Comments

BCBS Consultative Document No. 246 "Supervisory framework for measuring and controlling large exposures"

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

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I. General Comments

The German Banking Industry Committee generally welcomes the fact that the Basel Committee based the present proposal on existing and tested and tried processes pertaining to own funds requirements but also to the field of large exposures.

The Committee’s proposals are explicitly geared towards internationally active banks. At the same time, more likely than not, national supervisors will extend the regulatory scope to include smaller banks, too. Hence, it would be judicious to equally take the interests of smaller banks into account.

Under the current proposals, when it comes to the calculation of exposure values, the Committee gives preference to simpler approaches. We are of the opinion that this preference is unwarranted. For the banks concerned, this leads to a divergence between the regulatory capital framework and the large exposures framework. *In lieu* of this, banks should be able to use consistent approaches for both purposes and it should remain within their discretion to choose advanced methods, i.e. internal models for the calculation of the exposure values.

The Consultation Paper remains silent on the treatment of intragroup exposures. Notwithstanding the foregoing, we would like to emphasize our firm belief that there shall and must not be any impediment to the 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.

The Committee’s proposal does not comment on the treatment of Covered Bonds. We want to point out that due to the Liquidity Coverage Ratio requirements Covered Bonds were put into the center of attention of credit institutions worldwide. As Covered Bonds count for the second largest bond market they represent a significant part of the liquidity puffers. The reasons for this preferential treatment are in particular legal requirements specifically designed to determine inter alia the bankruptcy remoteness of the cover pools, the composition of the cover pools with regard to the quality of each cover asset as well as the maximum value and last but not least the special public supervision on the issuer and the cover pools to protect the investor. If the Large Exposure Regime requires credit institutions to add up Covered Bonds held in the liquidity puffers and the exposures incurred to the respective issuer of the Covered Bonds the 25% limit can easily be exceeded because of the small number of issuer. Detrimental impacts on the liquidity puffers could be the consequence. Therefore we assume that the exemption of Covered Bonds from the large exposure limits is appropriate and necessary.

II. Specific comments

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

Point 13 – 17 Scope and level of application

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 over this approach. Our reservations are owed to two reasons. First, more often than not, at least in the European Union it is a common market practice that the requirements of the Committee will see a comprehensive implementation and that their scope of application will cover all banks meaning that even smaller 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 which is owed especially to the limitation of eligible capital to Tier 1 Capital, potentially even to CET 1, 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 a further elaboration.

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 client 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 exposures is set at 10% of eligible capital. In our view, a 50% reduction of this limit is inacceptable. The 10% limit has stood the test of time as far as monitoring of idiosyncratic risk concentrations are 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, 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 Tier1 or CET1 will be 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 purpose as an early warning indicator for supervisors as well as for the 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 be to do with macro prudential 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 macro prudential risks. The large exposure provisions merely serve to limit the client related credit risk. It explicitly refrains from any contemplation of sectoral 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 stock taking on existing data to prevent from double reporting. We have strong doubts over the meaningfulness of macro-analyses that are based on large exposure reports. This is due to the fact that the level of large exposures that have 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 clients.

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 smaller 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 client. 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 elaborated further to the effect 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 any collateral received 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 applies particularly with regard to securities lending and securities repo transactions. If needed, exposures arising through the purchase of credit protection should only be reported, but not be subject to the large exposure limit.

2. The Committee welcomes 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, moreover, counterparties] is based on the requirements in effect within the European Union. Notwithstanding the foregoing, we would like to point out that a true and fair view especially of economic dependencies involves a major degree of subjectivity and discretion on the part of banks meaning that the implementation features a certain degree of complexity.

Under point 32, the Basel Committee suggests a series of indicators for the identification of connected clients. *Inter alia,* the proposals set out that banks are expected to refer to criteria specified in appropriate international accounting standards for further qualitatively based guidance when determining control. From our point of view, the definition of "control” should not be based on accounting rules but rather on stock corporation or company law.

