Preliminary remarks

We, the Zentraler Kreditausschuss[1], thank you for the opportunity to comment on the consultation paper on “CEBS’s draft implementation guidelines on the revised large exposure regime" (CP 26) and present the comments of the German banking industry to you in this letter.

We wish to point out that the proposed guidelines will necessitate significant adaptations of the loan decision and reporting applications as well as in the crucial IT applications in the individual member states. As a rule, the institutions will incur considerable increases in personnel and overhead costs for the identification, management and monitoring of connected clients. This applies equally to the implementation of the requirements for the obligatory look-through and the regulatory reporting system. It is therefore urgently necessary to establish sufficient transition periods for the implementation of the requirements and regulations for preservation of the status quo.

Connected Clients

Preliminary remarks

To support uniform application, in addition to the interpretations of the individual elements 'control', 'economic interconnectedness' and 'main common funding source', statements regarding the relationships of these elements to each other are required. The individual features pursue specific objectives and develop different effects through their interaction. For example, unlimited chain formation based on the existing features can result in risk units that are extremely large. The consequence of this could be that individual borrowers do not reflect the addressed specific risk to each other. Consolidation into a connected client should thus ensue only to the extent that one of the specific elements, e.g. 'control' or 'economic interconnectedness', actually has an effect.

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.**

In practice, the concept of control is an important criterion for the formation of groups of connected clients. In this respect we welcome further clarification and thus the strengthening of the concept of control. The guidelines should be limited

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[1] The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks financial group, and the Verband deutscher Pfandbriefbanken (VdP), for Pfandbrief banks. Collectively, they represent more than 1,900 banks.

primarily to the majority of voting rights in an entity, as capital majorities (sub-paragraph 37 ff.) without corresponding voting rights are retroactively excluded in sub-paragraph 45. For purposes of a uniform, rigorous implementation of the guidelines, the focus should be on the voting majorities, which in the end constitute a control.

As rightly detailed in sub-paragraph 36, with a voting quota of more than half (i.e. 50% + one vote), control can be usually be assumed. This also corresponds to Directive 83/349/EC (Consolidated Accounts Directive), according to which a parent-subsidiary relationship is explicitly stated only in the case of possession of voting rights over 50%. If, in a particular case, there is no control despite a voting majority, the institution must document this accordingly.

On the other hand, a voting share of exactly 50% (sub-paragraph 37) or less (sub-paragraph 38) leads only in exceptional cases to a control opportunity. Thus, in these cases there must be no obligation for the institutions to document the counter-evidence for the control (sub-paragraph 45).

We see the use of indicators (sub-paragraph 39) as problematic. Due to the varying corporate regulations in the EU, in our opinion it is not possible to establish uniform indicators whose existence would facilitate a reliable assumption of control. Moreover, we do not see any need for such regulatory indicators. The control criterion has been defined for years by the CRD and is logically applied by the institutions in collaboration with the supervisory authorities, in our opinion. Based on institution-specific, established criteria which focus on the crucial corporate legal specifications and the respective borrowers, the existence of control is hereby established in the case 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.

We emphatically welcome the proposed exception for subsidiaries of central governments, regional governments and local authorities. As a rule, the statements in sub-paragraph 46 are sufficiently clear.

However, in accordance with current regulatory practice, all foreign central governments, regardless of whether they have a risk weighting of 0%, should be exempt from the obligation to consolidate with their state corporations to form a connected client. Furthermore, the exception for regional governments and local authorities could then lead to problems if, as has happened recently, the ratings of the relevant country deteriorate. This can lead to the previous risk weighting of 0% increasing with the result that suddenly new or larger groups of connected clients must be formed. This would lead to considerable problems particularly in the area of community financing. We therefore propose a solution in which the loans issued to one of the aforementioned parties which are not to be included in a group of connected client as per sub-paragraph 46, remain exempt from inclusion until the loan maturity date.

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.**

The guidelines generate more questions than they answer. This is especially clear in the attempt made in sub-paragraph 50 to identify individual case groups. Undertaking even an approximation of an exhaustive list did not work here.

Consequently, the consideration of unilateral dependencies results in large parts of the loan portfolio of an institution represent a loan in the sense of the large exposure regulations, as financial dependencies are regularly identified directly or indirectly. The proposed interpretation would additionally mean that the discretion to issue loans particularly to small and medium-sized enterprises which are, for example, primary suppliers for a large company, but also for private persons would be greatly reduced. This would have primarily negative effects on the business activity of regionally oriented institutions, as strong financial dependencies regularly exist between the individual clients. But there would be considerable effort and expense involved in identification for larger institutions as well.

Furthermore, the proposed interpretation would greatly increase the number of all large exposures and the volume of individual ones. This contravenes the objective of CEBS of retaining the previous system fundamentally as a back-stop system. For this reason we request that the interpretation of 'interconnectedness' be changed so that only mutual dependencies are considered.

