

Consultation response

Draft RTS on the method for the identification of the geographical location of the relevant credit exposures under Article 140(7) of the CRD

31 October 2013

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the consultation on *Draft RTS on the method for the identification of the geographical location of the relevant credit exposures under Article 140(7) of the CRD (EBA/CP/2013/35)*. 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.

We provide below our over-arching response to the consultation, which is followed by a discussion of a number of important issues.

Over-arching comments

In this response we have focussed most of our comments on issues arising out of Article 3, relating to trading book exposures.

In general, we are very concerned about the proposals to require use of the standardised method to decompose the IRC across geographies. We believe that this proposal will lead to an inaccurate identification of geographical locations. IRC is not driven by or correlates well with the standardised capital charges, so geographies that might show up as being significant under the standardised method may not be a strong contributor to the IRC. This mis-apportionment across geographies would be distortive and could penalise jurisdictions that are not the target of countercyclical buffers (CCBs). Ultimately this could thwart the macroprudential objectives of the CCB.

Further, requiring use of the standardised method will create an unnecessary administrative burden for firms that do not use the standardised method, but for no benefit. This administrative burden will place a sizable obligation on such firms – a burden that does not seem to be reflected in the RTS's impact assessment.

As general principles we believe that (a) identification of geographical locations should be reasonably accurate, to avoid distortions, and (b) that the burden of implementing any approach should be balanced against the incremental benefits.

We do not believe the proposals meet these standards. We strongly encourage the EBA to take more time to consider the options for implementing this requirement and, in doing so, to undertake a dialogue with industry to find an appropriate solution. The phasing in of the countercyclical buffer does not begin until 1 January 2016. Even allowing for system build in advance of that date we believe more time is available to consider the issues, including if necessary a second round of consultation based on refined proposals by EBA. We would support the EBA seeking agreement from the Commission for an extension of the 1 January 2014 deadline for submission of this RTS to facilitate a more fulsome consideration of the issues.

We have set out two potential alternative approaches to determine the location of trading book exposures (set out below) which we believe warrant further consideration by the EBA. Due to the inherent complexities in IRC models, we would welcome further engagement with the EBA on this in particular taking into account the objectives of the CCB.

Approaches considered by the EBA

In the explanatory text for Article 3 the EBA has set out four further methods that might be explored for banks using internal models. We have made observations about each of those methods below.

As a proportion of the geographical distribution of the exposures

Though the specification of this method is not very clear, we strongly believe that short positions should be included in the calculation. To consider only long positions without the offsetting short positions would provide an incomplete and inaccurate picture of geographical distribution of exposures. Furthermore, this method would seem to make no distinction between countries in which a firm is exposed to high quality obligors less likely to suffer from a turn in the market and countries where a firm is exposed to lower credit quality obligors.

According to limits approved by the bank

Using limits would be problematic as banks will generally not define limits per jurisdiction in the way that would be required for this purpose. Furthermore, even where limits are defined limit usage will be very variable, meaning that using them for this purpose would result in inappropriate allocations.

Assigning exposures to the legal entity which holds the position

The accuracy of this approximation depends on the structure of the regulated group - i.e., it will be inappropriate for a multi-faceted and geographically diverse business operating through a single entity. It also suffers from the drawback that some internal models may not calculate exposures by entities. It is not clear exactly how the exposures would be calculated, and indeed whether those calculations would ultimately be similar to those required under the standardised method, which we do not support for banks using internal models.

Using the same geographical distribution as for credit risk

We note the ease of implementation of this option. For geographically diverse groups the location of credit risk exposures could correlate to the location of trading book exposures, thereby making this an appropriate approximation. However, this correlation will not hold in many instances, in which case this option would be too poor a proxy for the actual location of the risk exposure. We note that for trading book exposures under the materiality threshold this option is employed. This is appropriate for immaterial trading book exposures.

Alternative approaches

We believe that there are other approaches that the EBA should consider for trading book exposures, and have set out two alternatives below, noting that there may be others that could

be worth exploring with the EBA. These approaches would need further development, particularly taking into consideration the aims of the CCB. Their immediately observable advantage is that they could be workable as extensions of processes already established in firms. However, we also note that neither of them may in fact satisfy the intended aims of the CCB in all cases. For these reasons we believe it would be beneficial to discuss with EBA such approaches under the timeframe suggested earlier in this letter.

