POSITION PAPER

ESBG Response to

CEBS Consultation paper on draft implementation guidelines on the revised large exposures regime

(CP 26)

European Savings Banks Group Register ID 8765978796-80

11 September 2009

ESBG

I. General remarks

The European Savings Banks Group (ESBG) welcomes the opportunity to comment on the Consultation Paper on CEBS' draft implementation guidelines on the revised large exposures (LE) regime.

As a general remark, ESBG would like to highlight that the proposed guidelines would require considerable administrative efforts in all Member States and by all credit institutions. Identifying, managing and monitoring interconnections between borrowers will require substantial additional resources and costs. It is therefore imperative to establish sufficient transition periods and investor protection arrangements.

II. The definition of 'connected clients' and 'interconnectedness'

As a preliminary remark, ESBG would like to indicate that a uniform application of the revised large exposures regime would necessitate not only guidelines on the individual concepts of 'control', 'economic interconnectedness' and 'main common funding source', but also guidance on the way they interact. This is particularly important as the three elements pursue specific objectives and might develop different effects through their interaction.

1. Are the guidelines in relation to the interpretation of control sufficiently clear or are there issues which need to be elaborated further or which are missing? Please provide concrete proposals on how the text should be amended.

ESBG generally welcomes the further clarification and the strengthening of the concept of control, which is central when determining interconnectedness. CEBS guidelines should be limited to situations when the client owns a majority of voting rights in an entity, as capital owners of shares without voting rights – even if they represent majorities from a capital perspective – are explicitly excluded (see paragraph 45).

It is rightly foreseen in paragraph 36 that in case a client holds a voting quota of more than 50%, control is usually presumed. Therefore, if for specific reasons there is actually no control despite the voting majority it is the task of the institutions to document this accordingly. Conversely, it is only exceptionally that a client holding a voting quota of 50% or less (paragraphs 36, 37) can have also control. Therefore, in these situations there should be no obligation for the institutions to document that there is no control.

We see the proposal in paragraph 39 to introduce indicators of control as problematic. Given the variety of corporate laws and corporate governance mechanisms in the EU Member States, we perceive it as particularly difficult to establish uniform indicators that would facilitate a reliable identification of control situations. We do not see a need for regulatory harmonization of such indicators. The application of the control criterion in the CRD depends much on the particular circumstances of the client and the specificity of the corporate legal system. It has been effectively applied for years on the basis of collaboration between supervisory authorities and institutions. It is used for instance for establishing the existence of minority interests.

2. Are the guidelines in relation to the exemption from the requirement to group clients in relation to control sufficiently clear or are there issues which need to be elaborated further or which are missing? Please provide concrete proposals on how the text should be amended.

ESBG explicitly welcomes the proposed exemption for subsidiaries of central governments, regional governments and local authorities from the requirements to group the subsidiaries as connected clients. Overall the guidelines appear clear.

However, we would like to point out that in accordance with current regulatory practice, all exposures to central governments, regardless of whether they receive 0% weighting, should be exempted. In addition, the exemption of regional governments and local authorities may lead to problems, if – as it has recently happened – there is a deterioration of the ratings of the relevant country. This may lead to an increase in the previous risk-weighting of 0% and would require that more clients are suddenly grouped for being considered as a single risk. To avoid this situation we could envisage a solution where exposures to one of the parties mentioned under paragraph 46 remain exempted from the requirement to group clients in relation to 'control' until the date of maturity of that exposure.

3. Are the guidelines in relation to the interpretation of economic interconnectedness (single risk) sufficiently clear or are there issues which need to be elaborated further or which are missing? Please provide concrete proposals on how the text should be amended.

ESBG appreciates CEBS' efforts to provide examples that illustrate possible economic dependence between clients and would support also that new situations of interconnectedness – to be encountered in the future – will be publicly disclosed. However, as explicitly recognized in paragraph 50 it is not possible to have a comprehensive list of eventual cases of economic interconnectedness and each situation will have its own specificity that requires a thorough knowledge of the clients. For these reasons we see practical difficulties in applying the guidance.

