afme/ Finance for Europe

CRD 5: The new Large Exposures Framework

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1 - Overview of Key Messages

1. Significance and potential impacts

The Large Exposures framework is a key component of the prudential rules It is an important tool to limit concentration risk and an important complement to the capital framework. To work effectively, it is important that exposures and credit concentrations are appropriately identified and measured. Internal models have been able to achieve this accurately.

The LE rules can impact banks' ability to operate cross-border and to allocate resources efficiently. The treatment of intragroup exposures – as well as other intragroup transactions and flows covered by other parts of the capital or liquidity rules – currently creates unnecessary legal barriers to the free flow of funds within groups. This results in market fragmentation and inefficient allocation of resources.

2. Industry Recommendations

Retaining the use of internal models for estimating counterparty credit exposures arising from OTC derivatives, pending international adoption of SA-CCR (Standardised Approach for Counterparty Credit Risk), in line with EBA's advice and international developments.

Allowing the exemption of intragroup exposures if clear conditions are met to remove barriers to cross-border business and the free transfer of funds between the legal entities of a group subject to CRR or CRR equivalent requirements.

Improving other aspects on the framework including: Retaining the ability of an institution to use its own estimates of the effects of financial collateral for banks with permission to use internal models; Retaining optionality in risk substitution; More proportionate reporting requirements, linked to a relative threshold as per Basel Standard (10% of eligible capital) instead of an absolute one.

3. Assessment of EC proposals

The EC legislative proposals acknowledge the validity of the concerns explained above and includes

Mandatory use of SA-CCR for counterparty credit risk exposures – removal of internal models. The EC is proposing to remove the use of internal models. This would result in less accurate estimates of exposures. With models remaining available in the capital framework, their removal from the LE framework is unjustified.

Intragroup exposures: no improvement. The treatment of intragroup exposures remains unchanged; the discretionary nature of exemptions is retained, resulting in inconsistencies and fragmentation.

Credit Risk Mitigation: mandatory use of FCCM; mandatory 'substitution approach'

Reporting requirements: The EC has proposed an absolute threshold (€300m) which is not meaningful for large institution. The Basel threshold of 10% of eligible capital is more appropriate.

The table below provides an overview of the changes introduced by the CRD5/CRR2 package on large exposures. The key issues identified by AFME, which will be explained in the next sections, are also highlighted.

Main changes proposed in CRR2 / new BCBS framework	*Key issues identified by AFME:*
Exposures limits • In CRR2, in line with the BCBS standard, the 25% exposure limit is calculated on a narrower capital basis (Tier 1 capital, instead of the broader 'eligible capital'). In CRR1 the exposure limit was 25% of the institution's "eligible capital" (which includes CET1, additional Tier 1 and, with some limits, Tier 2 capital). This means that the capital base for the calculation is reduced, resulting in more stringent limits. • The exposure limit is lowered to 15% for exposures between G-SIBs. This tighter limit on exposures between G-SIBs are included in the framework, to reduce the risk of contagion.	
Measurement of exposures • The main difference with CRR1, is that **for exposures originating counterparty credit risk, the use of internal models is not allowed for calculating the exposure value.** The exposure value for instruments that give rise to counterparty credit risk is determined using standardised input factors (SA-CCR: standardised approach for counterparty credit risk), which have been predefined for the industry, rather than banks determining the value of these input factors using real data through their own internal models.	AFME believes that the use of internal models for estimating counterparty credit risk exposures arising from OTC derivatives should be retained, pending international adoption of SA-CCR. *See section I below for more details*
Treatment of intragroup exposures • The EC has not proposed any improvement of the treatment of intragroup exposures (as the to the Basel LE framework, it is designed for application at consolidated level so the intragroup transactions are not considered in Basel standards)	Clearer and less discretionary exemptions of intragroup exposures should be available to centralised capital and liquidity management and to avoid market fragmentation *See section II below for more details*
Treatment of Credit Risk Mitigation (CRM) techniques • In CRR2, the use of CRM techniques is not discretionary anymore. • **No permission to use own estimates for calculating the effect of CRM techniques**: effects of financial collateral are determined through the mandatory use of the Financial Collateral Comprehensive Method (FCCM[1]), and own estimates are not allowed anymore.	Banks should retain ability to use their own estimates of the effects of financial collateral, pending the finalization in Basel of the revised standardized approach for credit risk *See section IIIa for more details*
• **Mandatory application of the substitution approach** (according to which exposures to a client are replaced with exposures to the guarantor) to exposures guaranteed by a third party or secured by collateral issued by a third party.	AFME believes that mandatory risk substitution is not prudent and disincentivises use of CRM techniques. Optionality should be maintained. *See section IIIb for more details*
Reporting requirements to the supervisor • In CRR2, the threshold for reporting requirements previously implemented through a delegated act has been inscribed into level 1 text. The threshold is a fixed limit (€300m), which differs with Basel Standards where the limit is a percentage of the capital base and therefore reporting is more closely related to risks to capital.	AFME believes the Basel Standard re threshold for reporting requirements is most relevant for managing large exposure risks and should be adopted. *See section IV for more details*

[1] The Financial Collateral Comprehensive Method (FCCM) is, together with the Financial Collateral Simple Method, one of the methods for calculating the effects of credit risk mitigation; These methods are designed to assess whether the assets relied upon are sufficiently liquid and their value over time sufficiently stable to provide appropriate certainty as to the credit protection achieved.

