BNPP comments on BCBS consultative document on supervisory framework for measuring and controlling Large Exposure

- BNPP understands that BCBS intends to harmonize the supervisory framework for measuring and controlling large exposures (LE). Indeed since the last BCBS supervisory guidance in 1991 ("Core principles for effective banking supervision"), LE framework has been implemented by most of countries with some variations across banks. BNPP, fully supportive of single rule book within the EU, considers that some harmonization in LE regime is necessary. However, we also believe that most of these variations are quite natural and justified provided that each bank has its own business model, risk appetite and relevant internal processes. That is the reason why under Basel 2, the single name concentration risk has been classified as Pillar II risk fitting into the ICAAP. We believe therefore a principle based approach instead of Pillar 1 type approach would have been more appropriate in LE reform.

- To begin with, BNPP appreciates that BCBS has decided not to introduce a specific limit on intragroup exposures which was fiercely debated in the industry meeting in Jan. 2013 prior to this official consultation. For most banking groups, it is necessary to move capital and liquidity easily within their group in order to appropriately manage risks at a consolidated level. Introducing intragroup limits would have resulted in endorsing the FED proposal on Section 165 of DFA for FBOs which consists in creating capital and liquidity traps through the Intermediary Holding Company requirement. This proposal represents a worrying phenomenon of regulatory balkanisation which contradicts BCBS' harmonisation goal.

- BNPP has been complying with the LE regime for over 10 years within the Capital Requirements Directive framework. Some of the new rules proposed in this consultation such as the definition of connected counterparties in fact seem to be inspired by the CEBS' recommendations in 2009, already adopted as best practice. On the other hand, this document introduces quite a set of stringent measures such as a specific limit between G-SIFIs, a Look-through approach (LTA) with much lower granularity threshold than the CEBS recommendations (1% against 5%), a reduced capital base in conjunction with some rules increasing the exposure value and notably the unknown new CEM for derivatives. Although BCBS proposes an appropriate transitional period up to Jan. 2019, we are concerned that these measures already bring out unintended consequences on banking industry. The main issues identified by BNPP are elaborated below in order of priority.

- **<u>Increased exposure value</u>**

    - **<u>Reduced CRM effect and double counting of credit protection exposures</u>**: for financial collateral, BCBS suggests a "hybrid approach" combining elements of both the haircut-based and the substitution approaches but more prudent than either one. It requires the banks to reduce the original exposure by the post-haircut amount of collateral using the supervisory haircut under standardised approach and also treat the

amount by which the underlying exposure has been reduced due to the existence of collateral as an exposure to the issuer of the collateral in its own right. Where a bank buys credit protection for a reference exposure, the requirement that the bank shift the exposure amount from the counterparty to the credit protection provider entails double counting, in an extremely conservative way, the exposure amount on the counterparty risk and the protection provider. Indeed the underlying assumption of this approach is that all reference issuers who bought the protections from a counterparty default simultaneously with the protection provider itself with zero recovery. This is highly unlikely: a single index CDS might reference hundreds of issuers. The real exposure on the credit protection provider is over all the issuers for which it provides protection, the replacement cost of the protections as well as their potential shift of value over the period of time needed to replace them, i.e. the counterparty credit risk exposure on the credit protection provider. We urge that BCBS clarify that the exposure for a credit derivative position would not be counted twice for LE limit calculation purposes – i.e., just counted as to the derivative and not as a credit risk mitigant. Furthermore, it is to be noted that most of those credit derivative positions are or will be subject in the near future to the clearing obligation, hence artificially inflating the reported exposure on CCPs. Considering complexity of issues and unknown impact, we consider a cost and benefit analysis is necessary before settling on this approach.

- **Use of Current Exposure Method (CEM) and prohibition to use Internal Models Methods (IMM)**: we understand BCBS reservations on using IMM for LE regime provided the controversy based on what the many comparative analysis have revealed on RWA gaps. BCBS underpins CEM as the model risk should have no bearing on exposure values in LE framework as the backstop to the risk-based capital requirements. However, we do not agree to this rationale which fosters more doubts on internal models. BNPP like many other European institutions have made huge investments to implement the IMM approach recommended by Basel 2. The risk sensitive approach with use test was the core principle we have fully adhered to for the last decade. Our internal models are subject to the robust supervisory approval and regular review process. BCBS reservations on IMM are like challenging the competence of national supervisors who have validated our models. If BCBS has particular concerns on the model risk, it should be properly dealt with in its current RWA review. Discarding it only in the LE framework does not make the model risk disappear. The Basel 3 does not question the validity of IMM approach and also introduces the leverage ratio as the backstop. Departure of LE regime from the risk based measures used for regulatory capital obliges banks to implement and maintain another prudential standard. We strongly disagree with the CEM being better suited than IMM to capture peak exposures as stated in §57 of the proposal. Firstly, CEM has not been designed to capture peak exposure but rather CCR exposures. Secondly, internal models could easily be adapted to return peak exposures in lieu of EPE. We urge the BCBS reconsider allowing the use of IMM for the advanced banks. Furthermore, unaware of the quantitative impact of the future "revised" CEM, we are uncomfortable to accept taking it as the target method. As a minimum, we need to have the assurance that the revised CEM does not unduly overstate banks' potential losses from LE purposes.

