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EUROPEAN SECURITISATION FORUM

Joint Trade Associations' Response

CEBS Consultation Paper (CP14) On the First Part of its advice to the European Commission on large exposures

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 first 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 represent the views of a sub-section of our members made up of large internationally active financial institutions. For questions 11 and 12 on structured finance transactions, we are joined in our response by the European Securitisation Forum (ESF).

In this first section of our response we set out our key messages and a brief summary of our responses to the questions. The following section addresses the questions in more detail. We have also appended, in Annex 1, our further thinking on the market failure analysis.

Key messages

In responding to CEBS consultation on concentration risk it is important to bear in mind the context of the review, in particular the aims of the Commission in setting the call for advice, and Better regulation.

The EU Commission has acknowledged that the present rules, dating back to the early 1990s, do not sit comfortably alongside the new Basel 2 framework "and no longer appear pertinent". Informal consultation with the industry by the Commission, following that statement, revealed that, for larger banks at least, the reporting requirements were burdensome and a poor fit with industry best practice. The European Commission proposed to cover three key areas: increasing prudential soundness in light of new techniques in supervision and regulation, greater harmonisation across the member states and, reducing, where possible, regulatory burden. We therefore regard this as an opportunity for the EU to lead the debate in developing regulation for concentration risk.

The Commission also outlined its commitment to better regulation in its proposal of March 2005, which aimed to:

* Cut red tape by withdrawing/amending EU laws which prove to be excessive.
* Strengthen the Commission's extended impact assessment system to ensure that new EU legislation in the pipeline does not unnecessarily add to the administrative cost confronting firms.
* Accelerate the annual simplification rolling programme laying down clear targets to be met within specified deadlines.
* Draw on outside expertise to input on the quality and methodology we propose for individual impact assessments, to ensure we're addressing all the issues.

While we are pleased to note the Commission's decision to use CEBS to assist in the development of policy in this area, and the usefulness of the Level 3 process more generally, we question whether CP14 has really delivered proposals that will take thinking further forward.

In particular we question the presumption that a 25% limit is the appropriate tool to address single name concentration risk. Risk management and risk mitigation tools have developed significantly since the introduction of the large exposures regime. Our survey of industry practices has further confirmed that firms' take the management of concentration risk very seriously. It concluded that firm's limits are in general tighter than the regulatory limit because firms are managing to a lower level of loss severity than that which would threaten solvency. In addition it found that firms' own systems bear little or no relationship to the regulatory regime and that the regulatory regime provides a binding constraint only on those exposures that firms consider least risky. The evidence within the market failure analysis would also seem to support these conclusions. We therefore believe that there is an opportunity to reduce the regulatory burden and cut red tape by allowing firms to manage this risk for themselves, with regulatory focus on the supervisory dialogue surrounding the Pillar 2 guidelines on concentration risk.

We support CEBS stated commitment to better regulation. We commend CEBS on its already excellent consultation practices, which we regard as open and transparent. We also welcome CEBS' decision to undertake a market failure analysis (MFA) at this early stage of embedding impact analysis within the three Level Three Committees (3L3) procedures and processes. However we are disappointed that more has not been made of this opportunity to demonstrate better regulation in practice and with the analysis provided. We are surprised, given the conclusions in several areas of the MFA that there is an overall view that there is a material market failure relevant to the prudential objectives. Interim conclusions such as:

* many firms pay significant attention and have well considered policies and practices in relation to concentration risk (paragraph 68),
* rating agencies do take account of concentration risk (paragraph 83),
* difficulties arising from single name concentration risk do not appear to have been a significant factor in the banking failures covered by the Basel and Groupe de Contact's reviews, nor has CEBS found such evidence in its review of the period since 1999 (paragraph 119)

This overall view seems to rest on the assertion that firms will cease to exercise good governance in times of earnings volatility. We strongly refute the suggestion that firms will 'put good money after bad'. Not only is this statement inflammatory and not supported by the evidence presented, but we fail to understand why regulatory limits are the most appropriate tool to address the perceived risk. Ratings are similarly dismissed because of implicit government support, although this support, if available at all, will only be relevant to a very limited number of entities and there has been no analysis to determine whether firms take account of this factor in their own internal assessments. We also do not regard the fact that some firms rely on the regulatory framework as justification for retaining the 25% limit, in the absence of a more detailed review of the possible tools of regulation available. We think that the failure to review the tools available to regulators is a major omission in CP14 and will certainly require further consideration in part two. In addition we think that there should be further consideration of some of the major counterparty failures that have occurred in recent years, and why this has not lead to firm failures or losses to depositors. We continue to believe that such analysis provides evidence that firms are best able to manage this risk for themselves because regulatory and industry incentives are aligned.

Although Members are disappointed that CP14 has not fulfilled its potential, they would be prepared to live with a 25% limit as a regulatory backstop. Firms have obviously been doing so for some considerable time. However, Members would prefer to see this expressed as a guideline rather than a hard regulatory limit. And we believe that further consideration will need to be given to exposures to certain types of counterparties that will continue to require a preferential treatment; otherwise the regulatory frictions that currently exist will persist or be exacerbated. Any acceptance of a 25% limit regime is also predicated on the successful resolution of some of the issues considered in part two of the call for advice. Issues of particular concern to members are the supervisory tools available, the treatment of credit risk mitigants, intra-group exposures and underwriting. We will be developing our thinking on these issues during the period of part two.