2 – Detailed AFME Comments

Introduction

Large exposure rules are an important part of the prudential framework

The rules on large exposures (LE) aim to prevent a bank from developing exposures to a single counterparty (or connected counterparties) which are so significant that they may threaten the solvency of the institution (this is a form of concentration risk).
The Basel Committee on Banking Supervision (BCBS) published, in April 2014, a new standard that sets out a supervisory framework for measuring and controlling large exposures. With its CRD5/CRR2 package, the EC is proposing the implementation in the EU of such new standard.

The CRD5 package aims at implementing the new LE standard adopted in Basel

The following main elements are introduced by the new proposed rules:
- a higher quality of capital is used as a base for the calculation of the large exposures limit;
- exposures to credit derivatives are calculated with the SA-CCR (internal models are not allowed);
- the limit on the exposures that G-SIBs may have towards other G-SIBs is lowered (15% instead of 25%) to reduce systemic risks.

AFME views and recommendations

AFME's priority concerns in the area of the Large Exposures framework focus on the following main areas:

I. **Retaining the use of internal models for estimating counterparty credit exposures arising from OTC derivatives, pending international adoption of SA-CCR**;

II. **Exempting intragroup exposures from LE limits**

III. **Credit Risk Mitigation:**

   a. **Retaining the ability of an institution to use its own estimates of the effects of financial collateral**;
   b. **Retaining optionality in risk substitution**;

IV. **More proportionate reporting requirements**.

I. Retaining the use of internal models for estimating counterparty credit exposures arising from OTC derivatives, pending international adoption of SA-CCR;

Removal of internal models would result in less accurate, less risk sensitive, estimates of exposures

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 new Basel LE framework, internal models were excluded from the permitted approaches and replaced with the "Standardized Approach for Counterparty Credit Risk" (SA-CCR).
We believe preserving the ability of firms to use internal models for calculating exposures is important for the following reasons:
- Internal models provide the most accurate estimate of counterparty risk exposure as they can take into account a broad range of factors (e.g. correlations, volatilities, diversification, hedging). Simple standardised methods have unavoidable deficiencies

[2] Article 390 of CRR

due to the need for simplification. As such, removing the use of internal models reduce risk sensitivity in the LE framework.

- International implementation; some jurisdictions are retaining the use of internal models (e.g. this is the case in the US, in the recently re-proposed the Single Counterparty Credit Limit rule) because standardized approaches are an inferior option. Also, the deadline for the implementation of the SA-CCR is likely to be postponed in several jurisdictions.
- the EBA's recommendation[3] to continue the use of IMM in the large exposure framework for those banks with the requisite permission.

II. Exempting intragroup exposures from LE limits

Obstacles to intragroup exposures create fragmentation and reduces resilience

While the Basel Committee on Banking Supervision (BCBS) defines rules designed to be applied at the consolidated level, the EU applies BCBS standards at both solo and consolidated levels to all credit institutions in the EU. Thus, in the EU, these standards also apply to exposures between two entities within the same group (referred to as "intragroup"). This application of prudential requirements to intragroup flows and exposures creates fragmentation and additional costs not only for banks but also for end-users of financial services and products. Also, if capital and liquidity are trapped in local jurisdictions through regulatory constraints, this can have counterproductive influences on the resilience of a banking group and therefore on financial stability.

Under Article 113 (6) of the CRR, institutions can apply a 0% risk weight to their intragroup transactions subject to the approval of the Competent Authority and under a number of conditions. These conditions require the inclusion of the counterparty in the scope of prudential consolidation of the firm, for it to be subject to the same risk evaluation, measurement and control procedures as the institutions and for there to be no impediments to the transfer of funds. However, one of the conditions of these exemptions is that the group counterparty must be in the same Member State.

For cross-border banking groups, limiting such a provision to a single Member State places an unnecessary restriction on the flow of funds within a group, particularly in the context of the Banking Union. It is also questionable whether there is a need for such restrictions within the broader Single Market, and with respect to entities in third countries with equivalent prudential rules and they should also be reconsidered.

