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Association for Financial Markets in Europe

AFME Position Paper

CRD 5/CRR2: Large Exposures Framework

November 2016

Introduction

In the EBA's response, dated 24 October 2016, to the European Commission's call for advice on the review of the large exposures framework makes recommendations to align certain elements of the framework to BCBS standards and to remove three exemptions. This paper comments on some of these recommendations, as well as aspects of the large exposures framework not addressed in the call for advice, but where there are differences with BCBS standards.

In the Commission's consideration of EBA recommendations, due consideration should be given to the gross impact of proposed revisions rather than the impact of each proposed revision in isolation. The gross impact will not necessarily be the sum of the individual parts, but the interaction between proposed revisions may have a compounding effect and impacts / unintended consequences should aim to be avoided. In doing so, special consideration should be given to a consistent and coherent approach to dealing with the application of LE limits at a subsidiary level, where intragroup exposures – if they are not exempted - can be constrained by LE limits which were intended for third parties. This is a function of the wider implementation of the LE framework for CRR firms, which apply at both a solo and consolidated level, whereas the Basel standards were designed to apply to internationally-active banks at a consolidated level only.

Alignment with the BCBS large exposures framework

EBA Recommendation: A lower limit for globally important banks' (G-SIIs) exposures to other G-SIIs (15% of these banks' Tier 1 capital instead of the 25% of banks' Tier 1 capital required for other banks)

G-SIB to G-SIB exposures are limited to 15% of Tier 1 capital within the Basel framework. Currently, the CRR exposure limit does not differ from non G-SIIs and is set at 25% of eligible capital[1]. Alignment to Basel represents a 40% reduction in the limit. We understand that the G-SIB limit prescribed in the Basel LE framework was not intended to be applied to subsidiaries of G-SIBs, to Domestic-Systemically Important Banks (DSIBs), or to the European equivalent defined as Other Systemically Important Institutions (O-SIIs). AFME members would recommend that the forthcoming CRR legislative proposal clarifies that the G-SII limit only applies at a consolidated-level for G-SII to G-SII exposures.

We note further that the EBA's analysis in their report on the LE framework only considered EU G-SII to (EU and non-EU) G-SII exposures at the highest level of consolidation in a Member State. The EBA's conclusion therefore, that a reduction in the large exposures limit for exposures from G-SIIs to other G-SIIs to 15% of Tier

[1] Article 395 of CRR

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1 capital would not have an impact, is only relevant at a consolidated level; we understand this to be the intended implementation of the limit reduction from the following statement made in the report:

> "the EBA stands ready to amend the ITS on supervisory reporting and to clarify for which counterparties within a G-SII banking group this limit should apply, how they would be treated/aggregated, at what level of consolidation it should apply, and how the total exposures should be reflected in the regular large exposures reports".

EBA Recommendation: An exclusion of the use of internal models for exposures to Over The Counter (OTC) derivative transactions (which have to be determined using the recently finalised "standardized approach for measuring exposure at default for counterparty credit risk" (SA-CCR), even for banks which have been authorised to use internal models – IMM – to estimate counterparty credit exposures for assessing risk-weighted assets – RWA).

Under the existing European LE framework, defined in CRD IV, the Internal Model Method (IMM) is permitted[2] to calculate the counterparty credit risk of OTC derivatives where a bank has the permission of its supervisor. However, in the Basel LE framework, finalised in 2014, internal models were excluded from the permitted approaches and replaced with the "Standardized Approach for Counterparty Credit Risk" (SA-CCR).

We continue to support the ability of firms to use validated internal models for calculating exposures – both in the RWA framework and the LE framework. Internal models provide market participants with the most accurate estimate of counterparty risk exposure taking into account the specific risk factors, correlations and volatilities of a firms' exposures to its counterparties. Internal models have better risk capture, properly account for diversification and hedging, and adapt more swiftly to the changing market environment. Despite the improvements of SACCR relative to the existing Mark-to-Market Method (also known as the Current Exposure Method, CEM), standardised methods have unavoidable deficiencies due to the need for simplification. As such, removing the use of internal models from the LE framework will encourage banks to reduce notionals but not necessarily reduce risk.

Although we understand SA-CCR is likely to be adopted in the CRR/CRD through the CRD5/CRR2 proposals, it is unlikely that the Basel 1 January 2017 implementation timeline will be met, either in the EU or in other jurisdictions. Moreover, US Agencies, which have recently re-proposed the Single Counterparty Credit Limit (SCCL) rule to align with Basel's LE framework, have retained the use of IMM within the LE framework because the available standardised approaches were not deemed to be adequate replacements.

In light of international developments since the publication of the final Basel LE rule, we recommend that where firms have been authorised to use IMM for RWA (risk weighted assets), they should also be allowed to use IMM in the LE framework. This would also be consistent with the EBA's recommendation[3] to continue the use of IMM in the large exposure framework for those banks with the requisite permission.