Should CEBS insist on the proposed interpretation, the application of the only subjectively determinable fact of 'economic interconnectedness' with regard to unilateral dependencies will definitely lead to a stronger mixing with the objectively determinable control relationship. This raises the question of how national evidence registries can still provide useful information in the future. In our opinion, such facts in a central register can serve only informational purposes, but do not function as a binding summary. In the case of corresponding materiality for the institution, the register could at most indicate the need for a more exact review of the circumstances.

Furthermore, clarification that a bundling of borrowers to form groups of connected clients may ensue based strictly on economic calculations and not across the board. Here's an example: A supplier A is so dependent on two otherwise independent customers B and C that it has difficulties surviving if B or C go bankrupt. Then A must be bundled into a borrowers' unit with B and C. However, this must not result in bundling the borrowers B and C together with A into a single borrowers' unit as the result of "chaining" via A.

In particular, a clear, workable demarcation of the idiosyncratic "single risk" of sectoral 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 facilitates targeted decisions for other business cases outside of the examples.

To ensure manageability in practice, the interpretation of 'repayment difficulties' in sub-paragraph 47 must be given a narrow interpretation. Instead of simple 'repayment difficulties', CEBS should clearly focus on 'survival problems', i.e. primarily the insolvency of the borrower. We assume that the comments are meant to be understood this way. The examples in sub-paragraph 50 also make it clear that idiosyncratic risk and sectoral and/or geographic risks have not been cleanly separated up to now. In particular, the items 'only buyer of a given product' and 'producer and vendors' make the strong mixture of idiosyncratic and geographic/sectoral risk concentrations. Under the key term 'single risk', common risk concentrations are actually addressed to a large extent, which are already documented elsewhere; here they are also documented inappropriately. In particular, the aforementioned connections already form part of every solid loan analysis and for IRBA banks they serve as influencing factors for the rating.

Beyond that, the examples of retail business in sub-paragraph 50 call the focus of the large exposure regime into question. 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 urgently necessary to refrain from expanding the large exposure regime to the retail sector - especially in view of the fact that it is the embodiment of a one-size-fits-all backstop limitation which does not focus on the accuracy and precision of calculations at the retail level. In our view, such an expansion of the large exposure regime (the number of the potential reciprocal relationships to be reviewed increases exponentially with the number of elements) is a distraction from the substantive issues and endangers the functionality of the regime in vital areas.

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.**

We believe that the interpretations regarding the important refinancing sources generate considerable confusion.

In particular, the demarcation between sectoral and idiosyncratic risks requires clarification. While sub-paragraph 53 rightly points out that 'the intention is not to include cases where […] the money market or market for commercial paper in general is in trouble', the example in sub-paragraph 55 states '[…] the market for commercial paper, which caused the dependence.'

Except for this point, the example described in sub-paragraph 55 of a 'main source of funding being common' is clear and understandable with regard to the result. This example includes commitments to several SVPs which, under a contractual structure, can refinance themselves exclusively from a single source ('funding entity'). Based on the structure, a failure of this refinancing source automatically results in all support commitments being called in more or less simultaneously. The specific legal construct constitutes the 'single risk'.

Beyond the aforementioned example, however, the comments do not offer any reliable guidance. The other sub-paragraphs explain only a non-exhaustive list of exceptions (e.g. lack of creditworthiness, regional roots). To this extent, the scope of application of a 'main source of funding being common' is expanded beyond the SPV construct. However, it remains unclear precisely when this expansion constitutes a 'single risk' and when it does not. No positive delineation is made.

Thus, the interpretation of the term 'main source of funding being common' should remain limited to the case described in sub-paragraph 55. In our understanding, this also corresponds to the regulatory intention of the CRD.

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

We welcome the introduction of a threshold for the exposure to a borrower as of which the extremely expensive and time-consuming audits for this borrower are to be undertaken. Based on the very considerable information procurement, work and expenses involved for the institutions in identifying groups of connected clients, however, we advocate a threshold of 5%, which would be high enough to ensure crucial administrative relief. At the same time, we believe that 5% is little enough that the functionality of the large exposure regime will not be placed at risk. For small institutions with correspondingly low own funds, an adequate threshold in monetary terms of up to a maximum of € 1.5 million should also be introduced analogous to the CRD rules for interbank exposures. The maximal usable amount of the monetary threshold for the individual institution must thereby manifest an adequate distance from the individual institution's large exposure limit.

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.

In our opinion, the paper does not contain any guidelines for the control and management processes to be introduced by the institutions. Rather, there is only a call to establish appropriate processes in the institution. On the other hand, the question of which requirements these processes should fulfill from a regulatory point of view remains open. Here, orientation points for institution-specific implementation, matched to the respective business model, should be provided in order to prevent difficulties in regulatory review.

Furthermore, we wish to note that it is not clear why sub-paragraph 64 requires information about external customers who are not customers of the institution who are affiliated with the institution's own customers should be procured. In these cases the institution is often unable to procure the required information. Even within the framework of a trusting business relationship, the account manager will not always be able to obtain the corresponding data, as he is dependent on the good will of the borrower due to a lack of any legal basis.

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's guidelines?

No.

