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Banking supervision
And Accounting issues Unit
The Director

Paris, June 28th 2013

French Banking Federation comments on the BCBS Consultative Document on BCBS 246 supervisory framework for measuring and controlling large exposures

Dear Sir,

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

The French Banking Federation appreciates the opportunity to share its views on the Consultative Document issued by the Basel Committee on Banking Supervision on Supervisory framework for measuring and controlling large exposures. We understand this consultative paper aims at harmonizing all existing national large exposures frameworks, an objective we support.

However, we draw your attention on several points that are highlighted in the annex. We think using the Current Exposure Method (CEM) instead of Internal Model Method (IMM) could foster doubts on banks internal models. Then applying the Look-Through Approach (LTA) to funds exposures, which is currently already very complex under the European framework, will become totally inapplicable with the proposed granularity threshold.

We also would like to express our deepest concerns regarding the proposal of setting up a limit to G-SIBs exposures. Indeed under the new European regulatory framework, G-SIBs will be required to draw recovery and resolution plans, and to hold additional capital buffers. These measures aim properly at addressing systemic risk, so we think there is no justification to propose other rules.

Mr Wayne BYRES
General Secretary
Secretariat of the Basel Committee
on Banking Supervision
Bank for International Settlements
CH-4002 Basel - Switzerland

You will find in the annex attached our general comments and our responses to the questions raised in the consultative document.

We thank you for your consideration and remain at your disposal for any questions or additional information you might have.

Yours sincerely,

Jean-Paul Caudal

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French Banking Federation comments on consultative document on supervisory framework for measuring and controlling Large Exposures

- French banks welcome the initiative undertaken by the Basel Committee on Banking Supervision (hereafter BCBS) to review and 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 regime has been implemented by most of jurisdictions with variations across banks. In accordance with their support to a single rule book within the EU jurisdiction, French banks agree with BCBS in the need to harmonize the regulatory framework. However, French banks also believe that many 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 as part of a regular bilateral dialogue between the banks and their supervisors.

- In the EU, the LE regime has been a common practice for over 10 years within the Capital Requirements Directive framework. Some of the features proposed in this consultation such as the look through approach (LTA) for CIUs and the definition of connected counterparties in fact seem to stem from the CEBS’ 2009 recommendations , already adopted by most of European institutions. On the other hand, this document introduces quite a number of measures which are much more stringent than any existing legislations currently in force. Although the BCBS plans to perform a QIS before finalising this rule and proposing an appropriate transitional period up to Jan. 2019, we can already anticipate that some of these measures will imply significant impact on banking industry. The main issues identified by French banks are elaborated in the following paragraphs.

- **<u>Stricter limit between 10% and 15% for transactions between G-SIBs</u>**

  - 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. In the context of the European regulatory framework (Capital requirement directive 4 and Capital requirement regulation, hereafter CRD4/CRR) taking effect on 1 January 2014, some French 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, 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. 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, French banks doubt that the regulation of single name concentration is the appropriate tool to address systemic issues such bank interconnectedness.

- French banks are 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 interbank transactions among G-SIBs account for the top LEs for most of G-SIBs any ways. 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 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; 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. Preventing liquidity drain from this market is the safeguards for financing the economy.

- **Increased exposure value**

  - Use of Current Exposure Method (CEM) instead of to Internal Models Methods (IMM): The BCBS favors CEM as the backstop to the risk-based capital requirements, noting that model risk should have no bearing on exposure values in the LE framework. However, we do not agree to this rationale which fosters more doubts on internal models. Some French banks, like many other European institutions, have made huge investments to implement the IMM approach recommended by Basel 2. More risk sensitive approaches combined with use test has been the core principle we have fully adhered to for the last decade. Bank internal models are subject to the robust supervisory approval and regular review process. BCBS reservations on IMM can be interpreted as doubts cast on the competence of national supervisors who have validated bank models. If BCBS has particular concerns on model risks, those concerns should be properly dealt with in the current RWA review. Discarding it only in the LE framework does not make the model risk disappear. Basel 3 does not question the validity of IMM approach and also introduces the leverage ratio as a backstop. Departure of LE regime from the risk based measures used for regulatory capital forces banks to implement and maintain another prudential standard. Further, 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 exposures but rather CCR exposures. Secondly, internal models could easily be adapted to return peak exposures in lieu of EPE. We recommend the BCBS to reconsider the possibility to allow the use of IMM as long as this approach has been validated for regulatory capital. Furthermore, unaware of the exact nature and quantitative impact of the future “revised” CEM, we are uncomfortable with accepting it as the target method. We would also appreciate more clarity on the revised CEM actual calculations, as no detailed information is provided in the consultation paper.