While we appreciate the constraints that CEBS has been working under, we have found commenting on the consultation problematic because of the interrelationship between parts one and two of the call for advice. It is necessary to delve into some of the detailed aspects of part two to be able to comment on part one. For example, it is difficult to assess the proposals in relation to exposure measurement without consideration of credit risk mitigation (CRM) which is integral to firms' systems in this respect, or to consider whether a limit based approach is appropriate without considering the question of 'one size fits all'. In addition, we do not think it is possible to consider some of the aspects in part two without revisiting some of the issues in part one. For example, the market failure analysis and competition issues will need to be revisited once there is a clearer picture of the detailed nature of the proposals.

There are some difficult technical issues to consider in part two of the call for advice, which together with the need to revisit some of the issues in part one, lead us to believe that the timetable for CEBS is very tight. As due consideration will also need to be given to CEBS findings by the Commission and the European Banking Committee prior to proposals being put to the European Parliament we believe that it would be an appropriate moment to revisit the timetable to ensure that sufficient time has been built in ensure a good quality regulatory outcome is delivered. Members do not see value in pressing ahead with a very tight timetable if the end result recreates some of the perceived problems of the existing regime.

Other issues

We think that an operational objective of the large exposures regime should encompass idiosyncratic risk but think that objectives one and three in paragraph 30 of the consultation both represent this risk. However we think that tail event idiosyncratic risk is a legitimate concern for regulators, as it is to our Members. We previously defined the specific policy objective as 'to provide an appropriate degree of protection against firm failure arising from the concentration risk in the credit portfolio'. As such we do not believe that it is appropriate to provide absolute protection, as this would be inefficient and distort the market and any operational objective should be considered in this context.

We think that it is difficult to determine with any certainty whether the existing large exposures regime causes competitive distortions due to the need to consider the detailed practice of other jurisdictions; although we note the use limits based approaches in these countries. More importantly we think that further consideration should be given to the regulatory practices in other sectors, such as the proposed approach in Solvency II.

We believe that appropriate principles for the management of concentration risk have already been set out in the CEBS Pillar 2 guidelines and think that these should be the focus of regulation in this area going forward. We think that credit quality can be appropriately taken account of in a Pillar 2 approach to single name risk. Concentration risk management is an integral part of firms' credit risk management and credit worthiness is a key factor in determining acceptable levels of exposure. In practice firms' approach leads to the generally much tighter limits than the current regulatory regime and large exposures, by their very nature attract greater management attention. A Pillar 2 approach that allows firms to use their own systems would, therefore, by its very nature take account of credit worthiness. We would not advocate the mechanistic inclusion of credit worthiness in a limits based regime. However, we do think that further consideration will need to be given to taking account of credit worthiness (and credit risk mitigation) for some counterparties otherwise the divergences between regulatory requirements and good business practices that we have noted in our earlier submissions will persist.

We found the section on the measurement of off balance sheet exposures confusing. However, we welcome the proposal that firms would be able to use their internal risk management systems for generating values for off balance sheet transactions. We believe that EPE continues to be a relevant measure for these purposes for OTC derivatives and securities financing transactions (SFTs), although firms may use other measures. Where firms are not using a modelled approach to exposure value, we assume that the mark to market method is still an acceptable measure. And in relation to other off balance sheet items, we think that 100% CCF is overly prudent, as it does not recognise the behavioural aspects of these exposures.

The introduction of a principles based approach to structured finance transactions is undoubtedly welcomed. However, we think that the practicalities of the proposed approach to determining whether look through should occur will be burdensome and we suggest an alternative approach that takes account of the factors that firms take into consideration in their own determination. In addition we think that the 'principles' relating to exposure value should be dropped. As a general point we think that it is important that distinctions are made between principles and rules.

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

Questions

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

No.

The consultation paper describes the operational objectives of the regime in terms of three risks: (1) idiosyncratic risk; (2) sectoral and geographic concentration risks; and (3) unforeseen event risk. We agree that these risks should be considered but we think that (3) is actually part of (1). The existence of idiosyncratic risk arising from credit risk concentration implies the failure of the atomistic portfolio assumption in the Asymptotic Single Risk Factor model but does not imply the quantification of the resulting risk at a given confidence level. That said, we do agree that there are idiosyncratic risk events that fall beyond the chosen confidence level for the Internal Ratings Based Approach which are of legitimate concern to regulators (i.e. material tail events) but we do not believe it is a separate risk. Our survey of industry practice also revealed that some firms did define concentration risk in relation to losses in the distribution beyond a given confidence level. This suggests that regulatory and commercial concerns in respect of concentration risk in the credit risk portfolio might not diverge materially.

