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## AFME Position Paper

### CRD 5/CRR2: Large Exposures Framework

September 2016

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#### **Introduction**

The Commission issued a call for advice<sup>1</sup> to the EBA for the purpose of revising the large exposure framework as part of the CRR review in April 2016. This review is considering whether to implement the agreed BCBS framework detailed in the document “Supervisory framework for measuring and controlling large exposure”<sup>2</sup>, as well as the potential for reviewing existing exemptions to the large exposure rules laid down in Article 400(1)(j) and Article 400(2) CRR, with due consideration to the proportionality principle.

As such, this paper seeks to consider the main deviations of the large exposures (LE) framework under the CRR from the BCBS (Basel) framework.

As part of the Commission and EBA’s review of the framework, 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 particular, the Basel LE framework was designed to apply to internationally-active banks at a consolidated level. Whereas, the implementation of the LE framework in the EU is much wider, applying to nearly all CRR regulated firms at both a solo and consolidated level. 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.

#### **Alignments with Basel LE framework (excluding exemptions) under review**

##### ***Retain the use of internal models<sup>3</sup> for estimating counterparty credit exposures arising from OTC derivatives pending international adoption of SA-CCR***

Under the existing European LE framework, defined in CRD IV, the Internal Model Method (IMM) is allowed 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

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<sup>1</sup> Available at <https://www.eba.europa.eu/documents/10180/1466081/%28EBA-2016-E-675%29%20Call+for+Advice+Large+exposures.pdf/cf496c0d-4216-47c3-89c1-5443e388398a>

<sup>2</sup> BCBS, April 2014: (<http://www.bis.org/publ/bcbs283.pdf>)

<sup>3</sup> Article 390 of CRR

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, it is unlikely that the Basel 1 January 2017 timeline will be met, either in the EU or 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.

### ***LE limit for G-SIBs to G-SIBs exposures***

These exposures are limited to 15% of Tier 1 capital within the Basel framework. Currently, the CRR exposure limit does not differ from non G-SIBs and is set at 25% of eligible capital<sup>4</sup>. 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 GSIB limit only applies at a consolidated-level for G-SIB to G-SIB exposures.

### ***Positions in the trading book satisfying certain conditions***

There currently exists the ability for exposures on the trading book to temporarily be exceeded subject to certain conditions<sup>5</sup>, 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.

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<sup>4</sup> Article 395 of CRR

<sup>5</sup> Article 395(5) CRR

## **Exemptions within BCBS LE framework subject to Committee review**

The Basel Committee committed to reviewing by 2016 the appropriateness of setting a large exposure limit for exposures to qualifying central counterparties (QCCPs) related to clearing activities, which are currently exempted. In addition, it committed to reviewing the impact of the large exposures framework on monetary policy implementation<sup>6</sup>.

### ***Exposures to Central Counterparties (CCPs)***

The continued application of exemptions to CCPs, under Basel standards and within the CRR is supported by AFME members. This will encourage continued use of central clearing and help maintain reduced system-wide levels of counterparty credit risk and liquidity risk.

### ***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'<sup>7</sup> 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<sup>8</sup>, purchase and sale of securities<sup>9</sup> and client activity for the provision of money transmission<sup>10</sup>. The existence of these exemptions for the purpose of facilitating the smooth functioning of financial markets is recognised in CRR Recital (56)<sup>11</sup>, *excerpt*:

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<sup>6</sup> <http://www.bis.org/press/p140415.htm>

<sup>7</sup> Article 400 (2)(e)

<sup>8</sup> Article 390(6)(a) of CRR

<sup>9</sup> Article 390(6)(b) of CRR

<sup>10</sup> Article 390(6)(c) of CRR

<sup>11</sup> <https://www.eba.europa.eu/regulation-and-policy/single-rulebook/interactive-single-rulebook/-/interactive-single-rulebook/article-id/601>

“..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<sup>12</sup> 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.

### ***Reviewing economic dependencies for interconnected clients***

The EBA has recently published revised Guidelines<sup>13</sup> to replace the CEBS 2009 Guidelines on identifying interconnected clients. These Guidelines specify that banks must “*intensively investigate*” economic 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.