The control criteria developed by international accounting standards are only partly fit for this purpose. This is due to the fact that their conception was informed by other objectives. To name but one example: Under the IFRS, there would be "control” if a company has the right to a majority of opportunities arising within another company and if this does not involve the assumption of any risk (for instance in the event of an exclusive profit sharing agreement without sharing the losses or ABS structures with exclusive participation in the potential benefits without sharing the risks). However, for the supervisor, it is far more relevant to know if and to which extent risks and opportunities are shared.

Consequently, we have major concerns over a predication of the concept clarification of "control” on international accounting rules. Our concerns are also due to the fact that the definition of control may change over time. This change would automatically lead to a certain, slow volatility in the definition of "control” within the meaning of supervisory law. This could potentially erode the supervisory objectives. Furthermore it is worth noting that, in Europe, the IFRS rules are subject to a mandatory endorsement procedure. This means that – whenever IFRS rules referring to the concept of “control” do not see any official endorsement, the definition of “control” used in EU Member States on the one hand and in third countries on the other hand will drift apart further. Besides, it is worth bearing in mind that IFRS and US GAAP are divergent frameworks. In addition to this, the reference to international accounting rules does not offer any practical advantage, either. This is due to the fact that, for instance in

Germany but also in many other countries, only larger, capital market orientated banks have to draw up their group accounts under IFRS. All other companies prepare their group accounts under the local GAAP. As a consequence, even in the diverse countries, there are no accounting standards that are consistently applied across the board when it comes to determining an instance of “control”. Hence, we would welcome a harmonisation using consistent supervisory criteria for defining connected counterparties. In order to ensure a level playing field, when it comes to defining connections between counterparties based on "control", the Basel Committee should therefore develop uniform criteria. This should not be geared by accounting rules but on principles or, moreover, rules based in stock corporation or company law.

In practice, grouping clients on the basis of economic dependencies is frequently associated with a high degree of subjectivity and discretion on the part of banks meaning that the implementation is rather complex. Hence, as far as the identification of a group of connected customers on the basis of economic connectedness is concerned, it should be clearly highlighted that this grouping will only have to take place in those cases where the default of a client will, more likely than not, result in funding or repayment difficulties for the economically dependent party, that jeopardise the latter's going concern and is therefore existing threatening. As far as the qualitative criteria are concerned which the Basel Committee proposes in order to identify whether various clients are economically connected with each other, we suggest double-checking the relevance of the joint funding source in the form of the lending bank itself (point 6 under item 34). It remains unclear why a bank itself should use its own insolvency as a criterion for identifying a certain group of clients. After all, the rationale behind the large exposures regime consists precisely in limiting a bank’s maximum loss in order to avoid the very consequence of the bank becoming insolvent. The connectedness or, moreover, a simultaneous default of the clients can only become relevant once the very consequence which the grouping seeks to prevent (namely the default of the lending bank) has already materialised.

Furthermore, we suggest clarifying that both criteria for identifying connectedness shall not have to be used in a cumulative manner. In addition to this, an economic dependency of clients should not be assumed if the lending bank itself constitutes the clients’ main funding source.

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. Furthermore, the term "set of counterparties” requires a further clarification. Besides, this begs the question in which way it should be assessed whether loans to different clients which may potentially be aggregated, will reach the large exposure limit in the absence of an in-depth review (circular argument).

As a result, we hold the view that a predication on the respective loan exposure of a single client would be more suitable: Under such an approach, if the individual loan to a client exceeded a limit (the level of which ought to be agreed) there should be an in-depth review for economic connectedness. At this juncture, a 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 Basel Committee suggests retaining the large exposure limit of 25%, which is on principle fit for purpose.

However, when defining the level of eligible capital for the large exposure limits, there should be an exclusive focus on Common Equity Tier 1 (CET 1) or the entire Tier 1 capital (point 43). Compared to the *status quo,* this presents a more drastic approach. The rationale for ignoring Tier 2 capital when it comes to defining the large exposure limits is not immediately obvious to us. The qualitative requirements with regard to the capital instruments already became clearly more demanding in the wake of the revised capital definition under Basel III. Now, as a result, the capital available for loss absorption purposes is clearly “better". Corporate lendings would see a clear credit squeeze if supplementary capital components were dropped completely.