In one of our earlier papers we defined the specific policy objective for large exposures to be 'to provide an appropriate degree of protection against firm failure arising from the concentration risk in the credit portfolio'. In setting that objective we would emphasise that we believe that the aim should be to achieve an appropriate degree of protection. Absolute protection against any failure should not be sought, as this would be inefficient: a full guarantee induces moral hazard which grossly distorts lending decisions and results in the diversion of resources from profitable to unprofitable activities. Such an approach is also compatible with risk based supervision– devoting more supervisory effort to those activities that have high risk and high impact.

We also believe that in applying the operational objective, the relative importance of the overarching prudential policy objectives, of protecting consumers and maintaining confidence in the financial system, is likely to differ depending on the size and type of firm in question. With smaller firms the focus of concern is likely to be consumer protection; single name concentration risk is likely to be more of an issue given the more limited degree of balance sheet diversification. For larger firms the greater focus is likely to be on systemic protection; single name risk is less of an issue because of the diversification of the balance sheet.

Fraud appears to be the only example of 'unforeseen event risk' cited in the consultation. If the purpose of the regime is to address the risk of fraud, then we do not think that a limit regime is necessarily the most appropriate response. For some firms fraud risk will already be addressed as part of their approach to operational risk. More generally, increased regulatory focus on systems and controls and corporate governance would seem to be a more appropriate course of action.

We agree with the conclusion not to develop a granularity adjustment or a pillar 1 treatment for geographic or sectoral concentration risk. However, we are disappointed that these conclusions were not reached as part of a wider deliberation on the tools of supervision available.

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

No.

We welcome the commitment by the EU institutions to better regulation and in particular CEBS' decision to undertake a market failure analysis while the 3L3 Committees' impact assessment guidelines are still being consulted upon. Although we recognise that embedding impact assessment is at an early stage within CEBS, and we would not want to negatively impact the tight timetable, we would nevertheless like to raise our concerns with the current analysis.

We remain unconvinced that there is a material degree of market failure in respect of 'unforeseen event risk'. We believe that there is alignment between the objectives of management and those of the regulators. As outlined in our earlier submission on industry practice, firms continue to manage to limits that are, in general, significantly tighter than the 25% because they are managing to a much lower loss severity than one that would threaten solvency. We therefore agree with CEBS statement in paragraph 68 that firms have well considered policies and practices for managing this risk.

We also believe that there are other appropriate mitigants to the potential market failures identified in the form of the market discipline provided by ratings and wholesale counterparties. In fact rating agencies have been refining their approach. S&P have stated that concentration risk now drives in excess of 30% of their assessment of firm capital.

The available evidence on firm failures suggests that single name concentration risk does not appear to have been a significant factor. Risk management and risk management tools have developed significantly since the introduction of the large exposures regime, which we believe has contributed to the fact that despite some material failures of what appeared to be good quality counterparties, there have not been firm failures or losses to depositors. The market failure analysis fails to consider the implications of the significant counterparty collapses that have taken place over the last few years and why these have not resulted in firm failure.

We see three main threads to CEBS' arguments as to why there is a market failure:

* Gamble for resurrection
* Implicit state support
* Firms rely on regulatory limits

We do not believe that the gamble for resurrection, while a theoretical possibility, is a material risk because there are mitigants in the form of systems and controls and corporate governance to address this issue. In addition increasing concentration is not a rational response to a firm facing stress as greater returns would be expected from a diversification strategy. Finally, no evidence has been provided to suggest that the market has been pricing this risk incorrectly. Indeed where mark to market is available this risk will become apparent very quickly and be reflected in the premium charged. We also believe that limits are likely to be a crude and ineffective tool in addressing any gamble for resurrection risk that exists. We think that a much more targeted response would be the supervisory review of firms' corporate governance arrangements.

We do not find the argument that implicit state support undermines the effectiveness of ratings as a mitigant to market failure convincing. First, only a very limited number of counterparties would be considered to be within the remit of any implicit state support and therefore it is difficult to justify that the effectiveness of all ratings are undermined. Secondly, there has been no consideration of whether firms who use ratings as an input in their credit assessment take account of possible implicit support contained within the rating. Anecdotal evidence in relation to the recent discussions surrounding Moody's change of methodology for banks and the impact of implicit support would suggest that firms do take this issue seriously. Finally, if there is a risk that firms are failing to take account of the risk that implicit support will not be forthcoming in practice; it is questionable whether a limit is the best regulatory response. An approach that ensures firms internalise the value of the guarantee in their pricing would seem more appropriate, i.e. the price reflects the uninsured risk. It is arguable that in fact this end has already been achieved by imposing the 3bp floor on high quality exposures in the Internal Ratings Based (IRB) approach (as the counterparties most likely to benefit from any state support are probably caught by this floor). The floor acts to increase the cost of capital and therefore the risk premium demanded.

We acknowledge that some firms do indeed place reliance on the regulatory limits, but this is not the case for our constituency of larger more sophisticated firms. However, even for those firms where regulatory limits do play a role, there does not appear to have been any consideration as to whether there are other tools of regulation other than hard limits that might achieve the same goal. Where firms do base their risk management on the regulatory limits, we see no reason why they could not be expressed as guidelines, which we believe will still achieve the objectives of the large exposures regime.

