European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

Committee of European
Banking Supervisors

Brussels, 11th September 2009
HG/VH/B2/09-170

cp26@c-ebs.org

CONSULTATION PAPER ON CEBS'S DRAFT IMPLEMENTATION GUIDELINES ON THE REVISED LARGE EXPOSURES REGIME (CP 26)

Dear Sir/Madam,

The European Association of Co-operative Banks (EACB) welcomes the opportunity to comment on the consultation paper on CEBS's draft implementation guidelines on the revised large exposures regime.

Please find our remarks on the following pages. Do not hesitate to contact us should you have any questions.

Yours sincerely,

Hervé Guider
General Manager

Volker Heegemann
Head of Legal Department

EACB AISBL – Secretariat • Rue de l'Industrie 26-38 • B-1040 Brussels
Tel: (+32 2) 230 11 24 • Fax (+32 2) 230 06 49 • Enterprise 0896.081.149
European Commission Register of Interest Representatives Identification Number 4172526951-19
www.eurocoopbanks.coop • e-mail : secretariat@eurocoopbanks.coop

GENERAL REMARKS

We expect that the implementation of the new Large Exposures Regime, as contained in CEBS's draft guidelines, will require significant changes to banks' internal procedures and processes, as well as modifications of IT applications, especially regarding the identification of connected parties and the monitoring and controlling of exposures to connected parties. Equally, we fear that the look-through approach to be applied to the investment in schemes will significantly increase the workload for banks.

Therefore, we think that a smooth transition to the new regime will require both transition and grandfathering clauses.

Date of implementation is set at 31 December 2010. We would like to get confirmation that the first reporting under the new rules is in 2011.

SPECIFIC REMARKS

Connected Clients

General Comments

We think that a convergent application of concepts such as "control", "economic interconnectedness" and "main common funding source" does not only require guidance on their substance, as suggested, but also guidance on the delimitation of those terms. In fact, a cumulating approach could lead to a very extensive interpretation.

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.

The members of the EACB think that the concept of control should focus much more on whether a factual influence on the business of an entity is exerted. In particular, a majority of voting rights should be considered as the most decisive element. In fact, CEBS already stresses the relevance of voting rights when referring to non-voting capital (no. 36).

A majority of voting rights should establish a presumption of control (no. 37) unless specific evidence is provided that this is not the case. However, we strongly disagree with the presumption that already 50% of the voting rights, especially in the case of equal partners, create control. We recall that Directive 83/349/EC (Seventh Company Law Directive) explicitly refers to a mother-daughter relation that requires voting rights of more than 50%. It has to be taken into account that even when there are two equal partners, none of them can take a decision alone and the other can always object to a proposal of the other. This is completely different when there is a majority.

Furthermore, the proposed interpretation outruns the current understanding respectively otherwise requirements of control (e.g. the fifth bullet in point 39 is not consistent with Article 12 of the Seventh Council Directive 83/349/EEC). Therefore, an assuming most members states used the national discretion given in the above named article, the control relationship should be only if the majority of the governing or supervisory body or executive body consist of the same persons, as the same persons are in a minority in two or more companies they will not be able to influence control.

Finally, we feel that the interpretation of control should be more in line with the Article 12 of the Seventh Council Directive 83/349/EEC. Therefore in point 39 in the fifth bullet the control relationship should be only recognised if the majority of the governing or supervisory body or executive body consists of the same persons. As the same persons are in a minority in two or more companies they will not be able to influence control.

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 appreciate the exemption for subsidiaries where the majority of the shares are owned by the central government, and for exposures to the central government.

We understand that even subsidiaries of local authorities are exempted, even if only the central government but not the local authority has a risk weight of 0%.

However, the recent crisis has shown that any link of regulation to a certain rating or standing of a central government can be very dangerous, since a worsening of the rating/standard can trigger serious prudential effects. We therefore ask to consider whether it would not be better, at least with regard to EC member states to drop the reference to 0%. In our view the reasoning in point 87[1] in the CEBS's 2nd Advice to the Commission on large exposures is correct and it is valid in general and not only in case of those states where the central government bears a 0% risk weight given its AAA, AA rating.

Therefore, with regard to all EU countries the central government and the enterprises where it has a controlling stake should not be considered as connected clients. The same should be the rule for the Member States' regional and local authorities and the enterprises where the authorities mentioned have a controlling stake. Even if contrary to the above mentioned arguments, the CEBS wanted to treat the central governments, the regional governments, the local authorities and their controlled enterprises as groups of connected clients, in our view there is no reason that those public sector enterprises (PSEs) should be considered as connected clients to the controlling authority, where the exposures (without eligible credit protection) on the PSEs concerned do not qualify for favourable treatment under the capital adequacy regime.

