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EACB comments on BCBS Supervisory framework for measuring and controlling large exposures

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A. GENERAL REMARKS

The scope of application is widened to include also application of large exposure requirements at solo level in addition to the consolidated level. According to our experts individual bank level application would be highly problematic in groups with centralized liquidity management and funding. In this case all liquidity and funding comes from the central treasury department. This entity has relatively high claims resulting from funding of local banks as well as subsidiaries. In this way, the entity responsible for group wide liquidity management would have liquidity management related exposures far greater than would be needed for its own operations, which could breach large exposures limits. Additionally, funds deposited with the central treasury could result in a high level of claims on the central treasury department.

Therefore, we suggest that only the consolidated level should be in the scope of this framework.

Moreover, we believe that the suggested modifications to the current regime will have a significant impact, We therefore suggest an impact assessment in order to avoid a negative impact for economies.

B. SPECIFIC COMMENTS

1: The Committee welcomes views on the proposed definition of large exposures and on the proposal for reporting.

Under the Basel Committee's proposals, exposures shall be deemed "large exposures" if and when loans to a borrower amount to an aggregate of 5% of a bank's eligible capital or if they exceed this limit (point 24). There are many jurisdictions - such as e.g. the European Union – were the threshold defining a large exposures is set at 10% of liable capital.

In our view, this important reduction of 50%, if rolled out to the whole banking sector, will create significant problems for smaller institutions. We believe that concerning small banks, the 10% limit has stood the test of time as far as monitoring of idiosyncratic risk concentrations are concerned. The current proposals would lead to a progressive increase in the large exposures that need to be reported. Combined with the associated daily monitoring, the potentially applicable resolution guidelines as well as the corresponding reporting obligations, this would trigger a clear inflation of institutional operating expenditure for the necessary logistics which we do not see justified by any meaningful improvement regarding information for supervisors. A higher number of reports are already being triggered due to the fact that the reference to Tier1 or CET1 will change the capital base used for determining reportable items.

The limit defining large exposures (i.e. 10% of eligible capital) is already clearly below the upper limit for large exposures (i.e. 25%). We feel that a definition threshold of 10% is fit for purpose as an early warning indicator for supervisors as well as for the internal monitoring of risk concentrations.

Furthermore, we have difficulties in understanding the rationale behind a limit of 5%. We feel that the large exposures regime is inappropriate for gathering valid data in order to draw the right conclusions for macro prudential risks. The large exposure provisions merely serve to limit the borrower related credit risk. It explicitly refrains from any contemplation of industry and geographical risks. Such risks can be covered far better by other supervisory and statistical reports which are already collected by different Banking Authorities and statistical Institutions. We therefore advocate considering a stock taking on existing data to prevent from double reporting. Moreover, we have strong doubts regarding the meaningfulness of macro-analyses that are based on large exposure reports. This is due to the fact that the level of large exposures that have to be reported largely depends on the structure of a country's banking market. For instance, a country featuring a highly fragmented banking market (i.e. featuring a large number of smaller banks) will, on principle, report a greater number of large exposures as opposed to a country featuring e.g. a limited number of large banks.

Consequently, with a view to smaller banks, we advocate in favour of stipulating a reporting limit for large exposures that is at 10% of eligible capital and in addition to abandon any plans for reporting the 20 largest borrowers.

As for point 25, we suggest to further align the text to the Basel III document (Para 392) in order to avoid any contradictions regarding the substitution approach. In particular, we believe that when credit protection is provided by parties through collateral (e.g. securities) such exposure should not be added to the total of any direct exposures.

2: The Committee welcomes views on the criteria proposed for the identification of connected counterparties when they pose a single risk.

Most of the criteria under point 34 are such that they are in practise impossible to define in such manner that they could be identified by the bank. The suggested criteria leave too much room for interpretation. For example subcontractor chains might be long and default of one subcontractor would not necessarily lead to default of all remaining subcontractors, as usually other sources of income can be found.

Moreover, we feel that the proposal under point 36 is not feasible. First, the term "set of counterparties" requires a further clarification. Moreover, we wonder how it should be assessed that loans to different borrowers which may potentially be aggregated, will reach the large exposure limit prior to any in-depth review (circular argument). As a result, we hold the view that a predication on the respective loan exposure of a single borrower would be more suitable: Under such an approach, if the individual loan to a borrower exceeds a limit (the level of which ought to be agreed) there should be an in-depth review for economic connectedness. At this juncture, a 5% limit of eligible capital appears appropriate.