Although the Basel Committee’s going concern assumption is essentially plausible as a reason for the make-up of eligible capital, it is nonetheless questionable whether the entire capital stock will have to consist of going concern capital. From our point of view, it is appropriate to take Tier 2 capital instruments into account, too. For instance in Europe, the eligible capital will henceforth be comprised of Tier 1 and Tier 2 capital (having said this, the share of Tier 2 is limited to one third of the Tier 1 capital). Any potential insistence on an exclusive consideration of Tier 1 as relevant capital by the Committee would result in a compelling need to also increase the large exposure limits accordingly. The necessary level should be reviewed in the framework of the QIS.

The Committee proposals are explicitly geared towards internationally active banks. At the same time, more likely than not, there will be an extension of the regulatory scope to smaller banks by national supervisors. Hence, the interests of those banks should be taken into account. Whilst not limited to, particularly in the interbanking market, the 25% limit is met fairly quickly. In order to ensure continued funding also by smaller 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.

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.

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

We should like to reiterate our earlier point made above, i.e. that we feel that a renunciation to the use of internal models is inappropriate. Instead, it should be within the discretion of banks to choose the most appropriate approach for monitoring concentration risks: This may be internal models but this approach could also consist in methods for market valuation imposed by the supervisor as for example the marking-to-the market method or its successor.

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 feel that the discretion to choose between supervisory approaches and internal models is appropriate also when it comes to calculating the exposures from Securities Financing Transactions (SFT). We particularly advocate in favour of maintaining a synchronised approach when it comes to the treatment of these transactions under the regulatory capital regime.

Notwithstanding the foregoing, we feel that the choice between the application of a simple approach on the one hand or a comprehensive approach for collateral on the other hand is necessary. A limitation to the comprehensive method appears unwarranted. Furthermore the complete implementation of the methods allowed for solvency purposes (including the option of achieving a zero risk-weight under certain circumstances) would be welcome.

The compulsory use of the comprehensive approach would lead to a situation where especially risk mitigating financial investments in the form of reverse repo transactions would incur clearly more stringent requirements and higher expenses exclusively for the purposes of the large exposures regime – whilst for the purposes of solvency, said requirements and expenses would be uncalled for. This is inconsistent and excessively aggravating; whilst not limited to, our caveat applies particularly to smaller banks.

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 for in the large exposure limit with a credit conversion factor of 100%. Certain exceptions, 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 term to maturity of one year (maximum), which cannot be cancelled at any time in an unconditional manner without prior notice or where a deterioration of the client's creditworthiness does not automatically lead to a cancellation, should only see a 50% deduction from the exposure limits of their basis for measurement.

From the Basel Committee's point of view, the items featuring a 10% CCF for the leverage ratio are (from a macro perspective) globally irrelevant. Even if this statement were correct this is by no means necessarily irrelevant for the micro assessment level of an individual bank, i.e. the level that is relevant at this juncture. Depending on the business context, said 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 not only judicious but even paramount. 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. Hence, 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 mitigating effect should also adopt this approach for large exposures purposes (point 69). On the other hand, banks which apply the comprehensive method to financial collateral should use a so-called "hybrid approach“ for large exposures purposes, i.e. a combination of the comprehensive and of 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. Under the comprehensive method, the application of haircuts (either imposed by the supervisor or computed 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 default risk. We hold the view that this is inappropriate. We advocate in favour or a solution where banks shall be free to 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 a financial collateral would become a significant burden for the implementation of reverse repo transactions and securities lending transactions.