In our opinion the specific central government / public authority and the institutions listed in Article 2 of the Directive 2006/48/EC should not be considered either as connected clients, due to their specific role in the financial system of the Member State concerned.

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.

CEBS has to take into account that the European economy is characterized not only by a huge number of SMEs but also by a very small number of companies in some areas (e.g. cars, food, IT), by a high degree of specialization, division of labor and definitely by close interaction between all sectors.

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[1] "CEBS has identified one exemption from the requirement for grouping clients in cases where one client has control over the other, and that concerns subsidiaries where the majority of shares are owned by central governments, regional governments or local authorities. In such cases even though the owner has control over each subsidiary, the risk connected with exposure to one subsidiary is not related to the risk of exposures to other subsidiaries. A failure of one subsidiary, which is a separate legal person, does not necessarily impose a duty on the owner to invest more capital. If the owner still decides to do so, one assumes that this ultimately could be financed by raising revenues."

The developments at the end of 2008 have shown how closely interconnected the EU economy is and how a crisis in one major sector can affect other sectors. But the crisis has demonstrated as well how undertakings can master periods of stress and that such stress does not automatically lead to substantial difficulties.

The purpose of the concept of interconnectedness is to ensure that banks identify parties so closely linked by idiosyncratic risk factors that it is prudent to treat them as a single risk in order to mitigate a negative externality, i.e. the wider systemic impact of a failure. Since, however, such assessment requires a projection of possible events and, since the capacity of undertakings to adapt to a deteriorating business environment is considerable, such identification is a fairly difficult task. Moreover, too broad an approach to economic interconnectedness would make it impossible for banks to handle Article 4(45) CRD so that the desired results cannot be achieved.

The members of the EACB therefore think that it will be important for CEBS to draw a line in order to limit the concept of economic interconnectedness in a meaningful way so that the prudential purpose can be achieved.

With regard to Article 4(45)(b)[2] CRD this would require guidance on the following:

- Further clarification that "funding or repayment *difficulties*" are to be understood as **substantial** difficulties. In no. 48, CEBS rightly refers to the danger of "default contagion" and the "threat of insolvency". The members of the EACB think that CEBS should further clarify this understanding of difficulties throughout the text.
- Manifest Evidence: Any such presumption of "default contagion" would have to be established on the basis of evidence, which leads to the conclusion that there is a manifest danger of default. While in many cases one may presume that difficulties will arise, manifest evidence should be required that allows the conclusion that there is a high probability of contagion risk.
- The catalogue under no. 50 should be extended. For the purpose of a more convergent application of this highly vague concept, more illustrative examples would certainly be helpful and provide for useful guidance for supervisors.
- However, such catalogue should not limit itself to positive examples. We emphasize the importance and usefulness of a negative catalogue. More negative examples could be helpful This would provide for a solution to clearly communicate that certain relationships are not meant to be covered, such as:
    - A normal employer-employee-relationship (which could otherwise be in the scope)
    - A bank-customer relationship should not lead to connectedness as well.

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.

The illustration of a "main source of funding being common" seems clear.

We appreciate the clarification regarding a common source of funding and geographic location.

[2] *"(b) two or more natural or legal persons between whom there is no relationship of control as set out in point (a) but who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, in particular funding or repayment difficulties, the other or all of the others would be likely to encounter funding or repayment difficulties"*

Concerning ABCP (asset backed commercial paper) conduits, we would like to precise that if the intention of the CEBS is that all those conduits sponsored by an institution should be considered as a connected client, we feel that this approach would create a confusion between idiosyncratic credit risk (covered by the large exposure regime) and liquidity risk (which is not).

Indeed, while the reliance of the conduits on the commercial paper market creates a funding risk for the sponsoring institution which is addressed in other part of the regulatory framework, the various ABCP conduits do not constitute a single credit risk as ultimately, the sponsoring institution would be exposed to the conduits assets and not the conduits themselves.

The example in Nr. 55 refers to the very specific situation of IKB (Germany). However, since then, the situation has emerged. It would therefore be inappropriate to draw too far-reaching conclusions from this example. Therefore we suggest keeping the example, but rather delete the other ones

In the example, if the CP market were to close, the liquidity lines granted by the sponsoring institution would be drawn, without necessarily for the conduit to fall in default (because precisely this liquidity line is used to ensure refunding of CPs to investors). Moreover, once those lines are drawn, the bank would calculate its large exposures by applying transparency to the underlying assets and not to the conduits.