3: The Committee welcomes views and quantitative information on whether the limit should be based on CET1 or Tier 1.

For the definition of eligible capital large exposure limit the Committee suggests to exclusively focus on Common Equity Tier 1 (CET 1) or the entire Tier 1 capital (point 43). This is a much more restrictive approach compared to the status quo, while the rationale for ignoring Tier 2 capital is not immediately obvious to us. The qualitative requirements with regard to the capital instruments already became more demanding in the wake of the revised capital definitions under Basel III. Now, as a result, the capital available for loss absorption purposes is clearly “better".

Although the Basel Committee’s going concern assumption is essentially plausible as a reason for the make-up of eligible capital, it is nonetheless questionable whether the entire capital stock will have to consist of going concern capital. From our point of view, it is appropriate to take Tier 2 capital instruments into account, too.

In fact, the write-down or conversion to CET1 of AT1-instruments would indicate that they should also cover large exposures. Moreover, Tier2 instruments have similar write down or conversion characteristics before the point of non-viability, they should also be included in the own fund basis for the calculation of large exposures.

We would like to point out that the Committee proposals are explicitly geared towards internationally active banks. Nevertheless, there will be a roll-out of these rules to smaller banks by national supervisors. Hence, the interests of those banks should be taken into account. Whilst not limited to, particularly in the interbanking market, the 25% limit is met fairly quickly. In order to ensure continued funding also by smaller institutions, we feel that maintaining a special regime for smaller institutions (e.g. limit of EUR150 million or, moreover, 100% of eligible capital would be appropriate).

We believe that a ny potential insistence on an exclusive consideration of Tier 1 as relevant capital by the Committee would result in a compelling need to also increase the large exposure limits accordingly. The necessary level should be reviewed in the framework of the QIS.

4: The Committee welcomes views on the extent and nature of the use of internal models (when they have received supervisory approval for being used for Pillar 1 capital requirements purposes) to measure large exposures.

5: The Committee welcomes views on the proposal to calculate exposure value of banks’ investments in OTC derivatives.

We fully support the efforts of the BCBS to reuse existing exposure measures as much as possible. Therefore, we recommend applying the same calculation of exposure for Large Exposure Ratio (LER) as elsewhere for Pillar 1 purposes, also including off-balance sheet items. In this respect we note the following:

- The LER should not be viewed as the only tool available to supervisors to mitigate (name) concentration, but rather one of many views that an institution provides to its supervisor. Rather than trying to quantify every single exception, we see the LER as a simple backstop that will invite the supervisor to discuss the situation in more detail with the supervised institution.

- The models used for the capital calculations are extensively reviewed – both internally and by the supervisors – and back tested. They provide the best combination of sophistication and reliability that is available under the current regulatory framework. This will remain the case even after the introduction of the new Current Exposure Method (CEM).
- While we understand that the LER is based on different assumptions (sudden, worst-case situation), we believe that specific adjustments to the exposure measure specifically for the LER will not add to the overall usability of the report. For instance, we note that the use of the CEM over the IMM does not necessarily create a more conservative estimate, but rather a more simplistic one that can cause misrepresentation of the underlying risks.

6: The Committee welcomes views on the proposal for how the exposure values of banks' investments in securities financing transactions should be calculated, in particular on the need to deviate from the risk-based capital requirement rules given the objectives of a large exposures framework.

7: The Committee welcomes views on the proposal to generally apply a 100% CCF for "traditional" off-balance sheet commitments.

The flat 100% CCF is not in line with internally modelled CCFs at default. Instead, standardised CCFs or internally modelled CCFs should be used in the calculation if exposure for the large exposures.
In particular for exposures linked to trade finance activities (para. 66) a CCF lower than 100 should be considered.

8: The Committee welcomes views on the proposed hybrid approach for banks that apply the "comprehensive approach" to financial collaterals.

We believe that credit risk mitigation techniques should be admitted and would like to stress that physical collaterals (especially real estate) should be included in risk mitigation techniques using the haircut- based approach.