In fact one of the major gaps that we perceive in CP14 is the limited consideration of the various regulatory tools available in determining a way forward. Some have been considered along the way, such as the decision not to consider a pillar one granularity charge, but there is no comprehensive analysis. Such an analysis obviously needs to be mindful (as CEBS has noted) of the existing regulatory framework – pillars 1, 2 and 3 – and focus only on what is not already addressed. Some options that could be considered are: allowing firms to use their own systems where these are deemed appropriate by supervisors, guidelines rather than hard limits, use of independent third party review and reporting frameworks

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

We think that there are three main areas where the market failure analysis could be usefully deepened

* Assessing firms practice in relation to the significant counterparty failures that have happened over the last few years that have not resulted in firm failure and losses to determine why.
* Consideration of the policy options available
* Revisiting the market failure analysis in light of further thinking in part two of the call for advice

We would be happy to assist CEBS in considering these issues.

4. Do you agree with our perception that there are broad consistencies between the EU LE regime and those in other jurisdictions such that there is no systematic competitive disadvantage for EU institutions? If not, could you please provide us with a detailed explanation of where you consider that competitive distortions arise?

The analysis provided on the countries selected for the review is at a very high level. It is, therefore, very difficult to judge whether the detailed application of the rules in these jurisdictions causes a systematic advantage or disadvantage to EU firms. For example, the US National Bank Act 12 USC 84 superficially appears more restrictive than the EU rules (15% limit plus further 10% if collateralised), but it appears to apply to single counterparties rather than groups of closely related counterparties and excludes trading book exposures. Indeed within CEBS own report on supervisory practices it is apparent that there are quite significant differences in application between EU jurisdictions which cause frictions for members that operate across borders.

That said, there is a clear bias toward limit setting regimes in the jurisdictions selected which is arguably similar to the existing large exposures regime. However, it is notable that, with the exception of Switzerland (which has recently updated its rules) the regimes have been in place in their current form for a significant amount of time and therefore could also benefit from the analysis being undertaken currently in the EU. We regard the large exposures review as an ideal opportunity for the EU to demonstrate its commitment to better regulation and to lead the world in developing regulatory thinking in this area. Our members would value a consistent global approach to large exposures regulation.

We would also draw a comparison to the treatment of risk concentrations outside the banking and investment business sector. We note that the European Commission's recent proposals for Solvency II removed the limit-style regime on insurers' exposures to single names (in favour of 'prudent person' investment principles). The proposals include a capital charge for concentration risk under Pillar 1, but those firms with approved internal models would be given discretion on the measurement of this risk.

Finally, in our paper on objectives and principles we indicated that we would be looking at any proposals put forward for revising the regulatory regime to ensure that EU firms were not put at a competitive disadvantage. With this in mind, we think that CEBS will need to revisit this issue once it has developed final proposals at the conclusion of part 2 of the call for advice.

5. What are your views in respect of the analysis of the recognition of credit quality in large exposure limits and our orientation not to reflect further the credit quality of highly rated counterparties in large exposure limits?

We believe that firms have appropriate incentives to manage this risk for themselves and that the regulatory framework should focus on dialogue over these systems under Pillar 2. As such it is possible and, we believe, appropriate to take account of credit risk in a large exposures framework, as this will be a natural consequence of that decision.

One of the stated purposes of the review is to align regulation to existing business practices in line with the better regulation agenda – thereby reducing the burden and costs for firms while providing a more relevant regulatory framework. Firms implement both preventative and detective controls in their credit risk, and therefore concentration risk, management systems. Firms take account of all the necessary risk data in determining the level of exposure that fits with their desired risk appetite as set by the Board. Monitoring and reporting will then be used to determine whether limits need amending or whether mitigants need to be put in place and to identify breaches so that appropriate action can be taken. Appropriate authority levels will be determined for making decisions on the exposure levels being managed. As we have previously stated in our earlier submissions, credit quality is a key consideration in all these aspects of process, albeit in a flexible, non mechanistic way. Credit risk is also supplemented by a variety of other factors such as product type, tenor, currency etc.

However, should a limits framework prevail, we do recognise the difficulty faced by supervisors in creating a regulatory approach that would parallel the sophistication of firms' internal systems and , in particular, do not believe it would be appropriate to introduce lower limits for lower quality credits. Conversely given the frictions that we have previously outlined in relation to certain high quality exposures in the existing regime, such as US agencies that do not benefit from explicit government guarantees, we think that some recognition of credit quality/particular counterparty types will continue to be necessary or the regime will distort market behaviour in an unwarranted fashion.

Paragraph 145 assumes that the 25% limit will be retained. This predetermined assumption is a concern given our earlier comments in this response. We do not think that the case has been made for a regulatory limit system and even less analysis has been provided to support 25% as that limit (although firms would obviously be able to operate within such a framework, as they have done so to date). We do question the assertion that the loss of 25% of own funds will necessarily lead to insolvency. Even if a firm lost such an amount this would still leave at least 6% regulatory capital. In such a scenario we would naturally expect intervention by the regulators and the firm to determine appropriate remedial action; 8% is the minimum acceptable level of regulatory capital to support ongoing business. But if the objective of the regime is to protect consumers against firm failure, then we should recognise that 8% is not the point at which consumers would actually begin to suffer losses.