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[2] Article 390 of CRR

[3] EBA Review of the Large Exposures Regime, response to the EC's call for advice, 24 October 2016

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Exemptions to the large exposures regime

We believe that the data used to draw conclusions on maintaining or deleting existing exemptions was insufficient. The use of a single reference point, 31 March 2016, to infer the importance of the existing exemptions and the impact of their removal is not appropriate. In addition, the data gathered did not represent all member states in some instances and did not meet the EBA request of at least 60% of total assets of the financial sector in each member state.

As such, we believe the analysis would benefit from further data gathering to enable a fuller impact assessment of removing the exemptions. Therefore, we would support giving the EBA a mandate to perform a full review in the CRR, as requested in the report:

> "All considered, it is recommended that a mandate for an EBA report on the large exposures exemptions and discretionary exemptions under Article 400(1) and (2) of the CRR is included in the review of the CRR"

Notwithstanding this, we highlight the importance of maintaining the existing treatment of interbank exposures related to monetary policy, as well as aspects of the large exposures framework which need addressing in relation to intragroup transactions below.

Interbank exposures related to monetary policy

The current Basel standards note that to avoid disturbing the payment and settlement process, intraday interbank exposures are not subject to the large exposures framework, either for reporting purposes or for application of the large exposure limit. As such, the review's focus is on other interbank exposures for which the Basel Committee is considering whether a specific treatment (LE limits) may be necessary for a limited range of interbank exposures. Limitations of this nature in principle run counter to the stimulus objective of monetary policy and reduce the effectiveness of the monetary policy transmission mechanism. At a time when authorities are implementing quantitative easing programmes to avoid recessionary pressures, limiting the ability of banks to facilitate monetary policy would be counterproductive and add to these pressures.

Removing exemptions for large exposures between institutions where one or more parties 'provides or guarantees loans under legislative programmes or its statutes, to promote specified sectors of the economy under some form of government oversight'[4] will limit governments' ability to support specific sectors in their economy. Again, the interlinkage of different aspects of the economy should not be underestimated and the potential for a contagion scenario if the ability to support a crucial sector is reduced.

Removing other existent exemptions would hamper market efficiency, in particular limiting exposures of transactions covered by Article 390(6)(a)-(c) of the CRR. These relate to very short term exposures arising from the settlement of foreign exchange transactions[5], purchase and sale of securities[6] and client activity for

[4] Article 400 (2)(e)
[5] Article 390(6)(a) of CRR
[6] Article 390(6)(b) of CRR

the provision of money transmission[7]. The existence of these exemptions for the purpose of facilitating the smooth functioning of financial markets is recognised in CRR Recital (56)[8], *excerpt:*

> "..very short-term exposures related to money transmission including the execution of payment services, clearing, settlement and custody services to clients are **exempt to facilitate the smooth functioning of financial markets and of the related infrastructure.** Those services cover, for example, the execution of cash clearing and settlement and similar activities to facilitate settlement."

Furthermore, the Recital recognises that exemption to some exposures are not foreseeable and therefore not under the control of a credit institution, *excerpt:*

> "The related exposures include exposures which **might not be foreseeable and are therefore not under the full control of a credit institution**, inter alia, balances on inter-bank accounts resulting from client payments, including credited or debited fees and interest, and other payments for client services, as well as collateral given or received."

The timing difference, therefore, is a function of technical/operational factors[9] and is not representative of a client's credit worthiness, which is the core tenet of the large exposures framework, not operational risk. As such, these exemptions should be maintained.

Intragroup transactions in the large exposure framework

The Basel large exposure framework is designed for application to internationally active banking groups at the consolidated level. The Basel framework does therefore not consider the treatment of intragroup exposures.

The CRR however does apply large exposure limits to intragroup exposures but uses a relatively complicated and inconsistently applied system of discretion to allow for the possible exemption of intragroup exposures by Competent Authorities and/or Member States.

In summary, Article 400 1 (c) allows for the complete exemption of intragroup exposures from the Large Exposure framework if they would be assigned a 0% risk weight under the risk-based framework. Article 400 2 (c) gives competent authorities the discretion to go beyond the limited geographical scope of Article 400 1 (c), exempting cross-border intragroup exposures partially or fully. Finally, Article 493 3 (c), gives Member States the discretion to over-ride the choice of the Competent Authority in Article 400 2 (c) by fully or partially exempting cross-border intragroup exposures until 2029.

The inconsistent application that has occurred under the current legal framework therefore limits the ability of cross-border businesses to freely transfer funds between their legal entities. It also creates an unlevel playing field between these types of institutions depending on the type of choice made by their relevant competent authority and/or the Member State in question, with the two possibly contradicting each other. Therefore, legal change is required to enhance the ability of the SSM to exercise its powers as a common

[7] Article 390(6)(c) of CRR

[8] https://www.eba.europa.eu/regulation-and-policy/single-rulebook/interactive-single-rulebook/-/interactive-single-rulebook/article-id/601

[9] Rationale also applicable to Article 400 (2)(f)

supervisory authority of the Banking Union and to remove the conflicting powers currently afforded to Member States and Competent Authorities (and that will remain in place until 2029 unless change to the level 1 text is made before).