Decomposing IRC

Most firms have to run IRC over various aggregation levels to reflect the IRC requirement by desk, entity level and for Group. Like VaR, the IRC at a higher level of the aggregation is less than the sum of the parts being aggregated. In other words there is a diversification benefit such that IRC for an entity is less than the sum of IRC by desk within the entity, and IRC at Group level is less than the sum of IRC for each entity. Nevertheless, in order to decompose IRC by geographic region it should be possible for firms to use the same aggregation infrastructure to compute IRC by geographic location of the obligors. This requires the obligors to be grouped by geographic region and IRC run for each region and then also on an aggregated basis. The results of these runs can then be used to prorate aggregate IRC according to the obligor geography IRC:

$$IRC_R = IRC_{AGG} \frac{irc_r}{\sum_i irc_i}$$

Where IRC_R is prorated IRC for region R, IRC_{AGG} is aggregate IRC, and irc_i is standalone IRC for region i.

Other prorate schemes could similarly be applied. For example, by region of ownership rather than region of obligor if required, which may correspond to the entity level aggregation firms may already carry out.

We note, however, that such an approach may not deliver materially higher overall capital requirements in all cases following the imposition of or increase in a buffer rate in a particular jurisdiction, particularly for geographical portfolios that exhibit tight spreads. Such portfolios are likely to have low marginal contributions to IRC and therefore the application of the capital buffer to this geographical region will be small. That said, we note that the standardised approach would tend to exhibit the same feature (due to lower ratings generally in that country).

Stress test approach

A firm might apply credit spread shifts to their credit portfolios by currency or geographic region, one region at a time, and again prorate IRC according to the stress loss results. This method may require some alignment of the spread shifts used in the stress test with the shifts used in the IRC model for migrations in order to ensure that the decomposition is performed reasonably accurately. Note the IRC decomposition in this method would be aligned mainly to the migration part of the IRC and may not be able to capture multiple step downgrades and jump to default.

Such an approach would need to take into consideration the impact on profit and loss as the spreads are shocked, as well as the change to the distribution of exposures following the spread shock. Both of these factors make this analysis complex.

Materiality threshold

We believe that the materiality threshold set in Article 3(4), of 2%, is too low. At that level the maximum error in the calculation of the CCB for trading book exposures would be 5 basis points (2% multiplied by 2.5% maximum CCB). Given that trading book exposures included in the CCB calculation only represent a portion of total exposures (including credit and securitisation exposures also), and that error will only arise to the extent that trading book exposures are

differently distributed to credit and securitisation exposures, this expected potential error is even lower. We believe that a materiality threshold of 10% would still represent an acceptable level of potential error, but provide a more proportionate approach for firms with relatively small trading book exposures. Given the general relative sizes of credit and trading books, a 10% threshold for trading book exposures would be appropriately equivalent in absolute magnitude to the 2% materiality threshold for foreign credit exposures in Article 2(4).

Article 3(4) of the RTS defines the materiality threshold by the relative size of “total trading book risk-weighted exposures”. We believe, in the context of the RTS, it should be clarified that the reference to ‘total trading book risk-weighted exposures’ in fact relates to ‘own funds requirements for specific risk in the trading book or incremental default and migration risk’. As a general point it is important that references such as this are very precise in the RTS.

To be clear, the materiality threshold should be ‘optional’ for firms, who should be able to opt to determine locations for trading book exposures if they wish. They may wish to do so when their trading book exposure locations are significantly different from their other exposures, leading to an error in the calculation of their CCB.

Credit risk

While the location of the obligor may be appropriate for retail exposures, we believe that a more nuanced approach may be appropriate for many non-retail credit exposures. Banks should have the option to take account of wider circumstances, including credit risk mitigation, to determine the location of such exposures if they believe this will result in a more accurate identification and it is more in line with their risk management approach. As a protection from ‘gaming’ between the different approaches firms could be required to have the approval of their supervisor for any change in approach for either all of their credit exposures or for specific portfolios.

With respect to the materiality threshold for credit exposures in Article 2(4), we note that a similar but differently-calibrated threshold is being used for the purposes of COREP (Article 5 of EBA-ITS-2013-02), where information on geographical location is not required unless original ‘non-domestic’ exposures are greater than 10% of total original exposures. We believe that consideration should be given to increasing the materiality threshold in this RTS to align with that in the COREP ITS.

We believe the treatment of counterparty credit risk (CCR) needs more consideration. At present it appears to be treated together with credit risk exposures under Article 2. We are not convinced that for CCR this is necessarily appropriate. Banks do not tend to consider their underlying risk as relating to the location of the obligor. Rather, a more nuanced approach is taken, including consideration of the geographical location referenced by the underlying instrument, for example. Thus, an unrefined treatment of CCR could lead to inappropriate allocations and further consideration of the approach for CCR is appropriate.