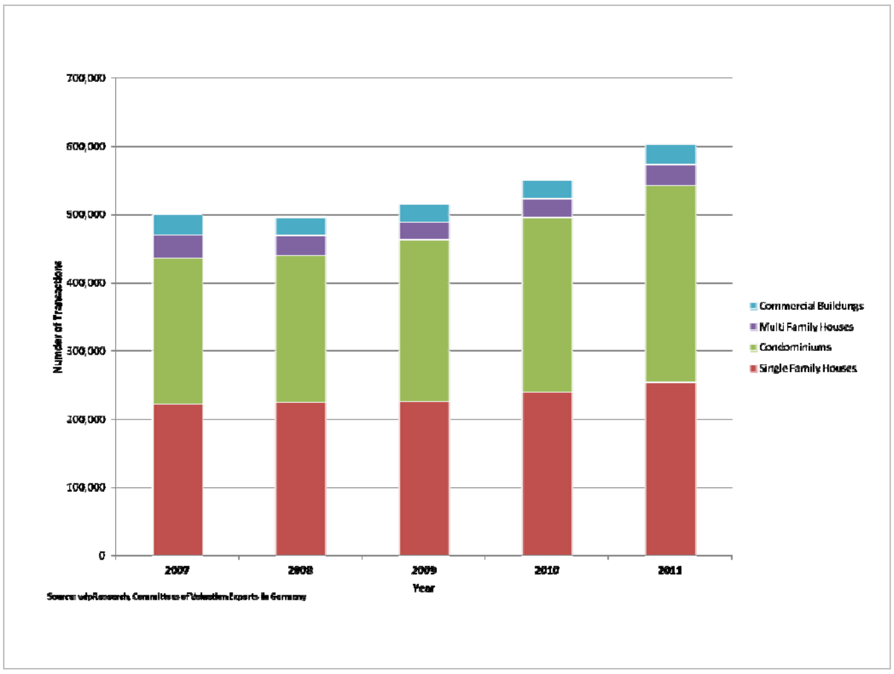
On principle, CRSA-banks as well as most IRBA banks should be granted the option of using the hybrid method. At this juncture, there should be an explicit clarification that the use of the hybrid approach does not involve the need for regular stress tests. Furthermore, it is our understanding that, also in future, a simple substitution approach will remain an option. Here, too, we suggest a corresponding clarification. The freedom of choice should especially be granted when it comes to SFTs (cf. also our presentations under Q6 for a more detailed discussion of this aspect).

For the time being, the Committee sets out that the scope of this Consultation Paper does not include the treatment of banks’ exposures to entities considered as sovereigns. Notwithstanding the foregoing (and without prejudice to the large exposures regime) we would like to point out that there is a fundamental need for adjustment in terms of collateral. From our point of view, counterparties featuring the same default risk in terms of solvency should also receive equal treatment in terms of the risk-mitigating impact. Also in terms of risk-mitigation, local or regional public entities the weight of which (in line with the rules) is *on a par* with that of central governments should receive equal treatment. Whilst, in order to achieve this, in terms of risk-protection, the prime objective should be an instrument rating, regarding privileged counterparties (central governments, other public entities, international organisations and MDBs) and in the absence of an instrument rating it should be possible to revert to an issuer rating (potentially, in the event of local or regional entities in the second stage it should be possible to revert to the rating of the central government).

Point 74 Physical Collateral

We hold the view that a complete ban on the recognition of physical collateral is excessively far-reaching. A long tradition of loans secured by mortgages on commercial or residential property can be seen particularly in Germany. Loans to small and medium sized entities are typically secured by business premises. In addition, if a conservative valuation is applied and demanding qualitative criteria in line with the supervisory requirements are met, residential and commercial real estate constitutes sound and stable value collateral which will be realisable should there be a client’s default. On the basis of real property transactions liquidity in German real estate markets increased since 2007 considerably.

The analyses of vdpResearch based on market surveys of regional committees of valuation experts provide evidence[1].



We feel that the consideration of this form of collateral under the large exposures regime remains justified and (provided strict requirements are met) it 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). Across the whole of Europe, the implementation of this rule will become more stringent: For instance, hard testing will not only be applied to commercial real estate financing but also to residential real estate loans and will also be a decisive criteria for a privileged treatment in the large exposure rules. Furthermore, only certain real estate types will be eligible collateral. In Germany, these hard tests have been carried out since 1988; there has not been a single instance where it was not passed. The stability of the German real estate market is also evidenced in a number of publications[2].

We therefore advocate to recognise 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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[1] Immobilienmarktbericht der Gutachterausschüsse und Oberen Gutachterausschüsse in der Bundesrepublik Deutschland, 2011.

