limits. Reporting of exposures should be appropriate to the size and nature of the business.

5. Limit breaches
   Firms should have a policy for dealing with breaches, with clearly identified reporting lines. Any breach of a credit limit should be identified, reported to the appropriate level within the firm and actions taken to resolve the breach should be documented

6. Internal audit
   Internal audit should review the processes set out above on a regular basis.

Cost benefit analysis

We regard the costs and benefits of the ILBA to be the following:

Benefits

- ✍ It provides incentive to manage concentration risk better and is therefore in line with the general objective of the CRD.
- ✍ Allows supervisors to properly understand the risk that firms are running and encourages a better and more focussed regulatory dialogue.
- ✍ It is a proportionate policy response because it builds upon business practices, while addressing the regulatory objective objectives.
- ✍ It would reduce the cost to firms because it eliminates the current regulatory function.
- ✍ It would reduce the capital cost of transactions in the trading book.

Costs

- o There is likely to be an initial set up costs for supervisors. However on ongoing basis we think that there would be re-deployment of supervisory resource over the current system.

Implementation options

We appreciate that initially there would be set up costs for supervisors. Since this approach would build on the supervisory knowledge gained as part of the IRB process, it could be restricted to those firms in the first instance.

Since this would be a significant departure from the existing regime, we would also suggest that a period of parallel running to allow supervisors to gain an understanding of firms' systems before removing the regulatory limits.

Conclusion

We acknowledge that CEBS is of the view that an amended limits based approach is the most appropriate way forward at this point. However we believe that the ILBA is a valid alternative option that should be considered. As such we recommend that a sunset clause is included within the proposed Directive changes which would allow further consideration of this option once supervisors have gained more experience of Pillar 2.

Annex 2 - Intra-group exposures

This Annex sets out the likely implications of imposing intra-group limits for both funding and risk management.

Funding

Removing intra-group concessions would entail severe consequences for the funding of the host entity in a cross border group.

If the home entity had to curtail its deposits or short term loans to the host entity as a result of the disappearance of intra-group concessions, it would first seek to replace these exposures with securities financing transactions: cash would be provided against collateral. This however assumes that collateral is available from the host entity.

(i) If collateral is available, the absorption of collateral by the home entity might restrict the host's ability to fund itself on the market over the longer term, or to enter into hedging transactions requiring margining.

(ii) If available collateral was insufficient, the host entity would have no other choice than to borrow on the inter-bank market:

- This would be difficult, because host entities tend to be unrated, and because the home entity could not guarantee the host entity without breaching the LE limits.
- Many firms potentially tapping into the market at the same time would likely cause a rise in the cost of funding.
- The inter-bank market might be illiquid, potentially placing the host entity at risk of default, even though cash was available in the home entity.
- In practice, the home entity would place cash with third party banks, which would in turn lend it back to the host entity. This would result in additional operational risk, funding mismatch risk and costs, not to mention trapped pools of liquidity and incompatibility with the centralised liquidity risk management models implemented in most financial groups.

The host entity would now depend on other banks for its funding, with the likely consequence of liquidity becoming tight very quickly in times of stress. Substituting third party providers of liquidity for the home entity will increase the probability of default of the host entity and, by exposing the host entity to funding from other banks, facilitate the transmission of an avoidable crisis to the wider banking sector.

The build-up of a large exposure between the home and the host entity might be a cause for concern. However, any intra-group credit risk is first and foremost mitigated through the establishment of an appropriate group control framework. A backstop limit is not a substitute for prudent management and adequate corporate governance. On the contrary, it can be argued that placing fewer constraints on cash flows within a group reduces the probability of default of the structural recipients of funding, and limits contagion risk.

Risk management

The paragraphs below have been addressed at the trading book, but similar risk management considerations may also be relevant to banking book positions.

Risk is channelled around the group to allow more effective risk management. Intra-group limits would inhibit this process, thereby concentrating risks in entities where it can be less effectively mitigated and managed.

Large groups manage risks centrally. This requires the transfer of risks from local entities to the group entity responsible for their central risk management. This is an important feature of integrated risk management and allows the group as a whole to work more efficiently and effectively. Restricting such back to back transactions will make it significantly more difficult to run a global risk management strategy and will also increase costs as it will be necessary to set up local risk management functions.

For example, if a firm takes on a long position via a client transaction in London, and an offsetting short position with a different client in New York, the firm will see itself as market risk flat, with counterparty risk to both clients. However at the solo level the firms will be long and short market risk respectively. For central risk management purposes, market risk is transferred centrally e.g. to an entity that may hold all such risk in the group. Such an entity would be 100% owned and integrated into the firm's management systems. This way market risk is in one place with the true economic position visible and understood. However the transfer of risk creates counterparty risk between group companies. In turn the build up of counterparty risk creates "large exposures" as defined by the CRD.

However the concentration of credit risk arising from this activity is not seen as meaningful by firms. This is primarily because the firms in the group are fully integrated, subject to common controls and risk management and because capital can be transferred around the group to where it is needed. Furthermore firms have materially more information on the group financial position.

It is also worth noting that some firms may set up margin terms so that intra-group derivative exposure is fully collateralised. Also some firms may have transaction specific parental guarantees (e.g. between local entity and its counterparties). Both help to mitigate the intra-group risk further. However neither is needed to reduce intra-group risk as we argue that risk is already within tolerable levels if the group is managed as per this Annex.