    Besides, for transactions for which required capital is not covered by an approved internal models method, a specific proposal for large exposures framework should be made in replacement of CEM until the revision of the CEM is finalized. Should the BCBS retain this option, this should be the case for listed activity through CCPs undertaken on behalf of clients. Indeed, in such cases, for the measurement of exposures to the clients, CEM is penalizing because it doesn’t enable to measure correctly risk on options and to take into account any potential hedging effects between futures & options

- Reduced credit risk mitigation benefit: 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 banks to reduce the original exposure by the post-haircut amount of collateral using 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. Whereas we admit this approach is conceptually valid given BCBS' concern with capturing the concentration risk to issuers of collateral or providers of credit protection, this hybrid approach is very difficult to implement. A thorough cost-benefit analysis needs to be conducted by the BCBS before settling on this approach. Besides, not permitting any physical collateral as eligible collateral within the LE framework seems unreasonable. Commodities for instance are available and relatively liquid, contrary to what the BCBS seems to assume. Overall, we recommend that the CRM approach be aligned with the approach used for regulatory capital.

- **Reduced eligible capital base**: the BCBS asks for views on whether the Tier 1 or CET1 should be the eligible capital base for LE calculations. With this question, the BCBS already eliminates the possibility of using the total regulatory capital currently used by most of LE legislations including in the EU. Considering that all the new LE measures will substantially increase the exposure value, we can predict quite a 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. We strongly favour total regulatory capital as the capital base for LE calculation and, at a minimum, Tier 1 capital; CET 1 is too restrictive considering all other measures set out in the LE proposal.

- In order to take into account specificities and **constraints of smaller and medium sized banks**, as specified in the European regulatory framework (CRD4/CRR, article 384), it should be added that: *"an institution shall not incur an exposure which exceeds 25 % of its eligible capital or EUR 150 million, whichever is the higher. Where the amount of EUR 150 million is higher than 25 % of the institution's eligible capital, the value of the exposure shall not exceed a reasonable limit in terms of the institution's eligible capital. This limit shall not exceed 100 % of the institution's eligible capital"*. It would allow medium or small sized banks that have largely liquid balances relative to their own funds, to maintain exposure to a same counterparty, subject to concentration risk to a reasonable amount, close to their own funds. It will also allow a better management of risk by preventing dispersion to less well-established institutions.

- **Unworkable LTA approach**: As previously said, the LTA approach proposed in this consultation seems to be highly inspired by the CEBS's guidance of Dec. 2009. However we note two 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 5% is not material enough to warrant such an operationally burdensome process, and is already a very low threshold. So 1% threshold would be 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. 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.". In particular, this approach would allow institutions to exempt all its securitisation structure backed by retail underlyings (RMBS, student loans, credit card,...) In addition, 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 credit in default and apply a look through approach on exposure to which banks are not exposed on the first default and 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 corporates. We propose that the structure-based approach and credit enhancement be recognised, like in the LTA approach set out in the CEBS's guidance.

- **Limit on CCP**: Part of the G-20 mandated global regulatory reforms is to actively encourage the use of CCPs for OTC derivatives. Imposing a LE limit on CCP is in contradiction with this political goal. We believe that the CCPs should be exempted from LE framework. Should BCBS retain limits for CCPs, it should be a soft limit only for monitoring purposes, and based on capital rules for trade exposure calculation on CCP, given on-going work between the IOSCO and the BCBS aiming at creating a regulatory framework for CCPs (please see http://www.bis.org/publ/cpss101.htm).

Definition of a LE

Q01: The Committee welcomes views on the proposed definition of LEs and on the proposal for reporting.

The proposed definition of LEs will increase dramatically the reporting burden for banks. There is a risk that additional information will overwhelm supervisors for very limited value added.

Definition of connected counterparties

Q02: The Committee welcomes views on the criteria proposed for the identification of connected counterparties when they pose a single risk.

No comment

Capital measure – definition of eligible capital

Q03: The Committee welcomes views and quantitative information on whether the limit should be based on CET1 or Tier 1.

As said previously we support total regulatory capital, and at a minimum Tier 1, to avoid severe scissors effects which might result from this reform.