[2] U.a. Henger, Ralph / Voigtländer, Michael: Immobilienfinanzierung nach der Finanzkrise in IW-Analyse, Nr. 73, 2011 (Institut der deutschen Wirtschaft) Köln; Strukturen der Eigenheimfinanzierung in Deutschland 2012 in immobilienmanager • 03-2013.

Apart from this, we would like to point out that a ban on the eligibility of real estate collateral will be accompanied by changes in the funding structures. For instance, for many banks it would become impossible to invite others to participate in a syndication of high volume real estate financing transactions or, moreover, infrastructure projects; this is 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 systemic concentrations. Furthermore, however, also small 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 forthcoming ineligibility of real estate collateral would seriously restrict lending decisions.

Hence, we have difficulties in comprehending the rationale behind the discrimination of a certain type of collateral. As a result, we suggest deleting the respective language from the current proposals. We strongly advocate expanding of the scope for recognition of physical collateral in the forthcoming proposals.

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

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

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

A. Sovereign Exposures and entities connected with sovereigns

Exposures towards multilateral development banks and to entities guaranteed by a central government or multilateral development banks should receive a similar treatment to the one afforded them for the purposes of the solvency regime. Attesting a probability of default of zero to individual multilateral development banks for the purpose of the solvency assessment and denying this PD under the large exposures rule appears unwarranted. By way of analogy, this also holds true for exposures to public entities, regional and local authorities as well as international organisations within the meaning of the Basel framework and exposures guaranteed by them.

B. Interbank exposures

On principle, interbank exposures should be treated the same way that is applied to any other exposures to third parties 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 feature an urgent need for such privileged treatment.

Whilst, from the point of view of a risk assessment (going concern) the equal treatment of interbank exposures seems perfectly understandable at first glance the role which banks play for the national economy should not be ignored in this, either. Deposit taking business and approval of loans are at the core of this function. In terms of the national economy, banks role in this is necessary both in terms of scaling (pooling / denomination) the transactions as well as due to banks’ risk management and risk decoupling, and, in particular, by virtue of their maturity transformation. Furthermore, banks are needed for clearing and settlement of payment transactions and financial market transactions. Depending on the currency, the maturity of the respective money and capital markets as well as depending on the time of the day when liquidity is needed or when a liquidity surplus materialises, interbank exposures at the short end of the money market can neither be prevented nor can they be comprehensively controlled. They are necessary in order to perform all the aforementioned functions without exclusively reverting to central banks for the purpose of settlement of fractions and payments in an attempt to thus avoid unwanted negative repercussions on money supply management and lending to the real economy. Furthermore, depending of the creditworthiness of the counterparties, the number of potential counterparties is rather moderate.

Based on the foregoing, we do feel that the exemption rules for interbank exposures under the European regulatory framework are inadequate. They are only partly incorporated in the Basel Committee’s proposals. Ideally, interbank exposures at the short end of the term to maturity (contractual term to maturity of up to one week) should not be deducted from the large exposures limit. As an addition, further measures, such as higher large exposure limits for interbank exposures, are also required in order to ensure structural liquidity.

The practical experience within the EU proves the following points:

- Any restriction to certain transactions is of limited benefit. This is due to the fact that identifying such transactions in an unambiguous manner is frequently impossible.
- The benefit of a restriction to customer induced exposures is limited. This is due to the fact that the financial settlement generally takes place in combination with own account deals. Hence, technically speaking, a segregation is virtually impossible.
- The limitation to transactions which (in retrospect) did not exceed an actual term to maturity (e.g. "which do not last longer than the following business day") can only be reviewed *ex post,* i.e. at a point in time where it is too late for any intervention. The exemption that is geared towards customer credit and resulting balances with other

banks which are callable at any point in time in a targeted manner (e.g. in order to settle pending transactions) is operationally unfeasible in practice.