In general, the consideration of "one way" dependence will result in large parts of an institution's loan portfolio being seen as a single risk in terms of the large exposures regime, as direct or indirect financial dependencies can be often identified. The proposed interpretation would result in a substantial reduction of the discretion to grant loans, particularly to small and medium-sized companies which are, for example, the principal suppliers of a large company, but also for private persons. This would have primarily negative effects on the business activity of locally acting institutions, given that strong financial dependencies regularly exist between their individual clients. But it would also require considerable efforts and costs for larger institutions as well. Furthermore, the proposed interpretation would result in a considerable increase of the number of all large exposures and the amount of individual ones. This contravenes to the declared objective of defining the large exposures regime as a back-stop system. For this reason ESBG urges CEBS to change the interpretation of 'interconnectedness' in the sense that only mutual dependencies are covered.

Considering – in relation to one way dependencies – the 'economic interconnectedness', which is an element that can be only subjectively determined, is likely to bring about a strong linkage with the objectively determinable control relationship.

Furthermore, ESBG believes that further clarification is needed for explaining that the grouping of clients to constitute a single risk can be based strictly on economic calculations and can by no means be all-inclusive.

For practical reasons, the expression 'repayment difficulties' in paragraph 47 must receive a narrow interpretation. Instead of invoking simple 'repayment difficulties', CEBS should clearly focus on 'survival problems', i.e. primarily the insolvency of the borrower. We assume that the guidelines are meant to be understood in this sense.

ESBG would like to highlight particularly that a clear, workable demarcation of the idiosyncratic "single risk" of sectoral concentration and geographic risk factors is important. The guidelines formulated by CEBS are not sufficiently clear in this regard. There is no objectively applicable definition which would facilitate targeted decisions for other business cases beyond the examples provided.

The examples in paragraph 50 also make it clear that idiosyncratic risk and sectoral and/or geographic risks have not been straightforwardly separated up to now. In particular, the items 'only buyer of a given product' and 'producer and vendors' illustrate the confusion between idiosyncratic and geographic risks/sectoral concentrations. Under the key term 'single risk', current risk concentrations are actually addressed, which – to a large extent – are already treated elsewhere; and therefore are inappropriately covered here.

In addition, the examples of retail business (in paragraph 50) question the objective of the large exposures regime. Retail requirements - even in small banks - do not justify large exposures. They can fundamentally be connected to an existing large exposure, but play no decisive role in relation to it. It is therefore imperative to refrain from expanding the large exposures regime to the retail activities - especially in view of the fact that it reflects a generic backstop limitation which disregards the accuracy and precision of calculations at the retail level. In our view, such an extension of the large exposures regime (the number of the mutual relationships to be potentially checked increases exponentially with the number of elements) would distract from the substantive objectives of the large exposures regime and endangers its efficiency.

4. Are the guidelines in relation to the interpretation of connection through the main source of funding being common sufficiently clear or are there issues which need to be elaborated further or which are missing? Please provide concrete proposals on how the text should be amended.

ESBG considers that the interpretation of connection through the main source of funding is likely to create confusion. The guidelines seem to fit only the specific example described in paragraph 55. It could be even questioned whether the example would fall under the definition of interconnectedness. However, beyond this example, no reliable guidance maybe found. The non-exhaustive list of exemptions in paragraphs 56 and 57 does not bring more clarity for identifying when clients should be connected because of a common source of funding, apart from the SPV construct described.

Consequently, CEBS interpretation of the term "main source of funding being common" should be confined to the situations described in paragraph 55.

5. What do you think about the proposed 1% threshold as proposed above?

ESBG considers the proposed 1% threshold as extremely low. It would trigger considerable costs and excessively burden even the institutions with the most conservative approach towards concentration risk.

We would advocate for a threshold of 5%, which would avoid disproportionate administrative burden without putting at risk the effectiveness of the large exposures regime. For small institutions, with correspondingly lower capital levels, an adequate threshold depending on the monetary amount – of up to Euro 1.5 million – could be envisaged, that would mirror the CRD rules for inter-bank exposures.

