POSITION PAPER

The ESBG's response to the BCBS' Consultative Document "Supervisory framework for measuring and controlling large exposures"

WSBI-ESBG (World Savings Banks Institute – European Savings Banks Group)

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<u>Question 1:</u> The Committee welcomes views on the proposed definition of large exposures and on the proposal for reporting.

- <u>Scope and level of application (point 13-17)</u>

Point 13 sets out that the Basel framework is geared towards internationally active banks. Notwithstanding the foregoing, member countries are entitled to set more stringent standards.

We have concerns regarding this approach. Our reservations are based on two reasons. First, more often than not, at least in the European Union, it is common market practice that the requirements of the Committee will undergo a comprehensive implementation and that their scope of application will cover all banks, meaning that even small- and medium-sized institutions primarily focusing on domestic operations will be affected by the forthcoming provisions. The latter will have a strong impact especially on smaller banks resulting in more restrictive lending decisions by these banks, especially because of the aggregate impact of lowering the large exposures definition limit from 10% to 5% of eligible capital, the limitation of eligible capital to Tier 1 Capital, potentially even to CET1, as well as the fact that the use of real estate collateral would no longer be an option.

Secondly, the feasibility of a level playing field becomes highly unlikely if the stringency with which national supervisors implement the provisions varies between individual jurisdictions. Hence, we would welcome it if the provisions for those financial institutions which are at the centre of the Basel Committee's focus were understood as uniform standards featuring no discretion for national authorities to adopt a more restrictive regime.

Point 16 sets out that a bank shall consider all exposures in a group level assessment. It is our understanding that this means that banks are free to exclusively consider those exposures which are relevant under materiality aspects. This part is not sufficiently clear and we would appreciate further elaboration.

- <u>Definition of large exposures (point 22 – 25)</u>

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 – in which the threshold defining a large exposure is set at 10% of liable capital. In our view, a 50% reduction in this limit is inacceptable. The 10% limit has stood the test of time as far as monitoring idiosyncratic risk concentrations is concerned. The current proposals seek 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, with the potentially applicable resolution guidelines as well as with the corresponding reporting obligations, this would trigger a clear inflation of institu-

tional operating expenditure for the necessary logistics – in the absence of any justification in terms of a significant improvement in the information for supervisors. A higher number of reports are already being triggered due to the fact that the reference to Tier 1 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% is fit for the purpose of an early warning indicator for supervisors, as well as for internal monitoring of risk concentrations.

Furthermore, we have difficulties in comprehending the rationale behind a defining limit of 5%. We can only speculate that the reason might have something to do with macroprudential analyses. However, if this were to be the case, we would like to highlight that we feel that the large exposures regime is inappropriate for gathering valid data in order to draw the right conclusions for macroprudential 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 to first of all consider a stocktaking of existing data to prevent from double reporting. We have strong doubts about the meaningfulness of macro-analyses that are based on large exposure reports. This is due to the fact that the level of large exposures which has 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, 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.

Notwithstanding the foregoing, we welcome the fact that the relevant limits are tested with a QIS. In order to obtain a picture that is as complete as possible, along with the involvement of large international financial institutions, the forthcoming impact study does to our knowledge also foresee the participation of a limited number of small- and medium-sized banks which will help to ensure a balanced calibration of the limits.

Under point 25, the Basel Committee essentially sets out that - for the purposes of the large exposures regime - the credit protection provider shall be deemed a borrower. Also the language on the credit risk mitigation techniques (point 69 ff.) sets out that, both under the substitution approach and also under the hybrid approach, there has to be a substitution to the credit risk mitigation provider. This is not sufficiently clear. It should be further elaborated that the credit risk mitigation providers have to be taken into account only in the framework of the actually used credit risk mitigation technique. Any independent requirement beyond this, to recognise each and every collateral perceived as concentration risk towards the credit risk mitigation provider, would provide a clearly exaggerated picture of the probability of default (PD). At the same time, banks would be pushed to turn down collateral. This particularly applies with regards to securities lending and securities repo

transactions.

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

The BCBS asks for views on whether Tier 1 or CET1 should be the eligible capital base for the large exposures calculations. With this question, the BCBS already eliminates the possibility of using the total regulatory capital currently used by most large exposures legislations, including in the EU. Considering that all the new large exposures measures will substantially increase the exposure value, we can predict quite significant scissor 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 III. We strongly favour total regulatory capital as capital base for the large exposures calculation and, at a minimum, Tier 1 capital; CET 1 is too restrictive considering all other measures set out in the large exposures proposal. This would also be in line with the reference chosen by the BCBS for the calculation of the leverage ratio.

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

The final CRR text as approved by the European institutions establishes the following:

> "Article 400 - Exemptions
>
> 1. The following exposures shall be exempted from the application of Article 395(1):
>
> (i) exposures arising from undrawn credit facilities that are classified as low-risk off balance sheet items in Annex I and provided that an agreement has been concluded with the client or group of connected clients under which the facility may be drawn only if it has been ascertained that it will not cause the limit applicable under Article 395(1) to be exceeded;"

This provision was also contained in the CRD III (Directive 2009/111/EC).