Consequently, the limitation to transactions needs to be appropriate and ought to cover the transactions in their entirety. Especially when it comes to exposures resulting from the settlement of (client) securities transactions, the outflow of funds is difficult to manage in the framework of settlements.
Should the client have provided liquidity and if a settlement transaction is pending, the settlement depends on the delivery of the securities by the counterparty. At this point, there can be a delay of several days. In the meantime, the bank is incapable of making reliable arrangements for the excess funds. Similarly, funds may also be withdrawn late in the day. Alternatively, they may arrive late in the day. Yet, it would be virtually impossible for the bank to seek diversification in the market. Hence, unless the term to maturity agreed with the client amounts to more than one working day, the respective correspondent bank will always have to keep enough liquidity in place for such client items. Furthermore, the scope of the exemption rule also has to extend to exposures which result from the mixed use of accounts during the settlement process (at least also from client transactions). Concerning the timing, there needs to be a predication on the agreed term to maturity.

Hence, the following transactions should be subsumed under the regulatory scope of the exemption rules:

- Exposures resulting from foreign exchange transactions during usual clearing and settlement procedures over a period of two business days after making the payment;
- Exposures in securities transactions resulting during usual clearing and settlement procedures during a five business days window of time after the payment has been made or after the securities have been delivered – depending on which one is the earlier date;
- Exposures resulting from the execution of payment transactions including the provisioning of payment services, clearing and the settlement in any currency and the correspondent banking business or the provisioning of services in the context of settlement and custody of financial instruments provided these exposures feature an agreed term to maturity of not more than one business day.

In order to cover interbank exposures from markets that are little developed or, however, “narrow”, the following addition should be added:

- Exposures to banks denominated in non-material trading currencies with an agreed term to maturity of one business day (maximum) shall not be deducted from the upper limit.

Furthermore, there should also be an exemption for development loans by development banks that are extended through key relationship banks. Development banks extend their loans to ultimate clients on a non-competitive basis according to a so-called “key relationship bank principle” via a limited number of banks. During this process, the key relationship bank will

regularly become a client. In other words, so-called interbanking loans will be created. Counting these interbank exposures fully towards the large exposure limits would challenge the public development mandate of development banks in a fundamental manner. Particularly development banks which only use a limited amount of key relationship banks in order to extend their loans would quickly exceed their respective large exposure limit.

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

In order to ascertain whether the underlying assets of a transaction and other clients 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 clients or, moreover, groups of connected customers (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 client (points 108 and 120).

The provisions on 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.

We essentially welcome the introduction of a *de minimis* rule for granular portfolios. Notwithstanding the foregoing, we feel that the proposed granularity threshold (i.e. 1 % of the overall transaction) is far too low. From the point of view of risks, such a low threshold is unwarranted. *De facto,* it would mean that banks would have to apply an LTA to almost all transactions. This would be necessary even in cases where, from the point of view of risks, these 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 bear no relation to the banking supervisor’s benefit; whilst not limited to, this applies especially to dynamic portfolios which (due to the frequent change of their composition) can make a viable contribution towards risk diversification.

Furthermore, if they are not able to look-through to the respective assets, banks would have to count these exposures towards the synthetic address “unknown client”. This, however, frequently leads to a situation where the large exposures limit will be fully used for these virtual clients 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 has already stood the test of time 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%).

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

Furthermore, we propose applying a so-called "structure based” approach. It should also be possible to waive the look-through and counting towards the item "unknown client" if and when the bank (e.g. by virtue of the 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 client.

Furthermore, we suggest introducing a materiality threshold as of which it will be 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. Whilst a further look-through would still involve a considerable administrative effort on the part of banks, from the point of view of aggregate risk, the individual items thus remaining will be of secondary importance. Hence, such a threshold is fit for purpose also from the point of view of the supervisor.

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 exempt from the look-through. In every case, however, alternative approaches should become an option for trading book transactions. At this point, for instance, it would be possible to envisage a look-trough only for products the exposure of which exceeds certain threshold levels or if the utilisation of the "unknown client" already exceeds 50%.

Furthermore, the Basel Committee suggests that, apart from the risks resulting from the underlying assets, 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 Committee gives one example: The risks stemming from the fund manager (e.g. fraud). If and when the bank identifies such risks, it needs to limit the risks from the transaction by allocating the overall transaction as a loan to the respective third party. The bank should even assign the exposure resulting from the investment in the relevant transactions to each of the risk driver, if and when several drivers are identified for the additional risks.