In line with this approach, the CRR applies large exposure limits to intragroup exposures; at the same time exemptions are possible. However, CRR provides for a complicated system. In summary:

Removal of internal models would result in less accurate, less risk sensitive, estimates of exposures

i. Article 400 §1 (f) 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[4] (and one of the conditions is that both group entities are located in the same Member State).
ii. Article 400 §2 (c) gives national Competent Authorities the discretion to go beyond the limited geographical scope of Article 400 1 (c), exempting cross-border intragroup exposures partially or fully.

[3] In the EBA Review of the Large Exposures Regime published on 24 October 2016, the EBA "*advises that the extension of the SA-CCR to the large exposures framework and the consequent exclusion of the use of internal models for exposures to OTC derivatives should be considered only after the full implementation of the SA-CCR (and other approaches applied for proportionality reasons) in the CRR, as well as an assessment of its impact on the large exposures framework*".

[4] Under Article 113 (6) of the CRR, institutions can apply a 0% risk weight to their intragroup transactions subject to the approval of the Competent Authority and under a number of conditions. These conditions require the inclusion of the counterparty in the scope of prudential consolidation of the firm, for it to be subject to the same risk evaluation, measurement and control procedures as the institutions and for there to be no impediments to the transfer of funds. However, one of the conditions of these exemptions is that the group counterparty must be in the same Member State.

iii. Finally, Article 493 §3 (c), gives Member States the discretion to over-ride the choice of the Competent Authority by fully or partially exempting cross-border intragroup exposures until 2029.

This complex and discretionary system has led to inconsistent application and strong limitations to the ability of cross-border businesses to freely transfer funds between their legal entities.

The purely discretionary nature of the exemptions should be removed and exemptions applied consistently

In this context, a clearer framework is needed to remove potentially conflicting powers afforded to Member States and Competent Authorities, as well as to enhance the ability of the SSM to exercise its powers as the common supervisory authority of the Banking Union. AFME recommends the following changes:

- where a firm's intragroup counterparty is subject to 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 must be fully and consistently excluded from large exposure limits. Once the competent authority is satisfied that these conditions are met, the exemption must be granted, and should not be discretionary.
- Article 493 §3 (c) of the CRR should be deleted to allow the SSM to exercise its supervisory powers without possible constraints stemming from national legislation.

III. Credit Risk Mitigation

a. Retaining the ability of an institution to use its own estimates of the effects of financial collateral

Mandatory use of FCCM should be deferred, pending Basel work

When banks use a credit risk mitigation technique and receive financial collateral, it needs to assess the effects of such financial collateral, i.e. to assess whether the collateral relied upon is sufficiently liquid and its value over time sufficiently stable to provide appropriate certainty as to the credit protection achieved.
This assessment is carried out either through standardised methods (e.g. FCCM: Financial Collateral Comprehensive Method; or FCSM: Financial Collateral Simple Method – see footnote 1 for more details) or by using, for those banks authorised to use internal models, own estimates.
This is true not only for the LE framework but also for the risk based capital framework for credit risk.

In the new Basel LE framework and in the CRD5/CRR2 proposal the ability for banks to use own estimates is removed (also for banks permitted to use internal models, which will have to use the FCCM).
However, work is under way in Basel to revise important aspects of the Standardised Approach to credit risk, including the treatment of financial collateral. Therefore, pending the introduction of the new Standardised Approach to credit risk an institution should be permitted to continue to use its own estimates of the effect of financial collateral.

b. Retaining optionality in risk substitution

Mandatory risk substitution has drawbacks

According to the new article 403(1), where an exposure to a client is guaranteed by a third party, or secured by collateral issued by a third party, and a number of additional conditions are met, an institution *shall* apply the so called "risk substitution", i.e. treat the portion of the exposure which is guaranteed or collateralised as an exposure to the third party rather than to the client. Until now the wording is "may"; therefore, the wording "shall" makes risk substitution mandatory and not optional.

This is problematic for the following reason: large exposures to clients could be understated, if those exposures are replaced by exposures to guarantors; this could also undermine the framework if risk substitution is used to "break up" large exposures. In certain circumstances, it may disincentivise use of CRM techniques, for instance, to avoid creating an additional exposure to a guarantor through risk substitution, an institution may decide not take out a guarantee. This outcome is counterintuitive from a risk management perspective. Also, risk substitution appears to be in contradiction with the proposed mandatory application of FCCM, where no additional exposure to the issuer of the collateral asset is created.

IV. More proportionate reporting requirements.

The EC is proposing reporting requirements based on the exposures being above an absolute threshold (set at the level of €300m). An absolute threshold is inappropriate for larger institutions and creates a significant amount of reporting of immaterial exposures. This reporting requirement represents a significant, disproportionate burden which should be removed. This should be addressed by setting the reporting threshold for connected client exposures at a 10% of eligible capital - a more appropriate approach and in line with the Basel Standard.

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About AFME

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