Since firms manage the riskier exposures well within the 25% limit, its status as a backstop is also questionable. It achieves little regulatory benefit while imposing compliance costs. Simultaneously it provides a binding constraint on those exposures that firms perceive as least risky. In addition if one of the main objectives is to counter unforeseen losses arising from fraud, we question whether a limit is really the most appropriate tool.

6. What do you consider to be the risks addressed by the 800% aggregate limit? What are your views as to the benefits of the 800% limit?

We do not think that there are any risks addressed by the 800% limit that are not already addressed under pillar 2. We agree with the Basel analysis that, other than idiosyncratic risk for single name exposures, the other risks relate to geographic or sectoral concentrations. In line with our objectives and principles paper, we believe that the 800% limit fails to address these risks on both suitability and proportionality grounds and we therefore see it providing little or no benefit to regulators, merely imposing a compliance burden on firms. We therefore think that the 800% limit should be removed and reliance should be placed on the guidelines already developed by CEBS on concentration risk in Pillar

2. Such an approach is in keeping with the philosophy of the Capital Requirements Directive (CRD) and the better regulation agenda.

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

We think that the appropriate principles for managing concentration risk are set out in the Pillar 2 guidelines previously issued by CEBS:

* Institutions should have clear policies and procedures for concentration risk which are approved by the management body
* Institutions should have appropriate processes to manage, monitor and report concentration risk, in keeping with the nature, scale and complexity of their business
* Institutions should use internal limits, thresholds or similar concepts
* Institutions should have processes in place for monitoring, managing and mitigating concentration risk against agreed policies, limits, thresholds or similar concepts
* Institutions should assess the amount of internal capital which they consider adequate against the level of concentration risk in their portfolio.

As noted in our survey on industry practice, these are already embodied in firms' approaches to the management of concentration risk.

However, should a limits regime prevail, our aspiration would be for a principles based regime with backstop limit guidance (with the ability to 'comply or explain' to regulators.) We think that such an approach is consistent with the better regulation agenda; provides regulators with sufficient comfort that the risks have been addressed; enables the regime to keep pace with complimentary regulatory developments; provides greater flexibility to accommodate ongoing advances in risk management; continues to provide smaller firms (who currently rely on the regulatory limits) with a relatively simple approach to compliance; allows larger, more sophisticated firms to employ their more advanced risk management techniques; and enhances the dialogue between firms and supervisors.

8. Do you consider that the principles outlined with respect to off balance sheet items would be suitable to govern the calculation of exposure values by institutions using the Advanced IRB Approach for Corporate exposures and/or the Internal Models Method (EPE) for financial derivatives and/or securities financing transactions?

We have assumed that SFTs are defined as repos, reverse repos, securities lending/borrowing transactions and margin lending. We assume that other off balance sheet items are those referred to in Annex II of the recast Consolidated Banking Directive (CBD).

Our comments on the principles outlined are predicated on our expectation of the recognition by CEBS of the full effects of credit risk mitigants. We have also assumed that the exposure value considered in this section is purely for the purposes of assessing against a limit rather than their applicability in the trading book for any capital charges

We found the section on off balance sheet exposures encompassed by questions 8, 9 and 10 unclear, particularly the distinctions between advanced and other less complex firms. For example firms using the standardised approach to credit risk might employ the IMM or VaR modelling for exposure determination for OTC derivatives and securities financing transactions (SFTs). Conversely firms using the advanced or foundation IRB approach may use the mark to market method for these transactions. The delineation between the two categories therefore becomes unclear. We think it would be better to distinguish firms on the basis of whether they use a modelled approach to determining exposure value in their capital calculation for that type of transaction or not.

We welcome the decision by CEBS to take a principles based approach in this area. However we have some comments on the principles themselves:

Principle 1 –

We welcome CEBS' proposal that firms should be able to use their own measures of concentration risk. We assume that this means that EPE will continue to be a relevant measure in determining their exposure value for OTC derivatives and SFTs, as this methodology is used by firms in their internal risk management systems. We think that the ability to use EPE is important. Consistency of approach across the regulatory system reduces the burden on firms. In addition we think that the conservatism built into this measure (the regulatory multiplier, the requirement not to take account of decreasing valuations and taking account of positive exposures only) means that it is appropriate for large exposures as well as capital purposes. We also note that firms also use other other exposure valuation methods. We assume that firms will have the option to use one of the other exposure valuation methods if they think this measure is more appropriate.

As regards the other off balance sheet items we assume that this means that firms can use their own exposure value not just for those items for which the firms assess EAD but also for items where regulatory conversion factors are set in Annex VII of the CBD for capital purposes.

Principles 2 and 4

We are concerned that principles 2 and 4 as currently stated would not facilitate the aim to reduce the number of exposure values that firms generate, as they would seem to be adding conservatism to either the valuation methods used for the capital calculation or other methods used internally.

