Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

- Submitted via email: baselcommittee@bis.org

28 June 2013

EAPB comments on the Basel Committee on Banking Supervision consultation for a supervisory framework for measuring and controlling large exposures

Dear Madam or Sir,

The EAPB welcomes the opportunity to participate in the Basel Committee on Banking Supervision discussion concerning a proposed new standard that aims to ensure greater consistency in the way banks and supervisors measure, aggregate and control exposures to single counterparties.

General comments

The EAPB would like to note that the Committee's proposals are explicitly geared towards internationally active banks. However it appears to be quite likely that national supervisors will extend the regulatory scope to all type of banks. We therefore would like to put forward the comments and concerns of public sector banks.

Surprisingly, the Consultation Paper remains silent on the treatment of intragroup exposures. The EAPB would like to stress the need for a free flow of capital and liquidity within a banking group. Any restriction would have negative repercussions for liquidity management and capital management within a banking group. Hence, we consider the exemption of these exposures from the large exposure limits as justified and necessary.

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Specific comments

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

Point 22 – 25 Definition of large exposure

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 exposure is set at 10% of the eligible capital. In our view, a 50% reduction of this limit is inacceptable. The 10% limit has proven its appropriateness over time. The current proposal seeks to lower this threshold defining a large exposure. This 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 – in the absence of any justification by any meaningful improvement in the information for supervisors. A higher number of reports are already being triggered due to the fact that the reference to Tier1 or CET1 has changed 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% fits the purpose of an early warning indicator for supervisors as well as for the internal monitoring of risk concentrations.

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

Point 26 – 36 Definition of connected counterparties

The proposed rules for defining groups of connected clients or counterparties are based on the requirements that are already in force in the European Union. The EAPB points out that a consistent view of economic dependencies involves a major degree of subjectivity and discretion which ultimately leads to a certain degree of complexity for implementation.

Under point 32, the Basel Committee suggests a series of indicators for the identification of connected clients. At the same time, the proposals set out that a bank should refer to criteria specified in appropriate international accounting standards for further qualitatively based guidance when determining control. We are of the opinion that the definition of "control" should not be based on accounting rules but rather on stock corporation or company law.

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The Basel Committee expects an in-depth review of potential economic connectedness if the aggregate loans of the respective counterparties would probably reach the limit defining large exposures, i.e. 5% of eligible capital (point 36). On principle, we welcome the introduction of a limit facilitating an in-depth review of economic connectedness. However, we feel that the proposal under point 36 is unfeasible. Also, the term “set of counterparties” should be clarified. This raises the question in which way it should be assessed whether loans to different borrowers which may potentially be aggregated, will reach the large exposure limit in the absence of an in-depth review (circular argument).

A centralised database that contains group structures would be helpful to reduce the administrative burden. Also, the requirements mentioned in paragraph 32 may not always be available or very hard to find out.

The EAPB consequently suggests a predication on the respective loan exposure of a single borrower as more suitable: Under such an approach, if the individual loan to a borrower exceeded a limit (the level which ought to be agreed) there should be an in-depth review for economic connectedness. In such a case, the 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.

Point 37 – 44 Large exposure limit / capital measure

The EAPB welcomes the decision of the Basel Committee to retain the large exposure limit of 25% which is deemed to fulfil its purpose. Regarding the definition of the level of eligible capital for the large exposure limits, the Committee intends to focus exclusively on Common Equity Tier 1 (CET 1) or Tier 1 capital (point 43). This is a quite severe change compared to the status quo. The rationale for ignoring Tier 2 capital when it comes to defining the large exposure limits is not quite accessible to us. The qualitative requirements with regard to the capital instruments already became more demanding in the wake of the revised capital definition under Basel III. Therefore, the capital available for loss absorption purposes will clearly be of “better" quality. Corporate lendings would certainly see a drop if Tier 2 capital components were dropped completely.