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

We understand that the threshold applies at the customer level i.e. to the global amount of exposures on the customer. It seems to us that another level of application would not be relevant. Clarification would be welcomed.

The members of the EACB think that a threshold of this kind will be necessary if banks are to handle Article 4(45) CRD properly so that the desired results can be achieved. We would like to stress that the relevant assessments will have to be done manually. Their complex nature will not allow to pass via IT-systems. Therefore proportionality will be a key in this context.

Seen from that angle, we think that the level is by far too low. We suggest increasing the level to 5%. Otherwise we see a danger that banks may not be able to really focus on those exposures that are potentially relevant for interconnectedness. It should be prevented that a too large number of finally irrelevant assessments of interconnectedness would have to be assessed.

With regard to the limited systemic relevance for smaller institutions, we think that a minimum amount for the assessment of interconnectedness would be justified. Exposures of less than €1.5 million should not be relevant. We fear that otherwise, the fixed cost for such loans may become too high and affect the competitiveness of smaller institutions. Furthermore, customers may wish to avoid complex procedures by simply choosing a larger bank.

In fact, we think that in principle the retail portfolio should be excluded from the assessment of economic interconnectedness. Typically, the retail portfolio is granular both in IRB and non IRB banks and therefore it not an issue for large exposures. (For the reasoning please see the example in the annex)
By conclusion, we think a 5% threshold on solo and consolidated level, would be appropriate, but it should be introduced in relevant cases (small institutions) a higher minimum amount of euro 1.5 million or a higher amount in consultation with the supervisor. In determining the higher minimum amount the purpose, risk profile and practical feasibility should be leading the decision.

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 see that there is only limited guidance on control and management procedures (e.g. no. 58, 60). It may be advisable to further elaborate on them.

With regard to no. 64, we doubt that banks will be able to gain access to information on companies that are not their customers. It is to be considered that there if no legal basis for institutions to enforce information transfer regarding non-customers. Therefore identification of connected clients and the data collection and storage should relate only to those persons of the group of connected clients with which the credit institution has a direct or indirect relationship on a solo or on a consolidated level and the identification should happen when the exposure of the direct or indirect relationship with regard to exposures is established.

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.

<u>Treatment of Exposures with underlying assets</u>

General Remarks

For the time being, the provision of the data required for a look-through approach for exposures with underlying assets by "schemes" to banks is not common practice. Thus, it will require that banks agree with those "schemes" that the relevant data will be provided. In order to allow for a smooth transition and implementation of agreements, the members of the EACB suggest exempting exposures that were created before 31st December 2010.

Furthermore, it would make sense to have intervals of three months for every look-through. Otherwise this exercise would be almost impossible to handle.

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?

The members of the EACB would encourage CEBS to allow a higher degree of flexibility as regards this rule:

- In many cases it will not be possible that banks are informed about the underlying assets;
- Even when they receive the information, it may turn out to be a fairly difficult exercise that is required to establish whether the issuer of the underlying asset, with whom probably no business relationship exists, is connected to any other company.

In order to limit the impact of the new provision, we suggest that:

- Trading Book positions which are usually held for a short time are not taken into consideration;

- Products where the underlying portfolio is highly granular should be considered as an exposure of their own and left aside when assessing interconnectedness. In fact, similar reflections should apply as under III.F (fix minimum).

The aforementioned rules would also counter the creation of any incentives for banks to invest in less diversified, "easier-to-handle" products.

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

While the suggested 4-step approach seems to be quite a reasonable concept in theory, we doubt that it can be implemented in practice.

We still have serious doubts that banks will succeed in accessing all relevant information and be able to execute a full look-through. Especially in the case of securitizations with several tranches will it be extremely difficult to achieve a proper allocation.

As for the partial look-through, we fear that the attribution to a specific group of unknown connected clients may lead to the result that the LE limit for that group will be reached very quickly.

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?

A partial look-through will certainly make the transition to a) easier. However, it seems that the situation is rather that there is all information or there is none. The situation that only some underlying assets are not known seems to be more an exception.

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?

We have doubts that this approach is feasible. Certainly it will not provide for more flexibility. In this regard, we would prefer the solution suggested under question 8 and 15.

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)?

