The voice of banking & financial services

British Bankers' Association response to the Basel Committee on Banking Supervision's consultation on Large Exposures[1]

Introduction

The ("BBA") is the leading association for UK banking and financial services, representing members on the full range of UK and international banking issues. It has almost 200 banking members that are active in the UK, which are headquartered in 50 countries and have operations in 180 countries worldwide. All the major banking groups in the UK are members of our association as are large international EU banks, US and Canadian banks operating in the UK and a range of other banks from the Middle East, Africa, South America and Asia, including China. The integrated nature of banking means that our members are engaged in activities, ranging widely across the financial spectrum from deposit taking and other more conventional forms of retail and commercial banking activities to products and services as diverse as trade and project finance, primary and secondary securities trading, insurance, investment banking and wealth management.

All of our members recognise the importance of properly aggregating, managing and mitigating exposures to counterparties, including single counterparties, this consultation paper is relevant to a significant range of BBA member banks. 24 of the 28 bank g-SIFIs are members of the BBA.

Key messages

We have responded to the questions posed in the consultation paper but make the following overarching observations which have informed our approach to answering them.

We support a well contrasted globally applicable Large Exposure regime

Our members manage and mitigate concentration risk for business purposes and calculate and report large exposures (LE) because regulators require them to do so. We recognise the importance to supervisors of understanding banks' significant exposures to their customers - based on the premise that:

'*Owe your banker £1,000 and you are at his mercy; owe him £1 million and the position is reversed*.[2]

[1] http://www.bis.org/publ/bcbs246.pdf

[2] John Maynard Keynes - Overseas Financial Policy in Stage III 1945

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But our members focus for their own risk management purposes on monitoring net exposures in relation to the internal limits that they have established.

Interlinkages –they must be understood but the QIS may not be sufficient

We do not think that the approach proposed by the Basel Committee on Banking Supervision (BCBS) adequately acknowledges the interplay between the different metrics that could be used to define large exposures, particularly the level at which an exposure becomes large and the measure of capital that is used to test it against. Plainly a change in one metric will impact the other - and the cumulative impacts of the proposals - numerator, denominator, stricter methodology, lower G-SIB limits – and their interrelationships should be an important outcome of the QIS, which should also seek to identify adverse consequences on interbank markets and liquidity. This may manifest itself as the placement of larger amount with smaller and lower rated banks, and possible shifts from the interbank placement of surplus funds to increased placements with sovereigns, which we would not see as a healthy development.

But the QIS may only be of limited value, because it is carried out at the consolidated-level only, whereas in our view the proposals will be most impactful at solo level. It also excludes changes to the approach to derivatives, pending its finalisation.

The role of modelling

We are concerned that the tone of the consultation appears to be dismissive of the role of models in calculating, for instance, derivative exposures. Where these have been approved for the purposes of calculating regulatory capital they should continue to be able to be used for LE purposes, recognising that they have been subject to regulatory scrutiny before being implemented.

Whilst the BCBS continues to consider the role of modelling generally there should be no pre-emptive introduction of, for instance, the Current Exposure Method so we do appreciate the Committee's recognition that this should indeed be the case.

G-SIFIs

The consultation's proposal in relation to inter G-SIB limits is duplicative of other already agreed approaches to g-SIFIs, including extra capital buffers, the AVC charge and reporting of top 50 exposures. G-SIBs should be subject the same LE limitations as all other financial institutions. So there is no requirement, in our view to require lower LE limits for G-SIBs.

Requiring exposures to G-SIBs to be subject to more stringent interbank limits will be self-defeating as in times of crisis it is observable that deposits tend to flow to those larger banks that are seen as of higher credit standing.

Similarly requiring smaller banks (which we take to mean any non-G-SIB), as para 133 does, to limit their exposure to G-SIBs will create further dislocation of the interbank market, the return of which is an important component in restoring health to the markets.

Responses to questions

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

We support the Committee's view that the LE framework should be a complement to its risk based capital standards, designed to prevent bank failure as a result of exposures to a single counterparty or group of connected counterparties. We believe, as the Committee does, that this framework should be simple, and act as a prompt to further discussions between the bank and its supervisor. We do not believe, however, that the framework as currently expressed is simple. It is overly focussed on collecting significant amounts of data and at levels of reporting that will provide regulators with a considerable amount of extra information that will require disproportionate analysis and understanding. Some of this is already collected, for instance under the g-SIFI regime, notably the FSB data templates for G-SIBs, raising the possibility of duplication.

A more pragmatic approach would be based on higher reporting thresholds – perhaps the 10% of capital approach with which BBA members are familiar – to ensure that only the largest and most pertinent exposures are captured. The Committee's proposal of a 5% reporting threshold will significantly increase the number of exposures reported - as we expect the QIS will show – but will also require banks to monitor those which are approaching 5%, meaning that an even greater number of exposures must be tracked for little added business or regulatory value other than reassurance that all exposures above the 5% + hurdle are actually being reported upon.

A 10% reporting limit is still sufficiently well below the 25% exposure limit for it still to be relevant and useful to the bank and its supervisors.

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

We agree with the assessment criteria of connectedness between two or more natural or legal persons based on a 50% test supplemented by the criteria described in paragraph 32.

However the identification of connectedness based on economic interdependence is more problematic and has proved not to be easy in Europe where a similar requirement has existed since 2007.