The Basel Committee’s going concern assumption is certainly plausible as a reason for the make-up of eligible capital. However it is questionable whether the entire capital stock must consist of going concern capital. In our view, it is appropriate to take Tier 2 capital instruments into account, too. For instance in Europe, the eligible capital will consist of Tier 1 and Tier 2 capital with a share of Tier 2 capital that is limited to one third of the Tier 1 capital. If the Committee insists to consider Tier 1 capital only as relevant capital, there

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would be a need to increase the large exposure limits accordingly. The necessary level should be reviewed in the framework of the QIS.

As mentioned already in the beginning, the Committee proposals are explicitly geared towards internationally active banks. Nevertheless, particularily in the interbanking market, the 25% limit is met fairly quickly. In order to ensure continued funding also by special public sector institutions, we feel that maintaining a special limit of EUR150 million or, moreover, 100% of eligible capital would be appropriate. This is similar to the current European requirements for larges exposures.

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

In general, off-balance sheet transactions should be taken into account in the large exposure limit with a credit conversion factor of 100%. Certain exemptions, applicable to the standardised approach to credit risk (20% and 50%) should also apply to large exposures (point 66).

We advocate in favour of a solution where undrawn credit facilities with an original maturity of one year (maximum), which cannot be cancelled at any time in an unconditional manner and without prior notice or where a deterioration of the borrower's creditworthiness does not automatically lead to a cancellation, should only be subject to a 50% deduction from the exposure limits of their assessment basis.

From the Basel Committee's point of view, the items featuring a 10% CCF for the leverage ratio are from a macro perspective irrelevant. For the micro assessment level of an individual bank this appears to be different. Depending on the business context, these lines that have been approved but which are callable at any point in time may account for a considerable amount. A reduced weighting (perhaps even a zero weighting) is vital. It appears inappropriate to merely look at loans in the context of genuine funding transactions thus ignoring lines for raising liquidity, for settling payment transactions as well as for securities transactions. These lines require an explicit regulation.

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

Point 67-76 Credit risk mitigation techniques

Banks which, for the purposes of their risk-based capital requirements, use the substitution approach for the calculation of the risk mitigation should also adopt this approach for large exposures purposes (point 69). On the other hand, banks which apply the comprehensive

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method to financial collateral should use a so-called "hybrid method" for large exposures purposes, i.e. a combination of the comprehensive and the simple method (point 71).

From our point of view, the proposed hybrid approach constitutes an excessively conservative approach. To date, for instance in Europe, the risk mitigation techniques could generally be broken down into either simple and advanced methods. The comprehensive method should also be permissible for large exposures purposes. In order to be eligible for the latter, banks have to meet a number of additional preconditions including, for instance, the implementation of stress tests or putting in place strategies in order to manage risk concentrations. Within the comprehensive method, the application of haircuts (either imposed by the supervisor or calculated internally) should ensure that market or credit risk induced value changes in the field of financial collateral are sufficiently taken into account. Based on the foregoing, a simultaneous consideration of haircuts together with an additional deduction of the value of the collateral to the credit risk mitigation provider leads to a double backing of the probability of default (PD). The EAPB considers this as inappropriate. We are in favour of a solution where banks can freely decide whether they chose a substitution approach or a comprehensive approach for risk mitigation purposes.

However, no additional substitution should take place under the comprehensive method. In practice, a mandatory substitution to the issuer of financial collateral would become a significant burden for the implementation of reverse repo transactions and securities lending transactions.

Point 74 Physical Collateral

We hold the view that a complete ban on the recognition of physical collateral is inadequate. In the event of a conservative valuation and provided demanding qualitative criteria are met, particularly real estate constitutes (in line with the supervisory requirements) sound and stable value collateral which will be realisable in case of a client's default. The EAPB is of the opinion that this form of collateral remains justified in the large exposures regime and provided strict requirements are met, 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). Hard tests are also applied to residential real estate loans and experiences with it for instance in Germany went fairly well. We therefore support the recognition of both commercial as well as residential real estate as collateral in the large exposure regime as long as the respective hard tests are fulfilled.

