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CEBS Consultation Paper on the First Part of its Advice to the European Commission on Large Exposures - CP 14

Dear Sir or Madam

On June 15 2007 the Committee on European Banking Supervisors presented its consultation paper on the first part of its advice to the European Commission on large exposures ("CP 14"). Comments on the paper should be submitted by August 15 2007.

With this letter we wish to inform you of the comments of the German banking industry regarding the aforementioned consultation paper and would be grateful if you could take these comments into account in further discussions.

General Comments

We welcome the fact that CEBS gives stakeholders an early opportunity to provide their views and comments on key aspects of the first part of the Call for Advice. Nevertheless, the timeframe set has been too thorough to allow an in-depth analysis of the paper. We doubt that the strict frame defined by the Commission helps to achieve the goals of the "Better Regulation" agenda.

The short time period for CEBS to elaborate on the different and complex aspects of the large exposures regime, including a market analysis, led to the paradox of a regulatory outcome with a

market analysis still in progress. It would have been much better to take the time necessary to elaborate on some of the important points.

Before answering the questions put forward in CP 14, we would like to stress an important issue:

The industry consultation has shown that large banks have implemented sophisticated and, to their understanding, generally more conservative approaches for the management of concentration risk, whereas smaller and less complex banks use the large exposures regime as the core structure of their management of concentration risk. In order to avoid over-regulation for the smaller institutions on the one hand, and prevent larger institutions from the implementation of an overly complex costly parallel structure, we would welcome a flexible supervisor's approach to the management of concentration risk as a combination of both, in particular using the new flexibility provided by the CRD-Pillar II framework.

Comments on the twelve questions put forward in CP 14

Q1. Do you agree with our analysis of the prudential objectives in this context?

We accept the general statement that the central purpose of a large exposures framework is to limit the degree to which institutions are exposed to incidents of traumatic loss which are likely to threaten their solvency.

We therefore support the analysis in paragraph 110 that a "light touch regulatory regime", operating as a kind of "regulatory backstop", would be the most appropriate means of limiting incidents of traumatic loss. The large exposures "backstop" regime should thereby be kept as simple as possible in order not to hinder the internal concentration risk management approaches of larger institutions, whereas smaller institutions would be able to maintain the current large exposures regime which has proven to be a working backstop regime.

Furthermore, we wish to emphasise that we strongly support CEBS' opinion that all issues concerning concentration risk should be dealt with under and covered by the second Pillar of the CRD which gives more flexibility. In our opinion the implementation of the ICAAP/SREP process already covers these issues appropriately.

Q2. Respondents are asked for their comments on the market failure analysis set out above. Do you agree with the analysis that there remains a material degree of market failure in respect of unforeseen event risk?

Q3. Respondents are asked for any further evidence that they consider useful for deepening this analysis.

We welcome CEBS' efforts for a market failure/regulatory failure analysis as part of the "Better Regulation" initiative, which gives an overview of the extent to which large exposures are addressed by other mechanisms operating outside the regulatory framework (e.g. market discipline imposed by rating agencies or other stakeholders). We are aware of the problems regarding the data collection for such an analysis. To determine whether or not a large exposures regime is needed, the analysis has to be carried out in a world in which a regime of this kind does not exist. But there are very few cases of bank insolvencies in such a scenario. Against this backdrop, the examples cited in the paper are implausible in our view. Furthermore, we believe they are more closely related to bad governance than to market failure as such.

In addition, the analysis needs to take a more differentiated approach. A distinction should be made between banks and counterparties of different sizes and business models. The pressure that credit rating agencies may exert is only felt by big banks, if at all. Furthermore, the assessment of a credit rating agency is more focused on the redemption of a concrete liability than on concentration risks. It is also difficult for disclosure requirements to contribute to market discipline in this context since they are updated too infrequently to offer timely information on this issue. In addition to this, even larger beneficiaries have the right to protection of confidence. We should like to stress that, in our view, a requirement to disclose exposures to single name counterparties, as envisaged in paragraph 91, would not serve a useful purpose. Market discipline may therefore be used as a motivating factor in theory but, in this context, it would have little relevance in practice. Finally, it could not be answered in general whether management compensation or criminal penalties for financial mismanagement have a positive effect for the diversification of risks.

