

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

TECHNICAL AMENDMENTS



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Technical Amendments, excluding Securitisation Parts D, E, and F

Key messages

- ? We support the objective to clarify a range of the technical provisions of the CRD and to ensure that the existing provisions lead to a capital treatment that works. We support many of the proposed changes and note that few of the technical changes proposed will lead to new obligations on our member firms.
- ? The Commission's proposed changes to Annex VIII, Part 3 dealing with Credit Risk Mitigation (CRM) could be improved. In particular, the issue raised in Question 208 submitted to the CRD Transposition Working Group (CRDTG) has not been clearly resolved.
- ? We would consider the threshold amount of €150MM for large exposures in the inter-bank market, should it survive the consultation process, an "essential element" of the Directive, and therefore question whether it should be subject to change without proper due process and further consultation via Article 151 (2)

Credit Risk Mitigation – Annex VIII, Part 3

With respect to Annex VIII, Part 3, and the treatment of credit risk mitigation (CRM), we think the Commission proposal is attempting to implement the answer to Question 208 submitted to the CRD Transposition Working Group (CRDTG). This answer explained that credit risk mitigation should be applied to the nominal value of an off-balance sheet exposure, rather than the on-balance sheet equivalent (after the application of the appropriate conversion factor).

In the Commission's proposed text, as currently drafted, the purpose of using the exposure value before the application of the appropriate conversion factor or percentage (nominal value) is not made clear. Is this purely for the purpose of determining whether or not a position is fully covered by the collateral or unfunded credit protection (as appropriate) and that the relevant conversion factor (i.e. the same factor as would be applied to a position without collateral or unfunded protection) should apply to the exposure value of both the covered and uncovered portions for the calculation of risk weights exposure amounts (under Standardised or IRB approach) and Expected Loss amounts (under IRB)?

The proposals as drafted could result in an increase in risk weighted exposure amounts for an exposure protected by either collateral or unfunded credit protection (compared with a similar exposure without such protection). If for instance an exposure qualified for medium/low risk (under Annex II) and received a 20% conversion factor (and unsecured attracted a 100% risk weight) and was fully guaranteed (by a provider qualifying for a 50% risk weight) then under the proposed text a 100% conversion factor would have to be applied resulting in higher capital requirements.

The only approach where this would not be the case is the Financial Collateral Comprehensive method where point 1.4.2.60 makes clear that “E* shall be taken as the value to which the percentages indicated in Article 78(1) shall be applied to arrive at the exposure value.”

The Commission’s proposal also appears to override an institution’s own conversion factors, as determined under Annex VII, Part 3, point 9e. Credit risk mitigation for firms able to determine their own LGDs and conversion factors are not subject to these methods as set out in Article 91.

The proposed modifications are designed to clarify that the purpose of the comparison is to determine the portion of the exposure covered by unfunded credit protection or collateral and that the relevant conversion factors continue to apply. The Commission’s proposed amendment to 2.2.2.87 is therefore deemed unnecessary since the approach only relates to a fully covered position.

Detailed comments:

SECTION D: WAIVERS FOR COOPERATIVE BANK NETWORKS AND OTHER TECHNICAL AMENDMENTS

Co-decision Changes to Directive 2006/48/EC	
Art 150	<p>“Powers of Execution”</p> <p>We support the intentions of the Commission here, but we are concerned that further amendments to “non-essential elements” of the Directive may not follow the appropriate due process and proper consultation in future.</p> <p>Should the compromise figure of €150MM survive the</p>

	<p>consultation process as a threshold amount for Large Exposure in the Interbank market, then we would consider this an “essential element” of the Directive, and should therefore not be subject to change via Article 151 (2). (See <i>section on Large Exposures</i>).</p>
<p><i>The treatment of counterparty credit risk of derivative instruments, repurchase transactions, securities or commodities lending or borrowing transactions, long settlement transactions and margin lending transactions</i></p>	
<p>Annex III, part 1, point 5</p>	<p>Netting sets, hedging sets, and related terms [CRDTG Question 194]</p> <p>The current requirement is to calculate EEPE at netting set level. However, counterparty risk is calculated and limits set at the level of the counterparty. Calculating EEPE at netting set level requires firms to run different systems and internal validation practices at great expense for the sole purpose of complying with regulation. As a result exposures used for risk management purposes will differ from those calculated for regulatory capital purposes. We do not believe computing EEPE at the level of the counterparty changes the size of total counterparty credit risk capital.</p> <p>The proposed CRD amendments attempts to clarify the definition of a netting set for the purposes of calculating EPE:</p> <p><i>“all netting sets with a single counterparty may be treated as single netting set if negative simulated market values of the individual netting sets are set to 0 in the estimation of expected exposure (EE)”.</i></p> <p>We understand the intentions of the proposed changes, but question whether it directly addresses the issues raised in Question 194 submitted to the CRD TG?</p>
<p>Annex III, part 5, point 15</p>	<p>Counterparty credit risk – Standardised method [CRDTG Question 169]</p>