On the assumption that EPE is an acceptable exposure measure then we do not understand the purpose of these two principles – if a firm has already demonstrated that a measure is acceptable for capital purposes, we do not understand why further tests are necessary. Either an exposure measure is acceptable or it is not. Therefore additional principles would only be relevant for other off balance sheet items where regulatory CCFs are set. In these instances we believe that the appropriate considerations are already covered by Principles 6 to 11 of the CEBS guidelines on concentration risk. These principles could equally apply to OTC derivatives and SFTs.

In addition we do not understand what principle 4(i) means or was trying to achieve.

Principle 3

Where firms are using EPE then we believe that any use test requirements will have already been met in meeting the use test condition in Annex III of the recast CBD. We agree that usage is important; if firms are using a methodology for their own purposes then by definition they will have confidence that it is an appropriate measure for managing the risk. We think that the principle should reference firm's concentration risk management system rather than 'approach to setting maximum limits'.

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

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

As with question 8, we have assumed the same definitions and our answer to these two questions, which we have tackled together, is predicated on our expectation of the full recognition by CEBS of credit risk mitigants.

Where firms are not using a modelled method of calculating exposure value for OTC derivatives and SFTs for capital purposes, we assume that the suggested 100% conversion factor is not relevant and firms will continue to be able to use the mark to market method. We are concerned that the proposed 100% conversion factor approach for 'less complex' institutions could be read as suggesting that 100% of the notional would be the exposure for LE purposes. We do not believe that such an approach would be appropriate because it would not reflect the risk associated with these transactions and would represent a material change in the approach that we do not believe could be justified by CBA.

We think that a convergent approach across EU jurisdictions to other off balance sheet items is desirable. However, we do not think that a 100% credit conversion factor (CCF) would necessarily be an appropriate outcome, even if it is convergent. While firms may use the full facility amount for the determination of the limit to particular counterparties, firms do not necessarily use only that value for their ongoing risk management. Only a few respondents in our survey indicated that they would use a 100% conversion factor in their internal risk management for guarantees. A 100% CCF suggests not only 100% exposure at default but also 100% loss given default. This is an extreme assumption, given firms' active management of these exposures. In the majority of cases, firms will use other values that more realistically reflect their risk. Such an approach reflects the behavioural realities of these exposures.

We have found it problematic to propose conversion factors in response to this consultation in the absence of further detail on CEBS thinking on part two of the call for advice. However, we would be pleased to discuss this issue further with CEBS over the coming months.

11. In the above analysis we have not given consideration to the appropriate treatment of either (a) liquidity facilities provided to structured finance transactions or (b) nth to default products. How do you calculate exposure values for such products for internal purposes?

It is not possible to answer this question without first considering to whom the exposure is recorded, and thus part of question 12. Although our industry survey did not explicitly outline firms' practice in determining counterparties with regard to these particular exposures we did note that, for structured transactions generally, Members tended to take a case by case approach in determining the counterparty. This is because of the variety and complexity of the structures, which makes it very difficult to determine a definitive set of rules. It is important to note that even where firms do not record the exposures as being to the underlying assets this does not mean that there is not a significant amount of upfront and ongoing analysis of the risks in these transactions, which will take account of, amongst other things, the underlying assets.

Liquidity facilities – As with determining counterparty, the variety of liquidity facilities to structured finance transactions produces a broad spectrum of valuations that may be used in firms' risk management. The appropriate exposure value will reflect the nature of the facility, for example a servicer cash advance facility, super senior liquidity provided to publicly traded transactions, backstop liquidity facility provided to multi seller ABCP programmes etc, and will be evaluated within the context of the probability of draw and repayment priority in the cash-flow stream, which drives the facility's exposure to loss. Where firms are not looking through to the underlying assets the broad concepts that underlie firms approaches include the amount of the facility (which will be the sanctioned amount), the amount of draw, the expected amount of draw, or loan equivalent amount and possibly also a stressed expectation. Where firms are looking through they will be recording the exposures as though they owned the underlying assets. We think that firms should be able to use the valuations that they use for their ongoing management of these exposures.

Nth to default products – As with liquidity facilities, firms use a range of approaches used to determine their exposure. These are relatively new products and the models used to value and risk manage them employ different techniques. Therefore it has not been possible to summarise the approaches for this response. However Members would be happy to discuss their approaches with CEBS on a bilateral basis.

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

Given the broad range of products that might be included (possibly inappropriately) under the heading of 'structured finance transactions' we have assume d for the purpose of answering this question that they are those that meet the definition of securitisation in the CRD. We have, therefore, assumed that they do not include other types of structured transactions, for example where there is an on balance sheet exposure with an embedded derivative.

We also assume that this section only applies to the situation where the choice is between looking to the scheme itself or to the underlying assets and not to the situation where firms may look through to other counterparties which might be regarded as connected to the scheme, for example where funds might be connected to their manager or where a servicer might be deemed to be connected to a securitisation transaction.

We support CEBS commitment to developing principles rather than rules in this incredibly complex area, as we think that the variety of structures makes it difficult to produce definitive regulatory requirements. However, we note with interest that 212 (c) and (d) are both rules rather than principles. As a general point we think that it is important to maintain a distinction between rules and principles .