### **Exemptions under review for potential removal from CRR**

#### ***Intragroup transactions [Article 400(2)(c) CRR]***

Intragroup exposures have been excluded from the scope of Basel’s large exposures framework. These exposures have been specifically addressed in the CRR through the use of exemptions.

We recommend that the exemption, Article 400(2)(c) of CRR, for intra-group transactions is applied consistently by Member States. Where a firm’s intragroup counterparty is subject to equivalent prudential requirements, included in the same consolidation as the firm on a full basis, subject to the same risk evaluation, measurement and control procedures as the firm and there are no current or foreseen material practical or

<sup>12</sup> Rationale also applicable to Article 400 (2)(f)

<sup>13</sup> <https://www.eba.europa.eu/documents/10180/1531170/EBA-CP-2016-09+CP+on+Guidelines+on+Connected+Clients.pdf>

legal impediment to the prompt transfer of funds or repayment of liabilities, the intragroup exemption should be fully applied.

Moreover, the full exemption for intragroup transactions should not be restricted to exposures within a single Member State. In a Single Market, the full intragroup exemption should be available for entities which are established in another Member State. Moreover, when the entities are established in a jurisdiction which applies consolidated prudential supervision equivalent to the CRR, there is also no reasons to restrict the exemption of these exposures. With the implementation of recovery and resolution frameworks since the crisis, national arguments to restrict intra-group exemptions are no longer valid, particularly as the conditions for obtaining the exemption would continue to apply. Finally, the Commission should ensure that the Large Exposure framework does not hamper firms' ability to fulfil their internal MREL requirements.

While AFME is firmly of the view that intragroup exposures should not be subject to large exposure limits, if this is not something that can be taken forward under the current CRD/CRR review, at the very least, we recommend that the EBA be given a mandate to investigate the implications of extending the exemptions beyond national borders and to make recommendations to the EC accordingly, who should then put forward legislative proposals if appropriate.

***Exposures to regional governments or local authorities which are assigned a 20% risk weight under solvency regime [Article 400(2)(b) of CRR]; & Exposures in the form of covered bonds satisfying certain conditions [Article 400(2)(a) of CRR];***

Removal of each of these would increase the cost of implementing government initiatives.

Loans to regional government would need to be re-priced to factor in the additional capital charge, thus leaving the regional or local authority with higher operational costs and lower disposable income to achieve their objectives.

Covered bonds help to maintain investor demand for mortgage and public loan products; increased costs of covered bonds would likely make these mortgage and public loan portfolios less attractive, meaning originators are unable to sell them at a mutually beneficial price and therefore will need to maintain these loans on balance sheet and retain minimal capacity to originate new loans.

***Off-balance sheet items [Article 400(1)(i) and Article 400(2)(i) of CRR].***

In assessing the merits of removing the exemption, the European Commission should be mindful of the use of credit conversion factors (CCFs) for converting off balance sheet items into credit exposure equivalents. Under the Basel LE framework, CCFs are applied based on the standardised approach for credit risk, subject to a floor of 10%.

The CRR approach to off balance sheet items is to exempt certain low risk exposures, with certain low/medium risk items attracting a 50% exemption, though this 50% exemption is subject to the discretion of national authorities to apply in part or full.

As such, under both approaches, it is recognised that the gross notional off balance sheet exposure should be adjusted to reflect the credit risk. Therefore, if it is decided that the CRR approach to applying exemptions is removed, this is replaced with an approach that uses CCFs, as defined in Article 111, to adjust the exposure. If, however, it is decided that the current exemptions are maintained, these exemptions should be applied consistently and in full to all affected institutions.

The Commission should however bear in mind ongoing discussions at Basel level on the CCF framework and ensure that arrangements under the unilateral control of the bank are explicitly excluded from the framework and that Unconditionally Cancellable Commitments (UCCs) are either fully exempted as low risk items (as is the case today) or receive a 0% CFF (should the Commission move towards a CCF approach).

### **Reporting Requirements**

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, disproportionate 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.

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### **About AFME**

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.