	<p>We understand that the Directive does not explicitly outline a treatment for basket “nth to default” CDS, and that it is difficult to derive a treatment from the rules for single name CDS. We therefore appreciate and consider helpful the proposed changes that result from the discussions of the CRDTG and that are based on the general approach for treating the underlying debt instruments.</p>
<p>Co-decision Changes to Directive 2006/49/EC</p>	
<p>Art 2 (1) last sub paragraph and Art 37 (1)</p>	<p>We propose that both these paragraphs [Art 2(1) last sub para and Art 37 (1)] are deleted and Art 37(1) is replaced by the following text:</p> <p><i>1. If a group has both investment firms and credit institutions, Title V, Chapter 4 of Directive [2000/12/EC] shall apply to the supervision of institutions as if references to credit institutions were institutions.</i></p> <p>In the circumstances envisaged by this provision in the directive, we believe that the principle should be that the balance of business of the group should determine the basis on which the consolidation is carried out.</p> <p>This amendment is in keeping with the principle of the Financial Conglomerates Directive [2002/87/EC] the regulations for consolidation and the allocation of responsibility for consolidated supervision to the competent authority should reflect the composition of the group on a case by case basis where a financial holding company has both a credit institution and investment firm as subsidiaries.</p>
<p>Art 45 and 48</p>	<p>This extends the review of the existing exemptions available to specialist commodities firms for whom the CRD does not currently apply. The review is extended by 2 yrs to 2012 to give time for a proper and thorough analysis to be conducted.</p> <p>? We welcome this amendment and support the need for</p>

	<p>more time to fully understand the appropriateness of regulation designed for financial institutions to specialist firms in the commodities sector.</p> <p>? We support an “alternative approach” to prudential regulation for specialist commodities firms, and encourage the Commission to use the extended period for the review to conduct a proper cost benefit analysis of the various policy options currently being considered.</p>
<p>AMENDMENTS SUBJECT TO THE COMITOLGY PROCEDURE</p>	
<p>Section E: TECHNICAL AMENDMENTS 2006/48/EC</p>	
<p>Annex VII, Part 2, 1.3.13 (c)</p>	<p>Maturity of repo style transactions subject to master netting agreement [CRDTG Question 121, and 128]:</p> <p>We support the proposed amendment, as it aligns the CRD more closely with the provisions of Basel II (paragraph 323). Basel II refers to repo style transactions in this provision, while the CRD currently does not.</p>
<p>Annex VIII, Part 1, 1.3.1.9</p>	<p>We have a comment regarding the proposed numbering. The new paragraph proposed is numbered (i) in the consultation paper, where the current CRD numbering for 1.3.1, point 9 only has an (a) and (b)? Should the new paragraph be labelled (c)?</p>
<p>Annex VIII, Part 1, 1.3.2.11</p>	<p>Again, we suggest the EU Commission check the proposed numbering / lettering of the existing paragraphs and the new paragraph proposed?</p>
<p>Annex VIII, Part 2, 1.8.2.13</p>	<p>On the treatment for life insurance policies, we suggest an additional clarification in point i) and refer to the “surrender value of the policy”.</p>
<p>Annex VIII, Part 3, 1.4.1.24</p>	<p>Although we have no serious concerns with the additional text in 1.4.1 point 24, the introduction to the Financial</p>

	<p>Collateral Simple Method, the requirement for firms to demonstrate that their choice of method is not motivated by regulatory arbitrage or lower capital requirements is unnecessary. If implemented correctly the incentive structure of the Basel II framework was designed to reward adoption of the advanced approaches, as they reflect a more sophisticated approach to risk management and a better understanding of the risks.</p>
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Consultation text	Recommended amendment
Annex VIII, Part 3, 1.4.1.26.	
<p>The risk weight that would be assigned under Articles 78 to 83 if the lender had a direct exposure to the collateral instrument shall be assigned to those portions of claims <u>exposure values</u> collateralised by the market value of recognised collateral. <u>For this purpose, the exposure value of an off-balance sheet item listed in Annex II shall be 100 % of its value rather than the exposure value indicated in Article 78(1).</u></p> <p>The risk weight of the collateralised portion shall be a minimum of 20 % except as specified in points 27 to 29. The remainder of the exposure <u>value</u> shall receive the risk weight that would be assigned to an unsecured exposure to the counterparty under Articles 78 to 83.</p>	<p>The risk weight that would be assigned under Articles 78 to 83 if the lender had a direct exposure to the collateral instrument shall be assigned to those portions of claims <u>exposure values</u> collateralised by the market value of recognised collateral. For the purpose of determining the collateralised portion, the exposure value of an off-balance sheet item listed in Annex II shall be 100% of its value rather than the exposure value indicated in Article 78(1). The relevant percentage set out in Annex II shall apply to both the collateralised portion and the remainder for the calculation of risk weighted exposure amounts. The risk weight of the collateralised portion shall be a minimum of 20 % except as specified in points 27 to 29. The remainder of the exposure <u>value</u> shall receive the risk weight that would be assigned to an unsecured exposure to the counterparty under Articles 78 to 83.</p>