We therefore recommend that the discretion set out in Article 400(2)(c) of the CRR be moved to Article 400 (1) as (l)new so that, where a firm's intragroup counterparty is subject to the same conditions as those listed above (i.e. equivalent prudential requirements, included in the same consolidation with the same levels of risk and control and with no impediments to the transfer of funds), intragroup exposures should be fully and consistently excluded from large exposure limits if the competent authority is satisfied that these conditions are met. This change should also be accompanied with the removal of Article 493(3)(c) of the CRR to allow for an appropriate legal framework form for the SSM to exercise these powers.

Another consequence of retaining the status quo is that any non-exempt intra-group transaction needs to be grouped together with all such transactions since large exposure requirements apply to so-called "groups of connected counterparties", compounding the effects of the current system.

We note that most of the above issues have already been recognised for a number of years. Indeed, the CRR mandates (in Art 507) the European Commission to review the current large exposure framework and to put forward legislative proposals if appropriate. Again, the regulatory developments and improvements in financial stability safeguards since the CRR introduced this mandate imply in our view that there are no longer any reasons to allow discretions (and therefore divergences) to remain in this area of the European framework. The CRRD5/CRR2 represents an opportunity to foster further harmonisation of the single rulebook.

Finally, , the present review must consider the introduction of internal TLAC/MREL requirements which should not be constrained by existing intra-group large exposure limits. We therefore suggest exempting exposures resulting from internal MREL from large exposure limits.

Additional Issues

EBA Recommendation: Non-recognition of 'real estate' as an eligible CRM technique

Under the BCBS framework, institutions are no longer allowed to reduce the amount of exposures by the value of immovable property used as collateral. Based on the EBA's analysis, the non-recognition of 'real estate' as an eligible CRM technique would have a small impact in terms of the compliance with the large exposures regime. However, as recognised in the report, the BCBS standards acknowledge that for banks that fall outside the scope of application of the Basel framework (i.e. non-internationally active banks), there may be a case for recognising physical collateral in the context of the large exposures framework. In addition, the report recognises that the analysis did not consider the impact of non-recognition of 'real estate' on smaller EU institutions, which could be material. As such, there should be a fuller impact assessment of the effect of non-recognition of 'real estate' as an eligible CRM technique on all affected institutions before its implementation.

EBA Recommendation: Remove flexibility in trading book to exceed 25% large exposures limit on a temporary basis (Article 395(5) of CRR)

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There currently exists the ability for exposures on the trading book to temporarily be exceeded subject to certain conditions[10], including having to meet an additional own funds requirement in respect of the exposure in excess of the specified LE limit. This flexibility enables markets to continue operating whilst ensuring this only takes place with sufficient capital resources to support the additional risk. The removal of this flexibility would thus restrict market activity which is appropriately capitalised and would result only in reduced market activity / trading volumes. It is particularly important to retain the flexibility for extra capacity in a market stress scenario, where this flexibility enables stronger market participants to cushion the impact for other participants and avoid a wider stress. This flexibility is important at both the individual bank (solo entity) level as well as the consolidated level and should be retained in both cases. In light of the above and the Commission's objectives to foster and encourage market based finance through the CMU, we recommend that this flexibility be retained.

EBA Recommendation: Reporting institutions should never be considered a common source of significant funding that connects clients that are, by no other means, related or economically dependent on each other

This recommendation is seeking alignment with Basel as there are no specific provisions requiring reporting institutions to be included within connected client groups that are by no other means related or economically dependent on each other.

An extreme interpretation of recital 54 of the CRR, which states that it is also important to take into account risks arising from a common source of significant funding provided by the institution itself, would result in an institution including all its customers that are totally or basically financially dependent on the institution as a single group of connected clients. As such, we agree with the EBA's recommendation that an alignment with the Basel framework in this area would be advisable.

EBA Recommendation: Amend Article 394 of the CRR to include a requirement for all institutions to report exposures that are above or equal to EUR 300 million

Proportionality should be addressed in relation to the threshold of reporting connected client exposures through adoption of Basel Standard's recommended threshold of 10% of eligible capital to represent exposures that are meaningful for the institution. The current fixed €300m limit captures connected client exposures that are immaterial for large institutions and which are not meaningful in the context of protecting a bank's eligible capital base against credit risk. This reporting requirement represents a significant, dis-proportionate burden which should be removed. Reporting only exposures that meet the Large Exposure definition of 10% of eligible capital would be a more appropriate approach.

Reviewing economic dependencies for interconnected clients

The EBA has recently published revised Guidelines[11] to replace the CEBS 2009 Guidelines on identifying interconnected clients. These Guidelines specify that banks must *"intensively investigate"* economic

[10] **Article 395(5) CRR**

[11] https://www.eba.europa.eu/documents/10180/1531170/EBA-CP-2016-09+CP+on+Guidelines+on+Connected+Clients.pdf

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dependencies of exposures which are greater than 2% of eligible capital. Meanwhile the Basel LE framework adopted a threshold of 5% of Tier 1 capital, which has also been adopted in the US Agencies Single Counterparty Credit Limit (SCCL) proposal. The application of a lower threshold in Europe is unduly burdensome and contradicts the European Commission's principle of proportionality. We recommend that the European Commission define the threshold within the CRR text and use the same threshold used in the Basel standards of 5% of Tier 1 capital.

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