We find this proposal utterly inacceptable. 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 the aforementioned risks as e.g. fraud should either remain subject to regulatory capital requirements for operational risks or it should be addressed under pillar II. In addition to this, for banks, such monitoring would incur disproportionately high expenses in the absence of any benefit for supervisors that would warrant this.
In our preliminary understanding the provisions under points 106, 107 and 120 mean that – provided the granularity test specified under point 107 has been passed, there shall be the right to waive a look-through and, in return, to apply point 120 as a risk mitigating measure (for instance in the event of a securitisation, an exposure to the SPV will have to be recorded and shall have to be limited). Conversely, however, this means that even if and when the granularity test has been passed - when applying the look-through there is the right to refrain from reporting an exposure to the SPV in the event of a securitisation. At this point, we feel that the language is not sufficiently clear. In order to avoid ambiguities, this should be elaborated further. Our reservations are owed to the fact that the chart on page 20 might make readers 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.

For the treatment of exposures to qualified central counterparties, the Basel Committee suggests two options. Under option one, exposures to qualified central counterparties should be counted towards the large exposure limit (point 124). Under the second option, these exposures would be exempted from the large exposure limits. However, banks would still be required to report them to the banking supervisor (point 125).

We strongly advocate in favour of option number two: A waiver for counting exposures to qualified central counterparties (CCP) towards the large exposure limit which, however, should be accompanied by a continued reporting obligation for these transactions. Inevitably, banks have to settle their standardised derivatives transactions through a central counterparty. This statutory contracting obligation shall and must 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 this respect, in line with the privileged treatment under the own funds regime, it is vital that exposures to qualified 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 qualified central counterparties. Under the current proposals, the Basel Committee suggests that this treatment should similarly be adopted under the large exposures framework. We explicitly welcome this synchronised approach. This is a reflection of the fact that a series of banks do not conduct their derivatives transactions directly with a central counterparty. Instead, they adopt an indirect approach and go through a clearing member.

Concerning point 130 it is not sufficiently clear why CCPs that lack a banking licence shall automatically be deemed a “financial institution”. What is more, in our view the Basel framework does not provide a definition of this term. Hence, the last half of the sentence should see a correction to this effect (“corporate”).

Large exposure rules for systemically relevant banks

The Basel Committee suggests a more stringent large exposures limit (between 10% and 15% for lendings between globally systemically important banks (point 132)). At the same time, Member States are invited to define a tighter limit also for exposures to nationally systemically relevant banks. This equally applies to exposures from smaller banks to global systemically important banks and exposures to non-bank G-SIFIs (point 133).

We have major concerns over future different large exposure limits for systemically important banks. The higher regulatory capital requirements for systemically relevant banks already strengthen the loss absorption capacity of systemically important banks. Banks’ resilience during a crisis is further boosted by the regulatory framework for recovery and resolution of banks. Hence, from our point of view there is no need for a tighter large exposures limit concerning exposures to systemically important banks.

Furthermore, a separate limit for systemically important banks is at odds with the underlying rationale of the regulatory framework, i.e. limiting the maximum loss in the event of a counterparty default. If the assumption under the large exposure regime is that a bank can absorb a loss up to the amount of 25% of its eligible capital, the question whether the counterparty is a systemically relevant financial institution or a bank that is not systemically important, becomes academic.

Regardless of this, the exposure limits of G-SIBs to other G-SIBs should be granted additional transitional periods. Otherwise, a G-SIB would have to reduce its exposure to another G-SIB within a very short period of time once the latter newly becomes classified as a G-SIB.

Grandfathering provisions

Member States shall implement the large exposures framework in its entirety by 1 January 2019. There shall be no grandfathering arrangements (point 136). The proposed rules are complex and comprehensive. They translate into considerable burdens for banks. The implementation process within banks places major logistical and technical demands. Hence, in order to allow banks a gradual familiarisation with the new rules there is a need for sufficient transitional periods.