6. Are the guidelines in relation to the control and management procedures in order to identify connected clients sufficiently clear or are there issues which need to be elaborated further or which are missing? Please provide concrete proposals on how the text should be amended.

We take the view that CEBS paper does not contain guidelines on the control and management processes to be introduced by the institutions. There is only a call to establish appropriate processes in the institutions. However, the question of which requirements these processes should fulfil from a regulatory point of view remains open. Here, some guidance for institution-specific implementation, in accordance with the respective business model, should be provided in order to prevent difficulties during the supervisory review.

It needs to be underlined also that it is not realistic to think that institutions will have available all information necessary for determining interconnectedness following CEBS' guidelines and that there would be cases, where interconnectedness could be easily established only ex post. Therefore, we would like to stress the need for institutions' processes to be proportionate not only to the size of the loan, but also to other parameters such as the risk policy and the size and complexity of the institution.

7. Are there remaining areas of interpretation of the definition in Article 4(45) of Directive 2006/48/EC that need to be covered in CEBS' guidelines?

No comments at this stage.

III. Treatment of exposures to schemes with underlying assets

In order be able to fulfil the planned requirements in accordance with the look-through principle, in the future the institutions will have to agree contractually that they will receive regular information from the schemes about the individual assets of the scheme. Such extensive information-related obligations have not been common practice up to now. In order to enable the schemes to make the corresponding changes in their contracts, the requirements implied by the look-through approach should not be applied to existing exposures in a portfolio, which should remain until their maturity under the current regime. The new requirements should apply only to exposures incurred by the institutions after the entry into force of the amendments to the CRD – that is after 31 December 2010.

In addition, applying the look-through approach to the items listed in the CRD involves high expenses and important efforts for information gathering and the accompanying work on the part of the institutions. It should therefore be clarified that the repeated look-through through a product held should be undertaken at sufficiently long intervals. We consider a three-month period to be appropriate and sufficient.

In general it appears to us that the whole consultation document goes further than the intention of simply harmonizing the implementation of the CRD provisions, but is in the forth section of CEBS guidelines where it reaches peak. The proposed treatment of schemes with underlying assets represents more than guidelines for the application of Article 106(3), is a new set or rules that needs to be follow the appropriate rule-making channels in the EU. These aspects should be properly included in the CRD.

8. Does the proposal provide sufficient flexibility for institutions to deal with different types of schemes? If you believe additional flexibility is necessary, how should the proposal be amended?

In our view the proposed approaches do not give institutions sufficient flexibility. The new rules would ultimately lead to requiring that in order to avoid exceeding the upper limit for large exposures, regardless of the actual risk content of the overall construct; the institutions have to look through to the debtors. The discretion of the institutions newly specified in Article 106, Paragraph 3 CRD will be effectively cancelled out by the otherwise compulsory grouping of all unknown exposures into a single entity.

However, CEBS has ignored that in practice no look-through is possible for numerous financial products (for example public investment funds, open-ended collective investment schemes, a.o.), i.e. the underlying debts are often unknown to the institutions. The clients identified during the look-through will be to a considerable extent parties with which there is no direct lending relationship and no customer relationship. Checking the capital and corporate structures – as a basis for establishing the existence of a group of connected clients – is in these cases possible only to a limited extent because of the lack of a legal basis that would allow gathering the required information.

To reduce the negative consequences of the new regulation for the institutions at least to a tolerable level, we consider it indispensable to introduce a *de minimis* arrangement for sufficiently granular portfolios. In these cases the institution should be able to forgo a look-through and handle the entire construct as an independent client, i.e. the construct does not have to be added to the connected group of unknown exposures. In our view, it should be possible to classify a portfolio as granular if the respective individual entities - analogous to our comments on Question 5 - do not exceed a limit value of 5% of the equity or a particular monetary amount. This should also apply to portfolios in which the precise composition is unknown to the institution, but in which the individual securities likewise never exceed the *de minimis* limit.