- **Stricter limit between 10% and 15% for transactions between G-SIBs**

- We urge that the stricter limit between G-SIBs be eliminated from this proposal. G-SIBs are already subject to stricter regulations and heavier compliance burden such as G-SIB capital surcharge and recovery and resolution requirements. As a European bank, BNPP might need to hold other capital buffers in the name of macroprudential risk or systemic risk as prescribed in the new CRD IV and CRR taking effect on 1 January 2014 which can be cumulative to the G-SIB surcharge. On top of all these provisions, BCBS suggests that LE limit applied to a G-SIB's exposure to another G-SIB should be tightened to the level between 10% and 15% of the eligible capital base. This is not only excessive but also duplicative with G-SIB surcharge requirement itself as the interconnectedness put forward as the very rationale for the introduction of this tightened limit serves also as one of the criteria for designation of G-SIBs. Besides lower limits for inter G-SIB transactions might lead to increased exposures to less well managed and less capitalised institutions adding risk to the bank and ultimately jeopardising the financial stability.

- BNPP is also concerned about the unintended knock-on impact that this is likely to have on the real economy. The 10% to 15% of limit is too harsh to abide by especially provided that the interbank transactions among G-SIBs account for the top LEs for most of G-SIBs any ways. This unjustified level of limit apparently aims at reducing the OTC transactions like so many other regulatory proposals since the crisis, i.e. incentivising the central clearing, requiring initial margin for non centrally cleared transactions and lately imposing tax on these transactions etc. Again, we would like to stress that the OTC market is vital to the real economy; it allows economic actors to optimize their capital and secure their investments. While we share the common objective of making it more secure and efficient, we firmly believe that the overdose of regulations for limiting OTC transactions will unduly penalize the way to properly reallocate risk within the economy. Despite all these measures, the OTC market will not disappear. Preventing liquidity drain from this market is the safeguards for financing the real economy.

- **Unworkable LTA**: As previously said, the LTA proposed in this proposal seems to be based on the CEBS's guidance of Dec. 2009. However we note three main gaps that are not quite justified. The first is the reduction of the granularity threshold from 5% to 1% below which LTA requirement is exempted. In our experience, even 5% is not material enough to warrant such an operationally burdensome process. 1% threshold is completely unrealistic and will not improve as BCBS might expect capturing more exposure. It will only inflate the "unknown clients" category upon which the 25% limit will be imposed. Secondly this proposal excludes the structure-based approach which is from our viewpoint quite a sensible recommendation from CEBS[a]. In particular, this approach would allow institutions to exempt all its securitisation structure backed by retail underlyings (RMBS, student loans, credit card,...). Lastly, the proposed framework doesn't recognise the benefit of credit enhancement on securitisation structures. The non recognition of this credit enhancement is penalising since in many cases (for instance ABCP conduits) the credit enhancement is structured to avoid any loss due to the first

[a] The paragraph 74 of the CEBS' guidance stipulates "If an institution can ensure (e.g. by means of a CIU's mandate) that the underlying assets of the scheme are not connected with any other direct or indirect exposure in the institution's portfolio (including other schemes) that is higher than 2% of the institutions own funds, it may treat these schemes as separate unconnected clients."

credit in default and apply a look through approach on exposure to which banks are not exposed on the first default would create undue exposure to group of connected clients or to the unknown client. In particular on securitisation of receivables, bank are aware on an ongoing basis of the credit enhancement and of the single name concentration, the non recognition of this credit enhancement is counter intuitive from a risk perspective and will penalise the financing of corporate. We propose that if BCBS has decided to recommend the LTA according to the CEBS's guidance, it should be thorough and apply the full aspect of it without cherry picking.

- **Reduced eligible capital base**: BCBS asks for views on whether the Tier 1 or CET1 should be the eligible capital base for LE calculations. With this question, BCBS already eliminates the possibility of using the total regulatory capital currently used by most of LE legislations including in the EU. Provided all the measures designed to substantially increase the exposure value, we can predict quite significant scissors effects already with Tier 1 capital. Tier 1 capital is loss absorbing and the quality of capital instruments is supposed to be improved under Basel 3. As a minimum the denominator for LE calculation should not be as strict as CET 1. The CRR in Europe coming into force on Jan. 1 2014 introduces an "eligible capital" replacing the total regulatory capital for LE purposes which recognises a portion of Tier 2 capped at 1/3 of T1 capital. If the total regulatory capital is unacceptable by BCBS, we would like BCBS to consider aligning with the European CRR notion of eligible capital.

- **Limit on Q-CCP**: Part of the G-20 mandated global regulatory reforms is to actively encourage the use of Q-CCPs for OTC derivatives. Imposing a LE limit on Q-CCP is contradicting this political goal. We believe that the Q-CCPs should be exempted from LE framework. Should BCBS retain limits for Q-CCPs, it should be a soft limit only for monitoring purposes. Besides, for exposures to a Q-CCP that lose its qualifying status, a grace period from the application of 25% limit should be granted to let institutions reduce their exposures to that CCP in an orderly manner.