Treatment of exposures to schemes with underlying assets

Preliminary remarks

In order be able to fulfill the planned requirements in accordance with the look-through approach, in 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 usual up to now. In order to enable the schemes to make the corresponding changes in their contracts, the regulations regarding look-through should be applied only to those items established by the institutions after 31 December 2010.

In addition, a look-through of the items listed in the CRD involves great expense and effort for information gathering and accompanying work on the part of the institutions. It should therefore be clarified that the repeated look-through through a product held can be accomplished at sufficiently long intervals. We consider a three-month period to be appropriate and sufficient.

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 the institutions enough flexibility. In the end, the regulation means 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 the debtors. The discretion of the institutions newly specified in Article 106, Paragraph 3 CRD will be effectively cancelled out due to the otherwise compulsory bundling of all unknown liabilities into a single overriding borrowers' unit.

However, with this CEBS has neglected to take into account that in practice no look-through is possible for numerous products, i.e. the underlying debts are often unknown to the institutions. The borrowers identified during the look-through will be to a considerable extent parties with which there is no direct lending and customer relationship. A review of the capital and corporate situations – as a basis for the formation of groups of connected clients – is in these cases possible only to a limited degree due to lack of a legal basis for the procurement of 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 borrower, 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 threshold of 5% of the own funds 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 borrowers. An extensive and time-consuming review would not be justified in view of the short holding periods of the securities.

Regulated investment funds issued under the UCITS Directive should also be exempt from the look-through and be regarded as individual clients since these funds are already subject to restrictions aimed at avoiding concentration risk.

For sufficiently granular or similar products with numerous small individual exposures, such as granular investment funds for which the institution decides to do a look-through, but a complete 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, analogous to the considerations in Section III.F I (control and management procedures), underlying assets for which the exposure is known to be consistently less than 5% or the monetary amount of the threshold 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 thresholds 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).

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).

For both public investment funds as well as schemes in schemes such as open-ended collective investment schemes it is nearly impossible to gain 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.

In particular, this would result in the securitization market coming to an actual standstill. However, such removals from the balance sheet are a prerequisite for a sufficient credit supply to industry. In particular, a revival of the securitization 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 fund products that are difficult to understand as well as non-granular securitization 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 entire item held.

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. The limit value review proposed under Question 8 and 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. Here as well, the consideration of the relief proposed in Question 8 would intensify the incentive 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. Then 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. Most investment structures actually strive for a minimum of diversification, which conflicts 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.

In particular, those investment structures for which a minimum diversification must be strictly maintained, for instance in accordance with state requirements, should be included in the resulting large exposure with a weighting significantly below 100%.

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 bundling with the overriding borrowers' unit.

We fundamentally welcome the option as holders of senior tranches to take account of subordinate tranches as a loan enhancement and thus to reduce the risk to be stated. However, in our opinion, tranches with a subordination should also be taken into account as mitigating factors within first loss items.

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?

Subject to the aforementioned fundamental reservations about the approaches, the proposed approach to exposure calculation for tranched products is appropriate (Examples 1, 3, 4).

However, due to the (potential) variety of the structures available in the market the approach will not be appropriate for all products. To this extent we support the proposal as a basic principle, but suggest the addition of the option to deviate from the currently defined procedure in justified cases, if the principle is not appropriate for the risk content of the respective tranche.

15. With respect to the treatment of tranched securitisation positions If it was be 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 FL tranches described in examples 1, 3 and 4 is appropriate. We consider handling of the mezzanine tranches as described in Example 2 to be problematic. The general haircut called for in sub-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 use of these haircuts. However, for complex structures an appropriate classification of haircuts raises difficult methodical issues, which are not even remotely reviewed. This is all the more so when all imaginable tranche categories are traded on the market. The transition between most senior, senior and mezzanine tranches must be precisely defined. As in example 2 the holder of the mezzanine tranche suffers exactly the same losses as the holder of the senior tranche in example 1 in the case of default of all borrowers, we propose a simplification of the large exposure regime to differentiate only between tranches in which a loss is directly threatened in the case of default of the borrower ('first loss') and those for which the loss is (partially) compensated by another tranche.

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

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 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 borrower if a look-through was carried out for the assets it holds.

However, for most of the schemes such as securitizations 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.

Reporting Requirements

Preliminary remarks

We wish to note that the implementation of the reporting requirement according to the new rules will be possible only when the national implementation of the new, still-to-be developed COREP reporting form has been completed. Based on the current planning at the European level, we assume that this work will be completed on 31 December 2012 at the earliest. We request a corresponding clarification in the document. In the case that the reports are to be issued before the completion of the COREP reporting form, in view of the considerable implementation expense and effort, particularly for the report of securities concentrations as per Article 110, Paragraph 3, we believe that a postponement of the implementation deadline to 1 January 2012 is urgently 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 own funds 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 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?

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

The '2-template approach' should be used.

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

These types of collateral 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?

In the sense of limiting the administrative burdens on the institution, the collection of further information should be omitted.

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

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.

As a rule, 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.