As regards (a) and (b), our belief is that these actually represent facets of one principle, where (b) is a qualification of (a). It is our understanding that it would be for firms to decide on a case by case basis whether economically their exposure is best represented as an exposure to the scheme, or the underlying assets. Having decided upon (a) the determining factor as to whether firms will be expected to look through will depend on the risk of incurring a material large exposure, which has been defined as 5%. It is our understanding that the materiality would be determined by aggregating the exposures in the pool to other exposures to the same names to determine whether the 5% was likely to be breached. While Members think that materiality is a useful concept, the application of this aspect of the principle would require firms to build systems to disaggregate all transactions (apart from retail) to determine whether the 5% is likely to be met. As this will require firms to monitor to yet another limit, and one for which no rationale has been provided, Members are concerned by the significant additional burden that this will impose.

In our report on industry practice we indicated that firms will record their exposures to the entity that best reflects where the ultimate risk is deemed to reside. We noted factors that firms take into consideration when making that determination. We think an alternative approach to the one suggested would be to amend principles (a) and (b) to take account of these as follows:

> Institutions should identify whether the risk of incurring a loss relates predominantly to the default of the underlying assets or the scheme itself, or both. In determining this assessment, firms must evaluate the economic substance of the transaction. Examples of factors that firms might take into account in determining this assessment include: sources of repayment, including recourse provisions; size, nature, quality and granularity of the underlying credit exposures; tenor; and the sustainability of the cashflows.

We believe that (c) should be deleted because firms are already required to determine prudent determinations of their exposure under the capital treatment. The rule also suggests that there is no middle ground between complete information and no information on the underlying exposures, this is not the case. In practice firms are likely to get periodic updates of the composition of the pool.

We think that rule (d) should be deleted. The purpose of creating tranched structures is to transform the risk; these structures take account of the idiosyncratic risk of the individual exposures within the pool as well as the correlation between them and create a blended risk exposure to the underlying pool of a particular credit quality. Therefore, the instances where firms would look through to the underlying assets in a tranched structure are relatively rare. Given the diverse nature of these transactions we think it would be more appropriate for firms to determine an appropriate approach for themselves, which they should be capable of demonstrating (when requested), is suitably prudent.

In addition in the case of (d) (i), it is highly likely that the first loss exposure will have already been deducted from capital under the risk weighting framework. As a result we believe that there is no need to record an exposure at all, let alone gross up that exposure amount, as no more can be lost. We think that it would be useful to clarify in any future regime that exposures which have been deducted under the capital framework do not need to be recorded for large exposures purposes.

As regards (d) (ii), we find the example confusing. Our understanding of the proposal would suggest that only one ninth of the amounts should be recorded to that senior exposure of 10 in paragraph 215.

Annex 1 - Market failure analysis

As noted in the main body of our response we welcome the commitment by the EU institutions to better regulation and in particular CEBS' decision to undertake a market failure analysis. In this Annex we offer some more detailed thinking on the analysis provided, which we hope will be of assistance in developing the final MFA for submission to the Commission

IV.I Relevant markets

We welcome CEBS commitment to take account of the relevant size and complexity of the broad range of firms falling within the CRD. We think that it is important to revisit all the conclusions in this light.

IV.II Potential market failures/regulatory failures

As outlined above in our response to objectives, our view of the potential problem is that there may be idiosyncratic tail events which are so significant that they can threaten firm solvency, which means that neither regulators, nor firms should rely entirely on probabilistic models setting capital requirements.

We agree with the determination of the potential market failures, although public good might also be relevant. We also agree with the potential regulatory failures identified. In relation to other market mechanisms that may mitigate the potential market failures it is important to recognise as outlined in the proposed 3L3 guidance that regulatory practice is no longer adapted to the realities of a rapidly evolving market and that regulatory interventions do generally increase the cost of providing financial services.

IV.III Evidence that suggests there is/is not a market failure, IV.IV Interim conclusions and request for input, V Evidence of institution failures or difficulties

Regulatory intervention requires not only that there be a market failure, but that it must also carry some threat to regulatory objectives. In identifying the market and regulatory failures the 3L3 proposed guidelines suggest a four step procedure:

* Determine whether the problem at hand is due to a significant market failure by assuming the complete absence of all regulation
* Determine which objectives are threatened by the failure
* Determine whether any relevant market failure identified has been targeted by regulatory intervention
* Determine whether there is a market failure.

It is obviously difficult to determine whether there is a market failure in the absence of regulation in the EU since the large exposures regime has been in place for fifteen years. Norway's introduction of a large exposures regime is possibly one of the few real life examples. Although it is clear from the consultation paper that Norwegian firms were running exposures in excess of 25% until the requirements came in, it is interesting to note that no evidence of firm failure, or indeed losses to depositors have been presented. Consequently the one real life example of the absence of large exposure regulation provides no evidence that that there is a significant market failure (or if there is a failure, would tend to suggest that it is not material) or that there is a threat to regulatory objectives (i.e. market confidence and protection of consumers)

In the absence of first hand evidence of the absence of regulation it is necessary to make an assessment of the market failure and threat to the objectives using other means. It is therefore necessary to consider the relevance, materiality and mitigants to the market failures

Information asymmetry characterises financial services and as such is one of the fundamental tenets underpinning regulation more generally. However it is questionable in this instance whether the full disclosure by firms of all the exposures that they have taken on would actually prevent firms from taking on exposures that if subsequently collapsed could threaten solvency and losses to depositors, i.e. smaller counterparties are unlikely to change their behaviour if more information on individual exposures was available. As a result we believe that the information asymmetry is only marginally relevant and therefore unlikely to be material. There are also mitigants in the market to address this issue as noted.