A complete ban on the recognition of physical collateral would be excessively far-reaching. In case of conservative valuation and demanding qualitative criteria, particularly real estate constitutes (in line with the supervisory requirements) sound and stable value collateral allowing easy liquidation in the case of client failure. We are strongly convinced that the consideration of this form of collateral under the large exposures regime remains justified and (provided strict requirements are met) that it is also adequately risk sensitive. The Basel rules themselves envisage such stringent requirements for commercial real estate financing, under the condition that they are privileged for solvency purposes. Consequently and in line with this approach, only real estate will be acceptable collateral if it pertains to markets the stability of which has been confirmed during so-called hard tests (i.e. the collection of maximum loss ratios). Across the whole of Europe, the implementation of this rule will become more stringent: For instance, hard testing will not only be applied to commercial real estate financing but also to residential real estate loans and will also be a decisive criteria for a privileged treatment in the large exposure rules. Furthermore, only certain real estate types will be eligible collateral.

9: The Committee welcomes views on whether the approach proposed for calculating exposure values for trading book positions raises specific issues.

10: The Committee welcomes views on the proposals for offsetting long and short positions, in particular when these positions are in different issues.

11: The Committee welcomes comments on the proposal regarding interbank exposures and in particular in which cases specific exemptions would be warranted.

Large exposure provisions are aiming at diversification and to avoid risk concentration. Applying those limits to decentralized networks of cooperative banks would significantly interfere into the operations of such networks and seriously affect their functioning. The Basel Committee has explicitly acknowledged the stabilizing effects of liquidity systems of cooperative banks in its liquidity rules. Such networks should be granted the same treatment as groups.

Competitiveness will oblige many smaller banks to bundle their excess liquidity in just one other institution. Thus, the stringent application of large exposure limits to smaller institutions will have a negative effect on their competitiveness and favour larger players. Therefore, the Basel standard should leave room for supervisors to address these aspects. In particular, the suggested reduction of the LE-limits to G-SIBs should not be extended to D-SIBs (see para. 133)

In particular competent authorities should have the power to fully or partially exempt exposures incurred by an institution to its parent undertaking, to other subsidiaries of that parent undertaking or to its own subsidiaries, in so far as those undertakings are covered by the supervision on a consolidated basis to which the institution itself is subject.

They should also have the power to exempt and asset items constituting claims on and other exposures, to regional or central credit institutions with which the credit institution is associated in a network in accordance with legal or statutory provisions and which are responsible, under those provisions, for cash-clearing operations within the network.

Moreover, we suggest to consider exemptions for interbank exposures of very small banks:

- Especially for smaller banks where the amount of € 150 million is higher than 25 % of the institution's eligible capital the value of the exposure, after taking into account the effect of credit risk mitigation in accordance with may exceed the 25% limit. From our perspective it would even seems appropriate to even establish an alternative threshold of € 150 Mio (limited to 100% of the institution's eligible capital).

- It would moreover seem appropriate to consider a minimum threshold of e.g. € 500.000 (equals 10% of the required initial capital of EUR 5 Mio) for the classification of an exposure as large exposure

12: The Committee welcomes comments on the calibration of the granularity threshold and whether the mandatory application of the look-through approach to the transaction where an underlying exposure may exceed the granularity threshold will raise specific issues.

Depending on how it is calibrated the look-through approach may result in unnecessary burden to banks. We generally agree with the use of a granularity threshold.

Nevertheless, we feel that the proposed granularity threshold (i.e. 1 % of the overall transaction) is far too low. From the risk perspective, such a low threshold does not seem to be justified. De facto, it would mean that banks would have to apply an LTA to almost all transactions. This would be necessary even in cases where, from the point of view of risks, these transactions shall be deemed granular, since they only contribute marginally to a bank's total risk profile. For banks, a look-through approach incurs considerable costs which bear no relation to the banking supervisor's benefit; whilst not limited to, this applies especially to dynamic portfolios which (due to the frequent change of their composition) can make a viable contribution towards risk diversification.

Furthermore, if they are not able to look-through to the respective assets, banks would have to add these exposures from the "unknown client" counterparty. This, however, frequently leads to a situation where the large exposures limit will be fully used for these virtual borrowers and where by result the large exposures threshold will be exceeded.