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In case of a ban on the eligibility of real estate collateral, changes in the funding structures will be the result. For instance, it could become impossible for third party to participate in a syndication of high volume real estate financing transactions or, moreover, infrastructure projects due to the fact that the exposure volume would require full recognition in a first step. Only very large banks would be able to take on this role. This would result in a concentration of risk with certain market stakeholders. Also smaller banks would quickly meet their limits during real estate financing transactions. Given the plans to restrict eligible capital to Tier 1 (potentially even to CET1), the potential ineligibility of real estate collateral would seriously restrict lending decisions.

The EAPB supports an expansion of the scope rather than a limitation of recognition of physical collateral in the forthcoming proposals.

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

B. Interbank exposures

In principle, interbank exposures should be treated the same way as it is applied to any other exposure to third party meaning that they should be fully taken into account for the large exposures limit (point 99). However there should be exceptions for intraday interbank exposures and certain overnight interbank exposures (point 101). We welcome the proposed derogation for such exposures. Payment transactions and securities settlement transactions are predestined for such privileged treatment.

The EAPB also strongly advocates for an exemption of development loans by development banks that are extended through partnership banks. Development banks extend their loans to ultimate borrowers on a non-competitive basis according to a so-called “housebank principle” via a limited number of banks. During this process, the partnership bank will regularly become a borrower. Consequently, so-called interbanking loans will be created. Counting these interbank exposures fully towards the large exposure limits would endanger the public development mandate of development banks in a fundamental manner. Particularly development banks which only use a limited amount of partnership banks in order to extend their loans would quickly exceed their respective large exposure limit.

Furthermore, asset items constituting claims on and other exposures to institutions, provided that those exposures do not constitute such institutions’ own funds and do not last longer than the following business day should be also exempted from the large exposure regime. The rationale behind this proposal is for public banks that in certain periods they receive large amounts of cash as collateral for derivative exposures (e.g. USD and EUR) and

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the cash is deposited with commercial banks. To reduce operational risk a limited number of counterparties are chosen for these short exposures and in terms of credit risk, a preference exists for having the whole deposit in one's main bank.

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

In order to assure whether the underlying assets of a transaction and other borrowers feature dependencies, banks are generally requested to apply a look-through approach (LTA) to the underlying assets and to assign these assets to the respective borrowers or, moreover, groups of connected clients (points 105 and 110). A look-through may be waived if the transaction is sufficiently granular (point 107 ff.). In this case, only the overall transaction will have to be taken into account as a borrower (points 108 and 120).

The provisions for funds, securitisations and similar transactions are based on the current European requirements. However, the Basel framework envisages derogations which require numerous banks to exert a far greater effort when identifying the relevant counterparties.

The EAPB in general welcomes the introduction of a *de minimis* rule for granular portfolios. Nevertheless, the proposed granularity threshold (i.e. 1 % of the overall transaction) is far too low. From risk's point of view, such a low threshold is unwarranted. It would mean that banks would have to apply an LTA to almost all transactions. This would even necessary for cases where, from a risk's point of view, 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 are in no relation to the banking supervisor's benefit. This applies especially to dynamic portfolios which (due to the frequent change of their composition) can make a viable contribution towards risk diversification.

In case the look-through approach is not applied to the respective assets, banks would have to deduct these exposures from the "unknown client" counterparty. Consequently this could to a situation where the large exposures limit will be fully used for these virtual borrowers and where the large exposures threshold will be exceeded as a result of this.

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 is already applied in the European large exposures regime. It ensures that the look-through will feature an appropriate cost-benefit ratio. Additionally, we suggest an alternative granularity threshold of 0.5% of eligible capital. The value is based on the product of the reporting threshold for large exposures (i.e. 10%) and the granularity threshold for transactions (i.e. 5%).

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At the same time, also "partial" granularity of the transactions should be taken into account. There should be a waiver for counting the intransparent assets under the item "unknown client" if a bank can identify a number of borrowers and if it is capable of simultaneously ensuring a sufficient granularity of the other unknown borrowers in the transaction.

The EAPB also supports the application of a so-called "structure based" approach. It should be possible to waive the look-through and counting towards the item "unknown client" if a bank (e.g. based on an investment firm's issuance information) is capable of ensuring that the transaction's underlying assets are not connected to any direct or indirect counterparty default risks in a bank's portfolio which amount to more than 2% of the eligible capital. In this case, it should be possible to consider the transaction as a borrower.