Beyond that, the institutions should also be able to take trading book items out of the look-through and handle them as independent clients. An extensive and time-consuming review would not be justified in view of the short holding periods of the securities.

Furthermore, it should be possible to remove regulated investment funds that were issued in accordance with the requirements of the UCITS guideline, from the look-through, as these are already subject to limitation rules to prevent concentration risks.

For sufficiently granular or similar products with numerous small individual exposures – such as granular investment funds for which the institution decides to apply the look-through approach, but a full look-through is possible only with considerable effort and expense and the corresponding individual exposures regularly are irrelevant with regard to the large exposure limits – it should be possible to assume a complete look-through if at least 80% of the individual exposures were identified during the look-through. The remaining maximum of 20% of the individual exposures can be neglected for the large-exposure regulations, as the crucial exposures were already documented during the look-through.

It continues to appear to be risk-appropriate if underlying assets, for which the exposure is known to be consistently less than 5% or the monetary amount of the limit value, fundamentally did not have to be included in a look-through insofar as no special references to possible large exposure relevance exist.

The introduction of the corresponding limit values would also dampen the otherwise generated adverse incentive that leads institutions to invest increasingly in poorly diversified products or unregulated markets because these are preferred by the large exposure regime due to the possible look-through (which is often not feasible for highly diversified products).

Furthermore, we do not understand the first principle for the application of the approaches (paragraph 84, first bullet). We do not see how interconnections may arise from servicers or originators, in securitisations, or mangers of CIUs. It needs to be explained in detail how the credit risk of a creditor to a scheme can be in any way connected to these entities for it will, most likely, fall completely outside of the scope of the large exposures framework.

9. Do the fall-back solutions (approaches b) to d)) appropriately take into account the uncertainty arising from unknown exposures and schemes?

The four-level hierarchy for the look-through proposed by CEBS generally appears appropriate, subject to the reservations expressed under Question 8. However, Approach d), which we regard as too conservative, significantly restricts the proper application of the proposed solutions (see also Question 12).

Particularly for multi-tranche securitisation items it is nearly impossible to acquire a clear understanding of the underlying liabilities. Thus an institution would be forced to select Approach d) and to bundle the debts into an overriding borrowers' unit. The upper limit for large exposures of an institution would then be quickly exceeded. This would result in the securitisation market coming to an actual standstill. However, such removals from the balance sheet are a prerequisite for a sufficient credit supply to the industry.

A revival of the securitisation market should therefore not be burdened with such obstacles. Against this background, the institutions should be given the opportunity - in addition to the approaches proposed by CEBS - to continue to handle non-granular securitisation items as independent borrowers subject to the use of increased weightings. We believe this treatment is justified, as the individual exposure of an individual borrower is merely of secondary importance. Thus its loss does not lead directly to a loss of the invested tranche.

10. Do you think the partial look-through approach provides additional flexibility or would an institution in practice rather apply either a full look-through or not look through at all?

Approach b) offers a combination of the alternatives a) and d), thus making a transition from d) to a) easier. However, widespread application in the present form appears to be questionable, as usually either complete information or no information on the composition is available. Thus, in practice we see little chance of the partial look-through approach being used and institutions would end up using a full look-through or no look-through approach.

The limit value review proposed in the answer to Question 8 and the exception for very granular products would reinforce the positive incentive for a partial look-through (compared to Approach d)) and lead to broader use of the partial look-through.

11. Do you think the mandate-based approach is feasible? If not, how could an approach based on the mandate work for large exposure purposes?

The mandate-based approach poses considerable challenges to institutions against the background of the requirements for the identification of a possible connection between exposures according to Section III of CEBS Guidelines. Here as well, the consideration of the relief proposed in the answer to Question 8 would give incentives to use the mandate-based approach, as not all potential assets would have to be subjected to a detailed analysis.