The BCBS consultative document proposes to generally apply a 100% CCF. In our opinion, the treatment proposed by the BCBS should be in line with the European legislation mentioned above. For this reason we consider that an exception should be included regarding the exposures with 0% CCF in terms of capital requirements in line with the CRR. For example, this could be the case regarding certain products, such as a credit line subject to the approval of the institution on a case-by-case basis.

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

According to current EU rules on capital adequacy and also in the coming (CRR/CRD IV), it is possible (at national supervisor's discretion) to exempt specific interbank exposures. These possibilities have been used by several EU Member States.

Sweden, e. g., has implemented exemptions for intraday and overnight exposures into national legislation. For Swedish banks exemptions for intraday, overnight and tomorrow next exposures are very important. A restriction of the interbank rules on large exposures would have a large negative impact on the functioning of the Swedish financial system and increase risks in the system.

Sweden is a small currency area with a limited number of large banks. This means that banks that have excess liquidity in Swedish Krona (SEK) must place it overnight with other banks having access to the Central Bank clearing in SEK. As there are only a limited number of banks, overnight deposits in individual banks can be large.

Currently there are only five banks that have access to the Central Bank clearing in SEK. Therefore, all other banks active in SEK place their excess SEK funds on accounts in one of these five clearing banks. The five clearing banks do also for historical reasons diverge in their customer bases, e.g. some banks being more oriented towards the larger enterprises and others more oriented towards households. This means that large cash balances are shifting between the clearing banks during the month due to the customer's payment patterns. E.g. the retail oriented banks receive a lot of cash from the corporate oriented banks at the end of the month when the retail customers receive their salaries, giving the retail oriented banks a surplus that they need to deposit at one of the other SEK clearing banks. This system only functions if there are exceptions for short time interbank large exposures. The other alternative would be that the Central Bank accepts larger volumes of bank deposits in SEK. The latter solution is however likely to have a negative impact on the monetary transmission mechanism

Currently the EU legislation provides exceptions for intraday and overnight exposures. It would however be preferable if also tomorrow next exposures were made exempt. The majority of upcoming payments are known a couple of days in advance. If there was an exemption for tomorrow next exposures, banks would have more room for planning their cash balances in advance, and thereby reduce operational risks.

Additional comments:

1. **Physical collateral (point 74)**

We strongly object the general proposal to deviate from the current framework and to question the eligibility of physical collateral to reduce values for large exposures purposes. A different treatment of physical collateral in the large exposures framework compared to the solvability framework is neither appropriate nor comprehensible, as both frameworks aim at minimising losses. The argument mentioned in Chapter III Section C point 74 on page 14 of the consultation paper "that eligible collateral can only mitigate the risk posed by the sudden failure of a counterparty if it is immediately available and liquid" does not appear to be particularly pertinent, and fails to take account of the fact that institutions have mandatory risk buffers readily available to cushion potential realisation periods of collateral. Those buffers are also available to compensate risks originating from large exposures.

Furthermore the cancellation of the eligibility of real estate collaterals would have a high unfavourable impact on limited-profit housing development companies, which are prominent in several Member States, among them e.g. Austria.

The special features and usefulness of limited-profit housing development companies and limited-profit residential building contractors in Austria

The approximate 190 limited-profit housing development companies in Austria are strictly regulated and under stringent supervision (especially through the "Wohnungsgemeinnützigkeitsgesetz"). Almost every sixth inhabitant of Austria resides in real estate that has been built or is administrated by one of the above mentioned companies. 117 out of 190 of these companies have a loan agreement with a member of the Austrian savings bank sector; and without exception all of them are allocated to high-quality risk classes. There has not been one single experience with a problem loan or a default.

The relation between the savings bank sector and the limited-profit residential building contractors with regard to project financing is complemented by independent private parties that generate a constant cash flow through aggregated cost-covering rental payments, which render the immediate liquidation of collateral unnecessary.

Thanks to the legal provisions governing these companies, a high and sustainable tenancy rate is guaranteed, as there is no room for speculative objects, rather a need for residential accommodation is a legal requirement. Therefore, even in the unlikely event of a default of these companies, the cash-flow would still continuously be generated. This is why the sudden failure of a building contractor in no way implies an immediate stoppage of recovery regarding the specific financed project. In

case the building contractor is legally dissolved, the new property owner is legally bound to existing rental agreements and mortgages.

The initial assumptions of the Basel Committee would therefore not apply to the above mentioned circumstances of this case.

Alternatively, the possibility should be considered to exclude Austrian limited-profit building contractors due to their comprehensive legal supervision and auditing from the scope of this consultation (as in point 97), in the sense that only the reporting requirement should apply.