Also a materiality threshold should be introduced, that makes it possible within a transaction to waive a look-through to further items. This threshold is, for instance, relevant with regard to funds in funds transactions (umbrella funds). It could be somewhere between 1.25 - 2% of the transaction's total volume. A further look-through would involve considerable administrative effort for banks, whilst from the aggregated risk's point of view, the remaining items will be of secondary importance.

Trading book transactions generally feature a short holding period. If it is foreseeable that these do not constitute a relevant risk concentration, in many cases it would be inappropriate to identify every individual counterparty in detail by means of a comprehensive and time consuming review. Hence, the trading book items should be entirely exempted from the look-through requirement. However, it should be possible for trading account transactions to optionally apply alternative approaches. For instance, it would be possible to envisage a look-trough only for products where the exposure of which exceeds certain threshold levels or if the utilisation of the "unknown client" already exceeds 50%.

The Basel Committee suggests that a bank shall also assess additional risks. To our understanding the Basel Committee proposes for these purposes in points 115-119 that all parties involved should be screened with a view to potential risk factors.

The EAPB finds this proposal too difficult and too costly. Screening all parties involved concerning their risk factors is inconsistent with the rationale underlying the large exposures framework, i.e. limiting concentration risk. Treatment of risks such as fraud should either remain subject to regulatory capital requirements for operational risks or it should be addressed under pillar II.

Our preliminary understanding of the provisions of points 106, 107 and 120 mean that - provided the granularity test specified under point 107 has been passed, there shall be the possibility to waive a look-through and, in return, to apply point 120 as a risk mitigating

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measure. Equally, this means that even if the granularity test has been passed and when applying the look-through there is e.g. the right to refrain from reporting an exposure to the SPV in the event of a securitisation. The precise meaning of the wording in the aforementioned points is sufficiently clear and further elaborations are necessary. One might assume that a look-through was no longer necessary once the granularity test has been passed and that thus point 120 would be applicable.

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

The EAPB strongly advocates in favour of option number two for the treatment of banks' exposures to CCPs, meaning that these exposures will not have to be deducted from large exposure limits and are only subject to reporting requirement. (point 125). In the future banks will have to settle their standardised derivatives transactions through a central counterparty. This statutory contracting obligation shall not lead to a situation where a potentially imminent danger of exceeding the large exposure thresholds will induce banks to refrain from specific credit protection transactions. In line with the privileged treatment in the own funds regime, it is vital that exposures to central counterparties will not count towards the large exposure limits.

For the purposes of the regulatory capital requirements, certain transactions with clearing members shall be treated in the same way as transactions with central counterparties. Under the current proposals, the Basel Committee suggests that this treatment should similarly be adopted under the large exposures framework. The EAPB explicitly welcome this synchronised approach. A lot of banks do not process their derivatives transactions directly with a central counterparty but they clear indirectly via a clearing member.

Large exposure rules for systemically relevant banks

EAPB members see future different large exposure limits for systemically important banks with concern. The higher regulatory capital requirements for systemically relevant banks already strengthen the loss absorption capacity of systemically important banks. Currently, there is no need for a tighter large exposures limit concerning exposures to systemically important banks.

A separate limit for systemically important banks is not coherent with the original intention of the regulatory framework, i.e. limiting the maximum loss in the event of a counterparty default. Having such purpose in mind, the question whether the counterparty is a

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systemically relevant financial institution or a bank that is not systemically important, becomes irrelevant.

Grandfathering provisions

Member States shall implement the large exposures framework by 1 January 2019. There shall be no grandfathering arrangements (point 136). Given the fact that the proposed rules are complex and comprehensive, banks should be allowed to have gradual phasing-in period.

In case of questions or comments, please do not hesitate to contact us.

Best regards,

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The European Association of Public Banks (EAPB) represents the interests of 36 public banks, funding agencies and associations of public banks throughout Europe, which together represent some 100 public financial institutions. The latter have a combined balance sheet total of about EUR 3,500 billion and represent about 190,000 employees, i.e. covering a European market share of approximately 15%.

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