In addition, the approach should be designed so that the documentation of the non-existent connectedness can be provided from the investment guidelines. An extensive analysis is not required.

12. Do you believe that considering all unknown exposures and schemes as belonging to one group of connected clients is too conservative (approach d)? What alternative treatment would you propose (please note that, as explained above, an approach which allows the treatment of unknown exposures and schemes as separate independent counterparties is not considered to be prudentially appropriate)?

The requirement of treating all exposures as connected to each other in accordance with approach d) is significantly too conservative and in practice leads *de facto* to a universal grouping. Assuming that all unknown exposures are a single exposure is too extreme and statistically unlikely. Most investment structures actually strive for a minimum of diversification, which contrasts with connectedness in the sense of a ‘single risk’. In addition to the introduction of relief in the consideration of investment structures (see Questions 5, 8, 11), a differentiated treatment of different investment structures is needed.

Institutions should be given the possibility to undertake an analysis and decide on whether the exposures for which they use the “unknown exposures” method are related to others in the same category. Otherwise the proposed approach would be extremely conservative. This represents the assumption that institutions would rely on their own processes and criteria to be applied when deciding whether to group together exposures under the "unknown exposures" method and that the supervisors do not expect that all are grouped together on a general basis.

In addition, as the potential effects of this measure can largely affect securitization markets, as mentioned in our response to Question 9, we believe that a thorough impact study needs to be carried out, before adopting this approach. However, in case CEBS decides to maintain its proposal disregarding our comments, and taking into account the fact that in many cases structured exposures are long term, we strongly suggest, at least, explicitly excluding from its application the exposures held by the institutions on their balance sheets by the end of 2010.

13. What are your views about the proposed treatment for tranched securitisation positions?

With regard to the treatment of tranched products, we also see the problem that the institutions are not given enough flexibility and are generally forced either to undertake a complete look-through or a grouping into a single entity.

The current proposal assumes that the exposure always needs to be assigned somewhere. The credit structure and the coverage provided by junior positions could be seen, up to a certain point, as a guarantee, which reduces credit risk. Thus, we do not consider it appropriate that the non-assigned part of the exposure has to be incorporated to the group of "unknown connected clients" (we have assumed this since it is the way it is actually done under some national regulations and it is mentioned in paragraph 88 and example 1.D of Annex 2, whereas paragraph 89 does not mention it when describing the process). Otherwise we could reach the extreme situation where an institution would have problems coping with large exposures limits when holding senior positions in different highly diversified schemes, just because they need to be grouped together as part of the "unknown connected clients".

14. Do you consider the proposed treatment of tranched securitisation positions when look through is applied as appropriate? Do you think that the proposed treatment sufficiently captures the risks involved in such an investment?

We do not consider the proposed treatment as appropriate. As has been explained in different responses to CEBS papers on the matter, all tranches should be qualified to benefit from the credit enhancement provided by junior tranches, regardless of their risk weighting. First loss tranches do not have restrictions in the loss protection received by junior tranches and therefore the maximum exposure to an underlying asset should be reduced in line with the proposed treatment for other more senior tranches. In example 3 on Annex 2, the exposures of institution 2 to the underlying portfolio creditors E to K cannot exceed an amount of 3.

15. With respect to the treatment of tranched securitisation positions if it was required to take every tranche into account from the outset instead of the proposed treatment, would such a treatment address all risk involved in such a transaction and would it be sufficient for addressing concerns on undue burdens?

We feel that the consideration of a risk reduction from first loss tranches is appropriate. If there is legal certainty of the structuring of credit risk into different tranches, the credit enhancement should be fully recognised for the purpose of determining the existence or large exposures.We consider the handling of the mezzanine tranches as described in Example 2 to be problematic. The general haircut called for in paragraph 92 for guaranteeing individual subordinate tranches is not justified as long as the current subordination is known or can be derived. The introduction of haircuts also requires a uniform regulation and the use of these haircuts. However, for complex structures an appropriate classification of haircuts raises difficult methodical issues. The transition between most senior, senior and mezzanine tranches must be precisely defined.