Banks already have processes in place which seek to identify economic interdependence for instance in relation to key markets, customers or suppliers or financing sources. These portfolio concentration factors will be assessed by product or asset type, including collateral taken or given, industry sector and geography in order to manage bottom up risk concentrations through product/portfolio limit setting that will also take into account reputational and liquidity risk factors. This is augmented by a top down approach that seeks to limit earning volatility on the basis that excess concentrations will generate higher volatility in periods of stress. But these processes do depend on a degree of subjectivity and expert judgement being deployed to make up for a lack of hard information on, for instance, supplier/customer relationships or funding sources.

A preferable alternative to the list of 'economic interdependence' criteria in paragraph 34 would in our view be a requirement that banks have suitable systems and controls supported by an

appropriate governance framework to identify sources of interconnectedness and this is the approach we recommend.

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

We believe that the limit should be based on a wider approach to an institution's capital rather than just its core equity tier 1 (CET1) capital. This should include those contingent capital instruments that can be viewed as CET1-like because of the operation of their trigger mechanisms. We take this view as LE limits are a going concern approach measure which should be supported by the totality of an institution's potential going concern capital. It should be noted that the loss absorbing capacity of Tier 1 capital has been significantly improved as a consequence of the Basel III revisions and a significant proportion of this will anyway be required to be CET1 once Basel III is fully implemented.

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.

Advanced modelling approaches, when coupled with credit mitigation techniques, are widely used within many of our member banks and subject to close scrutiny by the regulator before they can be used for risk weighted asset and regulatory capital calculation purposes.

We therefore urge the Committee's to permit the calculation of exposure values for LE purposes based on existing Pillar 1 regulatory capital modelling techniques that have received proper supervisory approval.

We are of course aware that banks' use of advanced modelling is being examined by the Basel Committee and assume that amendments, if any, to the current Pillar 1 regime would be reflected in the calculation of exposure values for LE purposes. This would preserve the proper alignment of the two metrics and avoid our members running and maintaining two calculation methodologies in parallel, which would be both expensive and fail the 'use test' as banks would have to adopt exposure measurement approaches that differ from those currently used in risk management and regulatory capital reporting, solely for large exposure reporting. This has unhelpful implications for an institution's oversight/assurance processes.

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

We welcome the Committee's recognition that in the interim, whilst an alternative to the Current Exposure Method (CEM) is being developed, our members will continue to be able to use Internal Model Methodologies (IMM). Indeed until we are able to form an assessment of any alternative to the CEM our instinct is for the continued use of the IMM in the LE regime as in our view they provide a better assessment of OTC derivative exposure value and are furthermore subject to supervisory approval before they can be used. It may be that a suitable compromise would be the continued use of IMM approaches but calculated to more conservative confidence levels.

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.

We do not support the deviation from risk-based capital approaches which allow banks with the necessary regulatory approval to their own estimates of haircuts or an IMM approach.

Imposing supervisory haircuts on the comprehensive approach will in our view introduce unwarranted levels of conservatism.

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

We broadly agree with the proposition that a 100% CCF should be applied to 'traditional' off balance sheet items, but where Basel II permits lesser CCFs these should be applied. And we welcome the Committee's proposed application of the 20/50/100 risk based regime to CCFs arising from trade finance transactions as this recognises the importance, and relative lack of risk that such activities pose.

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

We have no comment on this question.

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

We have no comment on this question

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

We have no comment on this question

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

We welcome the Committee's proposed exemption of intraday and overnight exposures from the LE regime but think there would be additional merit in exempting all forms of short-term interbank exposures relating to money transmission, payment services, clearing, settlement, custody services, and correspondent banking from large exposure reporting and limits, to avoid disruptions to market liquidity.

In Europe, where the LE regime applies to all banks, small as well as large, an alternative to the 25% limit has been introduced which caps interbank exposures at the greater of €150 million or 25% of capital.. Without this exemption smaller banks would have been prevented from placing large deposits with large banks, as they tend to do, with the result that they would have been spread more widely resulting in:

- Greater operational risk
- The use of interbank counter-parties with a lower credit rating
- the splitting of deposits into smaller amounts, resulting in a lower return on their deposits will be received

We would welcome the introduction of a similarly flexible approach to accommodate our smaller bank members in the Committee's proposed supervisory framework.

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.

Noting the misalignment between the BCBS proposals and the recent draft Technical Standards released by the EBA (on Article 379 of CRR), the BCBS is encouraged to consider increasing the granularity threshold for determining where the 'look through approach' must be applied, in order to balance the effectiveness of the proposals and the burden imposed by such requirements. We note that the 'look through approach' for securitisations fails to recognise credit enhancements and hence the disclosure of any exposures based on the underlying assets will overstate potential losses.

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

As we have noted above in Europe it has proved difficult to assess additional risks arising because of third party involvement in a transaction which could give rise to a common risk factor. Therefore requiring the inclusion of such additional risks factors will result in inconsistencies that will make it difficult for one institution to be compared objectively with another and is, frankly, seeking an over-engineered solution. We very much encourage the BCBS to stick to its overriding objective of simplicity and recognise that these are the sorts of issues that can be best addressed through a Pillar 2 approach.

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

The consultation rightly acknowledges the inherent conflict between applying an LE regime to CCPs and the stated G-20 recommendation that all standardised derivative products should be cleared through a central counterparty in order to mitigate systemic risk.

We therefore favour the second option, if one is to be applied at all, which exempts qualifying CCPs from any hard Pillar 1 limit based on a calculation methodology that follows the risk based capital requirement rules. However our preferred approach would be for national supervisors to consider the fundamental questions of CCP supervision, risk management and resolution.

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