We would agree that rating agencies do indeed address concentration risk in determining their ratings. In fact Standard & Poor's have declared their risk-adjusted capital measure should capture single-name concentrations, industry and/or geographical diversification. Standard & Poor's view is that more than 30% of the total capital assessment will be driven by concentration risk and diversification. This will, of course, influence financial institutions approach to and management of large exposures. And this information is used by market counterparties as part of their assessment. Major market counterparties will act on this information and will take action if they perceive weakness in the firm concerned through pricing and through taking mitigants (providing collateral is not a cost free exercise and therefore provides market discipline).

The consultation notes that rating agencies take account of the regulatory environment in their current consideration and appears to infer that this may reduce the efficacy of ratings as a mitigant. It however does not address the question of whether rating agencies would continue to consider concentration risk in the absence of a regulatory regime. We would contend that they would. It is also certainly appropriate to question whether implicit government support within ratings for certain counterparties might undermine their usefulness as a mitigant. However, we think that the MFA should also go on to ask firms whether they take account of this facet in their use of ratings and if so how. We further note your comments regarding the differing objectives between rating agencies and regulators and that rating agencies are not empowered to limit firms' exposures. While these statements are undoubtedly true – ratings agencies provide opinions on the relative probability that financial obligations may be met in a timely manner and regulators are seeking to ensure an appropriate level of soundness – this does not mean that rating agencies are interested in events of greater severity than regulators, since they are equally concerned with ratings migration.

We would however agree that the pillar 3 requirements do not address the issue of single name concentration risk. However, pillar 3 is not the only issue that drives firms' disclosure and this aspect has not been addressed.

We therefore do not believe that it is possible to conclude on the evidence presented that there has been a significant market failure relating to information asymmetry.

Negative externality is the other main potential market failure that underpins financial regulation, i.e. the risk that firms will not internalise the cost of maintaining the stability of the financial system or appropriately address the risks to consumers of concentration risk. While it is difficult to argue that this is not a market failure, this does not mean that there are not mitigants. In this respect rating agencies and other forms of market discipline have their place as well as the corporate governance framework within which organisations work. Looking first at the corporate governance framework and the incentives for management to act: A risk appetite is set at a board level and the authorisation to take on or extend the risk is delegated down throughout organisation through authorisation levels. Risks are then monitored against this framework. Any breaches result in management action and further credit risk is only accepted if appropriately authorised. Mitigants may be sought if firms risk appetite toward a counterparty changes. As such we would agree with the comments in paragraph 68 that firms take this risk seriously and have well considered policies and practices. We contend that these policies and practices would continue to exist in the absence of a limits regime. We also contend that these policies and procedures would act as a brake in situations where earnings have become volatile. As many firms target volatility of earnings, cost of funding (and rating, since this is a major driver of cost of funding) they are targeting loss levels that are significantly lower than those that would threaten solvency. Firms are in the business of making money not going bust and as such it is not a rational response to take on increased concentration risk when economic theory suggests that more money can be made from diversification. In addition market counterparties will continue to provide market discipline through pricing and mitigants

We therefore believe that while there is evidence that the negative externality market failure exists we think that there are appropriate mitigants to ensure that this is not a serious threat to the objectives of protecting consumers and maintaining market confidence.

We think that the low risk to the prudential objectives posed by these two market failures is borne out by the evidence presented by the institutional failures or difficulties, where the surveys and examples referenced suggest failures of management and control as being the more frequent causes.

While noting the need to consider whether there are potential regulatory failures, the MFA does not come to any conclusions. Current regulatory intervention is in the form of both the limits regime and the pillar 2 requirements. It is our view that the case for limits has not been made. Risk management and credit risk mitigants have developed significantly since the introduction of the limits regime. In general firms' internal limits are much tighter than the regulatory ones and therefore the regulation imposes a monitoring burden. And as CEBS itself notes there are a significant number of discretions relating to this regime which result in uneven implementation across the jurisdictions. Pillar 2, however, targets many of the concerns that are raised in the market failure analysis. The question, in considering any policy options, should be what, if any, additional regulatory intervention above and beyond the pillar 2 requirements is required?

The major gap that we perceive in the MFA is the absence of review of the policy options available. While we appreciate that the structure of the call for advice makes this more difficult, due to the interrelationship with the areas to be covered in Part two, we still think that it would be appropriate to discuss the tools available as part of the analysis in this CP.

VI Cost Benefit Analysis

We support CEBS commitment to undertaking the CBA and look forward to discussing the results in due course.