Annex VIII, Part 3, 1.5.2.69	
<p><u>For this purpose, the exposure value of the items listed in Annex VII, Part 3, points 9 to 11 shall be calculated using a conversion factor or percentage of 100 % rather than the conversion factors or percentages indicated in those points.</u></p>	<p><i>New sentence</i></p> <p>For the purpose of determining the collateralised portion of the exposure, the exposure value of items listed in Annex VII, Part 3, points 9 (except e) to 11 shall be calculated using a conversion factor or percentage of 100% rather than the conversion factors or percentages indicated in those points. The conversion factors set out in Annex VII, Part 3, points 9 (except e) to 11 shall apply for the determination of exposure value in calculation of the risk weighted exposure amounts and expected loss amounts.</p>
Annex VIII, Part 3, 2.2.2.87 – 2.2.2.92	
	<p>We are not convinced that the proposed changes deal adequately with the issues raised by question number 208 submitted to the CRD TG (31 Jan 2007) and discussed as part of the tri-party negotiations considering changes to the CRD text.</p> <p>The question refers to the calculation of risk weighted exposure amounts and expected loss amounts for where you have bought unfunded credit protection.</p> <p>We believe that there is still potential for a higher capital charge for a unit of undrawn exposure partially hedged by a CDS than for the same exposure without the hedge put in place.</p> <p>During the CRDTG discussions, it was decided to make explicit amendments to Annex VIII Part 3 points 33 and 60 (Financial Collateral Comprehensive Methods) clarifying that CRM should be applied first.</p>

Annex VIII, Part 3, 2.2.2.87

For the purposes of Article 80, g shall be the risk weight to be assigned to an exposure, the exposure value (E) of which is fully protected by unfunded protection (GA), where:

E is the exposure value according to Article 78; for this purpose, the exposure value of an off-balance sheet item listed in Annex II shall be 100 % of its value rather than the exposure value indicated in Article 78(1);

g is the risk weight of exposures to the protection provider as specified under Articles 78 to 83; and

GA is the value of G* as calculated under point 84 further adjusted for any maturity mismatch as laid down in Part 4.

For the purposes of Article 80, g shall be the risk weight to be assigned to an exposure, the exposure value (E) of which is fully protected by unfunded protection (GA), where:

~~E is the exposure value according to Article 78; for this purpose, the exposure value of an off-balance sheet item listed in Annex II shall be 100 % of its value rather than the exposure value indicated in Article 78(1);~~

g is the risk weight of exposures to the protection provider as specified under Articles 78 to 83; and

GA is the value of G* as calculated under point 84 further adjusted for any maturity mismatch as laid down in Part 4.

Annex VIII, Part 3, 2.2.2.88 Second Sentence

where:

E is the exposure value according to Article 78. For this purpose, the exposure value of an off-balance sheet item listed in Annex II shall be 100% of its value rather than the exposure value indicated in Article 78(1);

where:

E is the exposure value according to Article 78.
For the purpose of determining the portion of the exposure protected by unfunded credit protection, the exposure value of an off-balance sheet item listed in Annex II shall be 100% of its value rather than the exposure value indicated in Article 78(1). The relevant percentage set out in Annex II continues to apply to both the exposure

	values of the protected and unprotected portion for the calculation of risk weighted exposure amounts.
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Annex VIII, Part 3, 2.2.3.92	
<p>GA is the value of G* as calculated under point 84 further adjusted for any maturity mismatch as laid down in Part 4. E is the exposure value according to Annex VII, Part 3. <u>For this purpose, the exposure value of the items listed in Annex VII, Part 3, points 9 to 11 shall be calculated using a conversion factor or percentage of 100 % rather than the conversion factors or percentages indicated in those points.</u></p>	<p>GA is the value of G* as calculated under point 84 further adjusted for any maturity mismatch as laid down in Part 4. E is the exposure value according to Annex VII, Part 3. For the purpose of determining the portion of the exposure protected by unfunded credit protection, the exposure value of items listed in Annex VII, Part 3, points 9 (except e) to 11 shall be calculated using a conversion factor or percentage of 100% rather than the conversion factors or percentages indicated in those points. The conversion factors set out in Annex VII, Part 3, points 9 (except e) to 11 shall apply to both the protected and unprotected proportion for the determination of exposure value in calculation of the risk weighted exposure amounts and expected loss amounts.</p>

Technical Amendment (15) Re: Annex XII, Part 3	
	<p>Qualifying requirements for the use of particular instruments or methodologies:</p> <p>This amendment is just for Annex XII, Part 3, point 3, we are not sure what the (c) in the consultation paper refers to?</p>
<p>Section F: TECHNICAL AMENDMENTS to Directive 2006/49/EC</p>	

Annex I, point 14	There is no difference in the weighting between step 3 and 4 – so change has no impact.