

**JOINT ASSOCIATIONS' RESPONSE TO  
EUROPEAN COMMISSION CONSULTATION ON  
CRD POTENTIAL CHANGES**

**EXECUTIVE SUMMARY**



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## EXECUTIVE SUMMARY

### Introduction

This section of our response outlines the major points from each of the Annexes to our response and provides further explanation of the six key priorities identified in the cover letter. As with the cover letter, the executive summary follows the order of the consultation.

### Large Exposures

Large exposures is a very important part of the CRD amendment package for Members. We remain very disappointed that the review has not led to a significant revision of the Large Exposure Framework, as we continue to believe that the Internal Limits Based Approach, using the tools available to supervisors under Pillar 2, is the most appropriate regulatory response for those with the requisite systems and controls. As a result we think that there should be a sunset clause inserted into the Directive to allow it to be reconsidered once supervisors have gained more experience, and also to take account of other reviews that are currently ongoing but which have implications in this area. However, Members are prepared to accept a supervisory backstop regime, providing that it operates as such. Our four policy concerns (inter-bank, intra-group, connected clients and CRM) are therefore predicated on the proposals operating on this basis.

*Connected Clients.* We do not support the inclusion of the funding criterion within the definition of connected clients. Funding is only one issue that might result in concentrations of defaults that would more naturally be picked up as part of the Pillar 2 process. In addition, this criterion will be extremely difficult to make operational within firms, because of the difficulty of obtaining data. We also do not think that the connected client definition is the appropriate place to address liquidity and concentration risks arising from liquidity facilities.

*Inter-bank.* Members strongly believe that the existing exemption for inter-bank exposures of less than one year should be retained. We do not think that a 25% limit is the appropriate tool for addressing supervisory concerns identified by market failure analysis. Moreover it disincentives good risk management behaviour, by increasing liquidity and credit risk. It appears to be addressing post insolvency issues, which we do not believe are the primary objective of the regime (although we

acknowledge they are of concern to regulators), but in a way that is actually likely to exacerbate firm failure because it will restrict liquidity, which is a major factor in firm failure. Firms will need to increase the number of inter-bank counterparties thereby increasing the complexity of unwinding a large complex firm. The removal of the exemption is also not supported by any empirical evidence (this exemption has operated for over 15 years without problems).

*Intra group exposures.* We strongly support the introduction of a conditional exemption for intra-group exposures (subject to Article 80(7) criteria) and the risk-focused basis of the approach, but think that there are drafting changes that are necessary to make these proposals workable. Intra-group exposures are the main channels for liquidity to flow around the group and for the ability to manage risk on a global, centralised basis. The exemptions for intra-group and inter-bank are closely related and if it is not possible to make these proposals work then impact on firms is likely to be significant.

*Credit Risk Mitigation.* It should be clarified that exposure value, for the purposes of determining whether an exposure is large or not, should be calculated after taking account of credit risk mitigation. The current proposal is unclear on this point, as in some areas this is explicitly taken into account (e.g. in respect of the limit), in others implicitly (IMM will automatically integrate mitigants).

*Clarity of text.* We believe that there is much that can be done to improve the clarity of the proposed text – both drafting and re-ordering.

*Lamfalussy.* We believe that further consideration should be given to reviewing the large exposures material and structuring its provisions in accordance with the principles of a Lamfalussy Directive which would be in keeping with much of the rest of the content of the CRD.

### **Definition of Capital**

*Quality of Capital.* Embedded within the section on Hybrid Capital Instruments is a proposal that core capital be higher than a pre determined proportion of minimum capital requirements. We do not believe that the CRD Amendments consultation is the appropriate place to deal with this and nor do we agree that the section on Hybrid Capital Instruments section is the appropriate location to discuss this question.

There is no justification that core capital be higher than a pre determined proportion of minimum capital requirements. We are concerned that such changes will have significant unintended consequences on the composition of firms' capital. Requiring a certain proportion of capital to be covered by Tier 1 is inconsistent with the Tier 2 and Tier 3 limits that exist currently in the CRD. Such changes will disqualify very significant amounts of Tier 2 and Tier 3 capital that are currently used to meet market risk and large exposure requirements.

*Hybrid Capital Instruments.* The joint trade associations support a principles based approach to implementing a hybrid capital regime in the EU that mirrors the Sydney Press Release. We are delighted that in the future firms will be able to issue dated instruments as long they have a minimum maturity of 30 years. We appreciate the inclusion of Alternative Coupon Settlement Mechanisms but have included words that will permit the most commonly used form of ACSM, which is based on the sale of shares to raise funds to pay for a distribution rather than the direct issuance of shares to hybrid holders, who may not be able to hold equities by their investment rules.