This approach seems to be extremely conservative. It fully negates the fact that one of the purposes for investing in portfolio-based instruments is risk-diversification and that portfolios are therefore generally highly diversified.

The members of the EACB see a danger that in an approach as conservative as proposed it will most probably result in reaching the limit of 25% for that exposure class very soon.

We see a need for an alternative treatment which allows for a more granular approach. Consequently, we would suggest:

- Considering whether a financial instruments, whose underlying assets are highly diversified/granular, should not, for LE purposes, be treated stand-alone.
- Either to allow the allocation of unknown exposures to several 'unknown' client groups (e.g several fictive clients representing countries and/or asset classes)
- Or to apply a haircut to the total exposure to the 'unknown client' to account for diversification.

Such proposals would create incentives for more granular and diversified portfolios. CEBS's proposals may otherwise create an incentive for banks to invest in products that are easier to handle but far less risk-balanced.

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

All in all, we support the proposals regarding tranched products. However, it has to be underlined that this is also a very conservative approach, very burdensome to implement and thus overly costly.

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?

All in all, we consider the proposed treatment to be appropriate. However, with regard to the multitude of products and structures, it may not provide for appropriate solutions in all cases. Therefore, there should be a possibility to deviate if this appears appropriate with regard to the risk-profile of a tranche.

Moreover, we suggest to exclude ABS with retail underlying from the scope of application of this regime because we know that given the size of the underlying exposure they would not be relevant for the large exposures calculation while add all these tranches together could lead to a high amount of "unknown exposures" that would be inappropriate.

In example 3 / annex 2, we do not understand why the protection provided by a first loss tranche to another more senior 'first loss' tranche is ignored. It does not seem appropriate, especially if 'first loss is defined as 'receiving a 1250% RW.

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 appreciate the suggested treatment for positions in the first loss set. However, we think that the approach towards mezzanine tranches in example 2 may be problematic.

As regards the appropriateness of general haircuts for subordinated tranches, we have doubts where the subordination is not known. Furthermore, an appropriate calculation and handling of haircuts requires an extensive analysis.

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

As regards schemes that are established according to Directive 85/611/EEC (UCITS), we do not see any additional credit risk. Even in the case of insolvency of the scheme the underlying portfolios will not be affected. UCITS should therefore be excluded from an LE regime.

Furthermore, it is common to make arrangements regarding most other schemes as well in order to ensure that portfolios are not affected by its insolvency. Another solution is that arrangements are made for claims in the case of insolvency.

We think that in the above-mentioned cases structures should not be subject to LE rules.

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

Yes. However, we would ask for clarification of the following aspect: in par. 129. ref. real estate it is mentioned to deduct '50% of the value of eligible property….'. We would like to know what concept of 'value' is referred to.

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

An alternative approach, as stipulated in Article 13(2) CRD, should be possible when establishing the 10% threshold.

Moreover, in reference to points 123 and 135, we do not understand why the 10% limit should be systematically calculated on COREP 1.3 LE base (i.e. T1+T2) while the 25% limit is calculated either on COREP 1.3 LE base or on COREP 1.6 LE base (i.e. T1+T2+T3). The calculation base should be the same to determine the two limits.

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?

Reporting in column 8 is fine and fundamentally correct.

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).

The 1-Template-Approach offers the advantage to handle only one template. Nevertheless, we understand that approach requires to report all information for groups but also for all clients constituting the groups while the 2-Template-Approach only requires all information at group level and a lighter reporting at clients level (cf. point 108). The level of detail in the 1-Template-Approach seems to us unduly burdensome. Consequently, we are in favor of the 2-Template-Approach.

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

We think that this differentiation is sufficient.

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?

The inclusion of more detailed information would increase the administrative burden. We doubt that such information will be useful.

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

Guidance on how the analysis in no. 104 should be executed would be useful. Please see also our remark on par. 129 (‘value’) under question 17.

Moreover, we think it will be difficult to trace the correct weighting as only the breakdown between balance sheet and off balance is requested in template 1, without any differentiation of the risk typology, such as :

- Securities and credit risk for balance sheet,
- Guarantee given to counterparties and undrawn credit facility for off balance sheet on which a compound weighting is applicable (i.e. weighting of the commitment itself multiplied by the weighting of the beneficiary).

The weightings applied to each risk typology may be different.

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.

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.

One code is missing in the template 1 of annex 4 for the institution: in fact, there are 4 possible codes, of which “4” for intra-group non-credit institution.