We should also like to point out that the regulatory failure analysis referred to has yet to be carried out. Since CEBS indicates that further work is to be done on this chapter, we hope that this area will be revised.

Q4. Respondents are asked whether they 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? To the extent that you do not agree with this we would be grateful for a detailed explanation of where you consider that competitive distortions arise.

We welcome this analysis and would like to stress the importance we attach to the competitive aspect. We believe that the appropriate countries have been selected for comparison.

Nevertheless, based on our experience, we cannot share CEBS' conclusions. In Annex 2, paragraph 11, CEBS itself draws attention to the exemptions available in the US. It is clear, however, that the required capitalisation is so low that levels will be met by all major banks. This places European banks at a systematic competitive disadvantage compared to their counterparts in the US – for instance in the field of short-term financing of mergers and acquisitions. We would also like to point out that in the US only the current exposure of derivatives, with no add-ons, have to be taken into account in large exposures rules. Furthermore different definitions, according to civil law and the practice of supervisors, could distort the outcomes of the analysis.

We therefore suggest undertaking a more in-depth analysis and, if necessary, using the new findings as a basis for actively working towards harmonisation of large exposures rules beyond the European Union.

Q5. Respondents are asked for their views in respect of the analysis set out above and our orientation not to reflect further the credit quality of highly rated counterparties in large exposures limits.

We support CEBS´ view that counterparty credit quality should not be introduced generally into a new large exposures framework. Nevertheless, we believe that certain exceptions would not be at odds with a "light touch" regime. Top-class ratings of countries, regional governments and local authorities, as well as banks (central banks) or some sorts of intra-group exposures, already do not need to be considered. The inclusion of credit quality in evaluating collateral providers should also be discussed and good quality credit risk mitigation techniques should – as hitherto – be accepted. Such a rule should be introduced into the large exposures regime along the lines of the consideration of top-class credit quality in the double default rules of the CRD. It should also be possible not to consider exposures with very short maturities, such as guarantees of M&A transactions of first-class credit quality.

Q6. 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?

There is no one-size-fits-all reply to the question as to the purpose of the 800% aggregate limit, since its impact varies from one bank to another.

Particularly for smaller and medium-sized banks, which represent a predominant part of German institutions, the existing 800% limit systems really acts as a concrete limit regarding the institutions´ risk appetite of large exposures. On the other hand, we have experienced that the 800% limit is also necessary for the smaller and medium-sized institutions to have sufficient margin for the management of its large exposures. Therefore the limit is of considerable relevance for these banks. Against this background we wish to retain the limit.

In contrast to this, from the point of view of the big banks, the 800% limit does not act as a real limit system - due to the fact that because of the size of the institution, the limit often does not "bite". Therefore the internal systems trigger a limiting effect at a different and maybe earlier stage.

In light of the regulatory backstop concept on which the rules are to be based, we accept their retention but would firmly reject an attempt to make them more stringent.

Q7. What principles or criteria might be applied for an institution to demonstrate its ability to measure and manage the relevant risks?

In general, principles should be geared to the requirements of Pillar II and should consider individual circumstances. Against this background the following principles could be suitable:

- definition of causes of concentration risks;
- analysis of correlations between risks;
- internal regulations based on the aforesaid principles;
- adequacy of worst-case-scenario analysis.

Q8. Respondents are asked whether they consider that principles along these lines 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 welcome CEBS' efforts to align the calculation methods of the large exposures regime with those of the CRD on the one hand. This is the only possible way to assure practice-oriented handling and control of the calculation of exposure values. In this respect the suggested principles are – in general – appropriate. On the other hand, we are somewhat sceptical of the proposal set out in paragraph 195 4a). We infer from this that the intention is to carry out a large exposures approval test in addition to the review of the IRB system. We firmly reject such a plan.

Furthermore, we are not clear how CEBS expects banks to provide the evidence required in paragraph 195 4a). The use test requirement in paragraph 195 3) and the stress test requirement in paragraph 195 4b) are already part of the test for IRB recognition. We regard these tests as necessary and sufficient. We therefore suggest that recognition of EAD and EPE computation methods in the IRB approval should also constitute authorisation to use them within the large exposures regime.