### **Supervisory Arrangements**

Firms seek an efficient, non-duplicative set of supervisory arrangements. Arrangements must be suitable for all groups, whether global or regional and regardless of the nature, scale and complexity of their business. Arrangements cannot cater merely for groups whose activities are based only in the EU. In order to achieve this, the Commission proposals must separate out the concepts of (1) Consolidating Supervisor, which is valid for purely EU activities, and that of (2) Colleges of Regulators, which entails participation by and cooperation with the wider international community, where no single legislative authority has complete jurisdiction. It is important to note that the clarification and separation of these two concepts requires very little amendment to the substance of the existing draft text proposals. What is required is mainly, although not wholly, a re-ordering of the textual provisions.

The text needs to deliver: supervisory arrangements that are efficient and which meet the needs of worldwide financial group. We support the concept of "Colleges of Supervisors". The concept of consolidating supervisor is different and needs to be separately addressed. Additionally the concept of "emergency" and "normal" supervisory arrangements need to be treated distinctly.

## **Securitisation**

Securitisation is an important funding and risk transfer tool for the market. We strongly support efforts by the international regulatory community aimed at increasing confidence in the financial system, although this cannot be addressed by changes to the capital framework only. However, we are concerned by the lack of proper consultation in relation to the changes proposed. The absence of discussion on the market failure analysis, regulatory objectives, policy options and cost benefit analysis has made it extremely difficult to respond constructively. Therefore while we might support the concepts that we think lie behind the proposed changes there needs to be a full review and proper dialogue with the industry before changes are made.

We agree that risk management, implications of the 'originate to distribute model' and the capital charges for liquidity facilities are appropriate areas for consideration. We also think that the review should also take account of the industry initiatives that are currently ongoing. As the Basel Committee has already started such a review, we believe that it is appropriate to wait and make amendments once the outcome is known. This would have the added benefit of ensuring that a global standard is maintained. The securitisation market is global and many of our Members have significant operations beyond the bounds of the EU. Therefore it is vital that the regulatory framework here does not put them at a competitive disadvantage. There are two issues that are of particularly high priority to Members in the current proposals – the retention of a flat minimum capital charge (Article 95) and the treatment of Significant Risk Transfer (Annex IX, Part 2, 1.1 and 2.1).

*Flat minimum capital charge – Article 95.* We oppose the imposition of a minimum capital charge (15%) on firms that have originated the assets that are securitised. We assume that this proposal arises out of perceived failings in the 'originate to distribute' model. We agree that there are areas where this model requires strengthening (as identified in the Financial Stability Forum report), however, we do not believe the amendment will provide an incentive to achieve the desired outcome. As the proposal is for a flat capital charge members believe that it will encourage holdings of the positions that offer least value if transferred (i.e. senior pieces) and therefore will not encourage improvements in underwriting or risk management standards. It will not address the leverage and liquidity risk run by conduits and SIVs. Nor does the proposal target the contingent risks to such schemes to which firms were exposed. It will serve to undermine incentives to reduce reputational risks embodied in the significant risk transfer and implicit support requirements.

Furthermore the proposal may even encourage investors to expect firms to support their schemes. It will not address issues relating to the reliance of firms on active and liquid securitisation markets in their business models. Finally it is likely to create perverse incentives around the boundary of the securitisation framework or encourage assets to be originated outside the regulated community.

*Significant Risk Transfer - Annex IX, Part 2, 1.1 and 2.1.* We do not agree with the current proposal to amend the significant risk transfer requirements. As a point of principle we do not believe that the significant risk transfer requirement is necessary if the capital framework is appropriately and prudently calibrated. The QIS exercises and firm implementation of the framework would appear to us to demonstrate that this is the case. However, we acknowledge the supervisors' concern that the securitisation rules should not re-create the flaw in Basel I that resulted in transactions purely for regulatory purposes that undermined the capital framework as a whole. Ideally we would prefer a global solution to the definition of significant risk transfer. However, if a local solution must be agreed, we think that the focus should be on the regulatory failure identified, i.e. to ensure that the capital reduction is broadly commensurate with the reduction in credit risk. We do not support an approach based on arbitrary numerical limits or consider that it is necessary to take a case by case approach to determining if capital released is proportionate. We propose drafting recommendations in the securitisation annex this response.