<u>Exposure measure – definition of exposure</u>

Q04: 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 LEs.

As said previously we highly support the use of IMM approach for advanced banks under Basel 2 terms. What is approved by our supervisors for regulatory capital purposes must be also valid for LE calculations. The divergence will only increase compliance cost for banks having to maintain several prudential standards without the expected benefits outweighing the cost.

Q05: The Committee welcomes views on the proposal to calculate exposure value of banks' investments in OTC derivatives.

No comment. We would also appreciate more clarity on the revised CEM actual calculations, as no detailed information is provided in the consultation paper. Please refer to the introductory main text.

Q06: 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 LEs framework.

Again, imposing banks to use supervisory haircuts when their own estimates for haircuts have received formal approval from their local supervisors constitutes a disincentive for internal model enhancement and contradicts the use test paradigm. Banks using own estimates for haircuts would have to handle two sets of haircuts, one for the purpose of counterparty risk capital requirement and one for the purpose of large exposures reporting. The requirement to maintain 2 sets of haircuts will entail significant development for such banks which will be detrimental to enhancement of internal models. Last but not least, Basel 3 introduces stringer rules for the monitoring of IMM counterparty exposures (back-testing of the model, collateral management, stress testing). IMM banks are required to challenge their model and to rely on it in their daily risk management. Imposing to use supervisory haircuts for the sake of large exposures reporting creates in our opinion a regrettable break between capital requirement and risk management.

Q07: The Committee welcomes views on the proposal to generally apply a 100% CCF for "traditional" off-balance sheet commitments.

We urge that LE approach be aligned as closely as possible to the regulatory capital approach.

<u>Recognition of credit risk mitigation techniques</u>

Q08: The Committee welcomes views on the proposed hybrid approach for banks that apply the "comprehensive approach" to financial collaterals.

We are concerned about the operational burden and urge BCBS conduct a costs benefit analysis on this matter.

<u>Calculation of exposure value for trading book positions</u>

Q09: The Committee welcomes views on whether the approach proposed for calculating exposure values for trading book positions raises specific issues.

No comment

Q10: The Committee welcomes views on the proposals for offsetting long and short positions, in particular when these positions are in different issues.

The Committee does not intend to allow offsetting of short positions in the trading books against long positions in the banking book on the ground the 2 books are managed separately. We find this argument doesn't hold as in the event of a counterparty default, short trading positions become gains that effectively offset long banking book positions losses. We thus urge the Committee to reconsider its position with respect to netting between banking book and trading books positions. Moreover, institutions are supposed to comply with the large exposure limit on a daily basis and thus the management intention should not be taken in consideration.

Interbank exposures

Q11: The Committee welcomes comments on the proposal regarding interbank exposures and in particular in which cases specific exemptions would be warranted.

No comment. Please refer to the introductory main text.

Collective investment undertakings, securitisations and other vehicles

Q12: 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.

While we support the LTA approach, we recommend the full aspects of 2009 CEBS' guidance be adopted by BCBS without cherry picking, in particular when some protection is provided by credit enhancement of securitisation. In our view there is no difference with a single name funded guarantee and the protection received through credit enhancement.

Q13: The Committee welcomes comments on the proposals for the treatment of the identified additional risks in the LEs framework.

No comment

Exposures to central counterparties

Q14: The Committee welcomes views on the options for the treatment of banks' exposures to CCPs.

We suggest that CCP should be completely exempted from LE limits to ensure consistency with other OTC regulations incentivising clearing.
Inclusion of CCP within large exposure monitoring framework will have restraining negative effects on transactions volume, especially for institutions mainly based on clearing activities and will introduce a strong dependency on items out of institutions' control, with no possibility to check or challenge outcomes: qualifying status of the CCP, hypothetical capital calculation and its impact on the Default Fund capital charge.

Besides, if risk exposures on central counterparties had to be monitored in large exposures framework, we would opt for the soft limit proposed by BCBS and wish that the treatment of these exposures is aligned with capital requirements:

- Bankruptcy remote deposits on “non-qualifying” central counterparties should be excluded from the scope of large exposures, and not only deposits on “qualifying” CCP ;
- In case where the clearer does not protect the client for any losses due to a default of the central counterparty, client exposures on that CCP should be considered null.

As a fall-back solution, we would opt for the soft limit proposed by BCBS, given on-going work between the IOSCO and the BCBS aiming at creating a regulatory framework for CCPs (please see http://www.bis.org/publ/cpss101.htm).