2. Large exposures rules for global systemically important banks (G-SIBs) (point 131-134)

We urge that the stricter large exposure limit between G-SIBs be eliminated from this proposal. G-SIBs are already subject to stricter regulations and heavier compliance burdens, such as the G-SIB capital surcharge and the recovery and resolution requirements. In the context of the European regulatory framework (CRR and CRD IV) taking effect on 1 January 2014, some European banks might need to hold other capital buffers in the name of macroprudential risk or systemic risk which can be cumulative to the G-SIB surcharge. On top of all these provisions, the BCBS suggests that the large exposure 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 the 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 the designation of G-SIBs. Further sanctioning G-SIB transactions may give an incentive to increase exposures to institutions that are not subject to such stringent rules or more opaque counterparties, creating additional risk to reporting banks and ultimately jeopardising financial stability. In addition, we doubt that the regulation of single name concentration is the appropriate tool to address systemic issues, such as bank interconnectedness.

We are also concerned about the unintended knock-on impact that this is likely to have on the real economy. The 10% to 15% limit is too harsh to be abided, especially provided that interbank transactions among G-SIBs account for the top large exposures for most G-SIBs anyway. This is almost like imposing 10% or 15% limit generally instead of the "unchanged" limit of 25%. This unjustified level of limit apparently aims at reducing OTC transactions like so many other regulatory proposals since the crisis, i.e. incentivising central clearing, requiring initial margin for non-centrally cleared transactions, and lately, imposing a tax on these transactions etc. Again, we would like to stress that the OTC market is vital; it allows economic actors to optimise 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 penalise the way to properly reallocate risk within the economy. Preventing liquidity drain from this market is the safeguard for financing the economy.

3. Exposures to covered bonds

Covered bonds enjoy a special status in the EU legislation as well as under national law in many EU Member States. These exemptions are based on the high quality of the product – there has so far not been any default. According to current EU rules on capital adequacy and also in upcoming legislation (CRR/CRD IV) it is possible (at national supervisor's discretion) to exempt exposures to covered bonds in calculations of large exposures. This exemption was provided due to the high level of security offered by covered bonds, the high quality assets in the cover pool (mortgages with strong eligibility rules and public sector assets), strict compliance with CRD rules and constant national supervision of covered bonds.

The special features and usefulness of covered bonds

Covered bonds are issued in accordance with a special national legislation having some basic features in common. The covered bond legislation usually requires that the holders of the bonds should benefit from a priority claim over a pool of high quality assets (the "Cover Pool") in the event of the issuing institution's bankruptcy. The assets eligible for inclusion in the pool are usually mortgage loans not exceeding special loan to value limits and loans to - or guaranteed by - the national sovereign and in some cases national municipalities, if they fulfil certain requirements guaranteeing the credit quality of their liabilities. According to the typical covered bond legislation the pool of assets must be of a size sufficient to protect the bonds from losses even if the value of the assets falls, i.e. there is a certain degree of overcollateralisation. If the value of the assets in the pool deteriorates the issuer of the bonds is obliged to add additional assets to the pool.

If the issuer goes bankrupt the covered bonds and the cover pool shall be separated from the bankrupt's estate and the bond holders will continue to receive timely payments financed by the cash flow from the cover pool. The assets in the pool will not be available for the other creditors of the issuer until all obligations towards the bond holders are fulfilled. The credit quality of covered bonds is hence significantly higher than on senior unsecured debt issued by the same issuer. This is also reflected in the rating of covered bonds usually being significantly higher than on senior unsecured liabilities issued by the same issuer. For instance, EU covered bonds are in most cases rated AAA, while the rating of senior unsecured debt from the issuing banks usually have lower ratings, in some cases 6 notches below AAA.

Since covered bonds are sheltered by a pool of high quality assets, it can also be discussed to what extent the bond should be regarded as an exposure on the issuer. It is only under very exceptional circumstances that the bond holders will suffer any reduction in coupon or principal due to the liquidation or bankruptcy of the issuer. We are thus of the opinion that exposures to covered bonds should, due to their special features, be exempted from the framework for measuring and controlling large exposures.

In some European countries outside the Euro zone, covered bonds are in addition to government bonds the only highly rated and liquid security that is available in the domestic currency to the extent needed to fulfil the current requirement on liquidity reserves and for fulfilling collateral requirements with assets denominated in the domestic currency.

If the current exemption for covered bonds in the large exposure framework is removed significant volumes of covered bonds, currently held in the liquidity reserve of European banks must be sold. In some countries outside the Euro zone the only alternative asset denominated in the domestic currency will be government bonds, which will become a scarce resource if/when governments are successful in avoiding budget deficits. The other alternative for the affected banks will be to hold a larger part of the liquidity reserve in securities denominated in foreign currencies. This will however create additional risks and complexity since the banks must then also handle the currency risks associated with these securities. This will in particular be problematic for smaller banks, e.g. savings banks, as they are usually not very active in the FX markets.

In smaller currency areas the liquidity in the covered bond market is facilitated by some banks acting as market makers. If the exception for covered bonds was removed from the large exposure, it would be doubtful whether these banks would be able to uphold their market maker roles.

About ESBG (European Savings Banks Group)

ESBG – The European Voice of Savings and Retail Banking

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of over €7,600 billion, non-bank deposits of €3,500 billion and non-bank loans of €4,200 billion (31 December 2011). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. ESBG member banks have reinvested responsibly in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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