Q9. Do respondents support harmonisation of the conversion factors applied to the off-balance items set out above? How important are these national discretions?

Q10. How are these facilities, transactions etc. regarded for internal limits-setting purposes? What conversion factors do respondents consider appropriate?

Q11. 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. We are interested in receiving views from respondents on how they calculate exposure values for such products for internal purposes.

Regarding conversion factors for the calculation of exposure values, a risk-sensitive approach should be adopted, taking into consideration the different risk characteristics of off-balance sheet items. In particular, as described in paragraph 200 of CP 14, most member states use conversion factors in their large exposures regimes for low and medium risks. These CCFs have proved their worth and should be maintained.

For structured finance and/or basket products, large sophisticated banks simulate a change in market value for each individual transaction, according to a jump-to-default approach. The difference between this simulated value and the current value is then considered. We would like to

stress, however, that we regard this method to be too complex and costly for a “light touch” regulatory regime. In our view, a more suitable solution would be the method outlined in paragraphs 212 a) and 213. In addition to this, we would recommend differentiating between baskets according to the number of transactions they contain. In baskets with a large number of transactions (e.g. retail exposures), where the size of individual transactions is low, the implications are so minor as to make it unnecessary to insist on their inclusion in the large exposures regime.

Q12. Respondents are asked whether they consider these suggested principles appropriate for application to institutions´ exposures to collective investment schemes and/or structured finance transactions?

This is a crucially important issue in our view because a badly designed rule could easily give rise to highly onerous requirements, out of all proportion to the desired prudential objectives. Therefore, we would request that CEBS be very cautious with general principles for these types of products.

Furthermore, we would like to point out that CIU should be excluded from this analysis since principles for a “look through” treatment of CIU are already in place (e.g. in the CRD, Annex VI, Part 1, No. 79). However, we think that the requirement of daily information about the composition of a CIU in the trading book could be eased without detriment to the prudential objectives of either capital adequacy or a large exposures backstop regime.

We find the proposals outlined in paragraph 212 a)-c) difficult to understand in parts and would welcome it if CEBS would provide greater clarification, and perhaps illustrate its suggested method with an example. Having said that, we interpret this paragraph to mean that each time an exposure to a borrower exceeds 5% of the bank’s own funds, all transaction possibilities, known here as “schemes”, must be investigated to determine whether or not they still contribute something to the total exposure value of the counterparty. This method is excessively complex and we firmly reject it. An implementation in practice would be almost impossible. It would mean having to conduct this test on a larger number of borrowers than if the 10 % large exposures limit were applied.

Whether or not a look-through solution is in reasonable proportion to the prudential objectives depends on the number of transactions involved. Banks should therefore have the option of either categorising the scheme, as such, as a borrower or assigning individual components of the scheme to individual borrowers.

Furthermore, we would like to stress that structured transactions in general have an individual character. A one-size-fits-all system of dealing with such transactions in large exposures reporting

is therefore not sufficient. The solution outlined in paragraphs 212d)–215 is, in principle, appropriate. However, there are many cases in which financial institutions do not have enough information at their disposal to apply this solution, as it is not currently available on the market in such detail (e.g. private placements of mezzanine tranches). This is because, depending on where in the ranking it holds a position, it needs to know how much exposure (volume of emission x pool factor) remains outstanding from the other tranches. It is also unclear how positions (e.g. market risk hedges) ranked above the senior tranches referred to should be handled, particularly given that these do not represent a counterparty risk.

A final point is that a mandatory look-through solution would make it essential to define the scope of application of the rule very precisely. To solve the difficulties mentioned above, as well as the problem of finding an appropriate definition, we would again suggest granting institutions the option, depending on the risk profile of the position, of either applying the proposed look-through solution or treating the structured transaction as a borrower.

We look forward to the further discussions on the topic, especially the second part of CEBS' advice to the European Commission, and would appreciate your taking these comments into consideration in further discussions.

Yours faithfully

On behalf of
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pp.

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