16. In which cases is there no risk from the scheme itself so that it can be excluded from the large exposure regime?

This can be hardly established in general terms and would need to be checked on a case-by-case basis.

Investment funds that were issued in accordance with the requirements of the UCITS guideline do not justify any additional credit risk for the institution with regard to the funds. Even in the case of the insolvency of the fund, the institution has an insolvency-proof claim to restitution of the assets held by the fund. Therefore in these cases it is not necessary to state the fund additionally as an individual client if a look-through was carried out for the assets it holds.

However, for most of the schemes such as securitisations or investment holdings held by the institutions, either an insolvency-proof restitution claim to the individual assets or an insolvency-proof compensation claim is agreed, so that even in these cases an inclusion of the scheme itself in the large-exposure arrangements is not required.

Thus, during a look-through, in addition to the individual assets, only those schemes must be taken into account in the large exposure arrangement, for which no corresponding insolvency-proof agreement was concluded.

IV. Reporting requirements

ESBG would like to underline that the implementation of the reporting requirements according to the new rules will be possible only when the national implementation of the new, still-to-be developed COREP reporting format has been completed. Based on the current planning, we assume that this work will be completed on 31 December 2012 at the earliest. However, as the new rules on large exposures will come into force on 31 December 2010, there will be a gap of at least two years, for which clarification is required.

17. Do you agree that the net exposure should be calculated as proposed above?

The proposed method appears to be practical.

18. Do you agree that the 10% limit should be calculated as proposed in column LE 1.11 above?

The alternative calculation of equity in accordance with national discretion as described in Article 13 (2) of the CRD should also be possible with the present calculation of the 10% limit.

19. Regarding the example about the Credit Linked Note (set out in the text above and in Annex 5 as example 6), bank X is the 35 protection seller and reports its potential exposure to Bank B as indirect exposure (5). Do you believe it is correct to report such exposures in column 8 or would they be better reported in column 5 as direct exposures, because they did not arise as a consequence of substitution?

No comments at this point.

20. Please express your preference for one of the two alternatives outlined for the identification of a client or group of connected clients (2-Templates-Approach vs. 1-Template-Approach).

We consider the two template approach to be more appropriate.

21. Do you agree with the proposed reporting of CRM, in particular to differentiate only between “unfunded”, “funded” and “real estate”?

Yes. These types of guarantees should be sufficient and prevent unnecessary added expense in data provision.

22. Would it be possible to include more detailed information into the large exposure reporting, like total amount of collateral and guarantees available vs. the eligible part, types of securities and issuers provided as collateral or would this be too burdensome?

We do not see the need for further detail which in most cases would not provide useful information for supervisors and would add to the administrative burden. Also, if needed, supervisors could ask for further detail under the supervisory review process.

23. Please provide examples where the reporting instructions are not clear to you.

In addition to the data previously required in the large exposures report, in the future it is to be reviewed whether guarantors for various large-scale loans have provided guarantees (analysis of concentration - Paragraph 104 of the consultation paper). The risks from a possible payment obligation of the guarantor must be determined. In this regard more information is required as to which values should be included in the large exposure report.

24. Do you think the identification system of the counterparty as proposed and based on national practices is practical? Does an identification system based on national practices generate problems for cross-border banks? If yes, please describe the problems and propose how they can be solved.

In principle, with regard to changes in encryption, the costs involved must be taken into consideration and suitable lead times planned.

25. Are the references to COREP provided in this paper and in Template 1 - as set out in Annex 4 - clear and sufficient or is further guidance required? If yes, please specify the problems.

No comments at this point.

About ESBG (European Savings Banks Group)

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of € 5967 billion (1 January 2008). It represents the interest of its Members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

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

European Savings Banks Group - aisbl
Rue Marie-Thérèse, 11 □ B-1000 Brussels □ Tel: +32 2 211 11 11 □ Fax : +32 2 211 11 99

Info@savings-banks.eu □ www.esbg.eu

Published by ESBG. September 2009