We therefore propose that a transaction shall be deemed sufficiently granular if the largest exposure amounts to less than 5% of the entire transaction. This threshold has already stood the test of time in the European large exposures regime. It ensures that the look-through will feature an appropriate cost-benefit ratio.

Moreover, the simple aggregation of all unknown exposures to a single amount does not provide a realistic view of concentrations that could be useful to the supervisor. While the exact underlying exposures are unknown, it can be determined whether the exposures are in different regions or to different sectors. We suggest that the institution reports the underlying unknown exposures according to concrete categories.

<u>1. Collective investment undertakings, securitisations and other vehicles</u>

In general we find the proposed approach prudent as a bank should assess investments in transactions where there are exposures to underlying assets. When these underlying risks are material these should be added to the individual large exposures. In fact prudent banks already take such risks (when they are material) into account in the standing risk management procedures.

In general the approach as described is suitable. Nevertheless we should not forget that the large exposure calculation should only be performed in case of "large" exposures. The decision tree as described does not take this into account sufficiently. For example, when a large bank would invest an insignificant amount in a non-granular fund, this bank should perform the analysis leading to a result that after the calculations the large bank will have to add even more insignificant amounts to the LER exposures. We are unsure of the rationale for this.

It would be advisable to dissociate the stipulations on securitization and those on CIUs because they cannot be fully compared.

The proposal aims to include a look through approach for investments in funds. The risk that the bank holds is only the pro rata part of underlying assets, which normally is very small. It would be, for example, in the case of a bank´s own funds, the amount of the corporate bond that the fund holds as investment times the percentage that the seed capital in the fund represents, normally a very small percentage. This is so small that the operational burden of even investigating it is not commensurate with the prudential benefit of adding it to the exposure to the corporate in question.

<u>2. Securitisations</u>

In securitisations, a look through to the assets is not fully warranted given that an investor is not exposed to the pro rata share of the underlying asset because of built in credit enhancement. If the bank invests in a AAA tranche, and the securitisation (e.g. a CLO) holds a loan to corporate X, the bank would only enter into difficulties under a bankruptcy scenario of corporate X if all credit enhancement built in the structure is depleted: the loss on the corporate loan would first be assumed by the (holders of the) subordinated tranches and by excess spread etc; the overall pool performance and credit enhancement determines the ultimate loss. The maximum loss the bank would have on the corporate loan included in the securitisation in case of a bankruptcy of the said corporate from its investment in the super senior securitisation tranche is more likely to be zero.

We understand the requirements to the effect that in passing granularity test according to paragraph 107, the option is to forego a look through and to limit the size of exposures by recognising the fund i.e. SPV as obligor. Conversely, this however, means that if a look through approach is applied, even if the granularity test has passed, there is no need to show an exposure to the fund i.e SPV. Here it would be helpful to put this straight, as the chart on page 20 could lead to a different interpretation.

13: The Committee welcomes comments on the proposals for the treatment of the identified additional risks in the large exposures framework.

14: The Committee welcomes views on the options for the treatment of banks' exposures to CCPs

The CCP landscape is at the moment very much in a transition phase. It is unclear what it will look like in the near future, how many alternatives there will be per market, how large the exposures will be, etc. Much of this will become much clearer in the coming years. As the clearing obligation becomes active new CCPs may be set up and/or the existing ones will enter new markets. As long as it is unclear where these developments will lead, we would suggest that no hard limit is installed that may hinder the efficiency of international finance.

Exposure rules for systemically important banks

We understand the Committee's concern that the interbank exposures between significant financial institutions can cause a "domino effect". However, we find that, taking into consideration the lowering of the eligible capital base, the proposed limit of 10% is too restrictive. We note that interbank exposures will be more regulated through other rules, including the clearing obligation and the additional margining of un-cleared derivatives. Therefore, we believe a higher threshold is more appropriate.

In general, we believe that the effects of the Basel III framework on the stability of the banking system should be assessed first, before adding new requirements for SIFIs. The fundamental idea of Basel III framework was to promote the stability of the global banking system. This was further addressed through SIFI-buffer requirements. Moreover, the additional rules on global systemically important banks could later be extended to other systemically important banks (i.e. domestic systematically important banks). This could pose significant additional burden and is expected to have a direct impact to GDP growth.