AFME Position Paper

CRD 5/CRR2: Large Exposures Framework

May 2018

Introduction

This paper outlines draft CRR amendments in relation to the Large Exposures framework where further attention is required. In particular, the mandatory use of SA-CCR, FCCM and risk substitution are areas of concern for AFME as well as the continued inconsistent application of intragroup exemptions.

Retain the use of internal models[1] 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 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 clear that the Basel 1 January 2017 implementation timeline has not been 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

[1] Draft amendments to Article 390 of CRR impose the use of the SA-CCR methods for determining exposures to OTC derivative transactions, even for banks that have been authorised to use internal models.
[2] Article 390 of CRR

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.

At a minimum, the continued use of IMM should be permitted until the EBA has performed its review of SA-CCR calibration by 4 years after entry into force of the CRR, as mandated by proposals put forward by both Council and Parliament. It should be noted that a large proportion of the undue impact of SA-CCR arises through its interaction with the LE framework. Therefore, continued use of IMM will not only allow for the BCBS to perform its review of the calibration of SA-CCR, which it has added on to its agenda, and give the EBA the flexibility to propose changes to the Commission arising from revised Basel standards, but it will avoid a large proportion of the under impact of SA-CCR in the LE framework by not mandating use of SA-CCR where an institution has permission to use IMM.

Retain the ability of an institution to use its own estimates of the effects of financial collateral

As part of the finalisation of Basel III post-crisis reforms, the BCBS consulted on revisions to the Standardised Approach to credit risk and as part of that consultation considered removal of the option of banks to use: (i) own-estimates of haircuts under the comprehensive approach; (ii) value-at-risk (VaR) models for certain securities financing transactions (SFTs), and (iii) the internal model method for SFTs and collateralised OTC derivative transactions. The Standardised Approach to credit risk has now been revised and finalised, with the final standard permitting for both SFTs and OTC derivatives, the use of Internal Model Method subject to supervisory approval[1]. The current CRR requirements should therefore be maintained for calculating SFT and collateralised OTC derivative exposures and mandatory use of FCCM for banks with IMM permissions should not be introduced in the EU. Such an introduction would be a divergence from agreed international standards and introduce an unlevel playing field.

Retain optionality in risk substitution

We believe mandatory substitution as prescribed per Article 403(1) is not prudent from a risk management perspective. Institutions should be permitted to record an exposure to the client, even if a guarantor has a lower or equal risk weighting. In a first instance mandating the substitution approach will result in client credit concentration risks potentially being understated as exposures to clients will be replaced with exposures to higher rated guarantors. This is because depending on business model, the client will remain in most instances the primary obligor. As a result, mandating substitution for large exposure purposes will provide an inaccurate description of the large exposure risks. It could also be used to undermine the framework, as it could be relatively simple to use substitution to "break up" large exposures. We therefore view mandatory substitution as possibly incentivising the taking of excessive credit risk, which would otherwise have been limited through client concentration risk limits. Similarly, mandatory substitution may reduce the incentive for banks to seek additional credit risk mitigation.

[3] EBA Review of the Large Exposures Regime, response to the EC's call for advice, 24 October 2016
[1] https://www.bis.org/bcbs/publ/d424.pdf - paragraph 86

It should also be noted that under the FCCM approach itself, the collateral reduces the exposures value to the original counterparty by the value of the collateral less the haircut, but does not of itself create an additional exposure to the issuer of the collateral asset.

Therefore, we do not see a rationale to impose the mandatory risk substitution as prescribed per Article 403(1) amendment: …shall" in relation to 403(1)(b) "collateral issuer" when it attracts an equal or lower risk weight. This appears contradictory with the requirement of a regulatory mandatory use of FCCM.

At least, more specifically with regards to the treatment of exposures with funded credit protection, for example SFTs, we highly recommend clarifying in the CRR amendments that these exposures will have to be reported on a net basis <u>only to the original counterparty</u>, while other exposures with effect of CRM techniques (exposures with unfunded credit protection) will be subject to an additional recognition to the CRM provider.

Alternatively, if mandatory risk substitution were to be maintained, we believe the scope of mandatory risk substitution should be limited to cases where both the underlier and reference entity are financial institutions in line with the Basel standard.

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.

In summary, 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. 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 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. This approach creates significant obstacles for firms with centralised liquidity management as entities must be mindful of incurring large exposures to the parent entity which acts as the main funding entity. In this context, legislative change is required to remove the 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.

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 must 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 the SSM to exercise these powers without possible constraints stemming from national legislation.

It is also worthwhile recalling that another consequence of retaining the status quo is that any non-exempt intragroup transaction needs to be grouped together with all such transactions since large exposure requirements apply to so-called "groups of connected counterparties". This compounds the negative 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 whether it is appropriate for the exemptions set out in Article 400(2) to continue to be discretionary (or whether they should become mandatory exemptions). In particular, the Commission is required to take into account the efficiency of group risk management whilst ensuring appropriate financial stability safeguards are in place. 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 present review of the CRD/R represents an opportunity to foster further harmonisation of the single rulebook in this area.

Finally, the introduction of internal TLAC/MREL requirements should not be constrained by intragroup large exposure limits. Any exposures resulting from internal MREL must be exempt from large exposure limits. We note that an additional exemption has been introduced in Article 400 (1)(l) in respect of resolution entities' holdings of eligible liabilities issued by entities in the same resolution group. Whilst this is a welcome amendment, it should be extended to cover institutions or group entities' holdings more generally, given internal TLAC/MREL may be down streamed via a chain of entities rather than directly from the resolution entity only.

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