

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

**LARGE EXPOSURES**



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## Large Exposures

### **Key messages**

Large exposures is a very important part of the CRD amendment package for Members. We remain disappointed that the review has not led to a fundamental structural revision of the approach to large exposures. We continue to believe that an Internal Limits Based Approach, using the tools available to supervisors under Pillar 2 is the most appropriate regulatory response for those with appropriate systems and controls. It would be credible, proportionate, clear and transparent and is in line with the better regulation agenda. As such we believe that there should be a sunset clause inserted into both 2006/48/EC and 2006/49/EC to allow for further review (by the end of 2011) once supervisors have gained more experience with Pillar 2. Such a sunset clause would also have the benefit of allowing for the implications of other current regulatory reviews, such as the definition of capital, to be taken into account and for the inter-bank issue to be given further consideration once the consequences of recent events have had chance to be fully evaluated.

However, as they have done for many years, Members are prepared to accept a supervisory backstop limit regime. Our comments therefore are on the basis of the amended current regime operating in that way. Members have four major policy concerns regarding the current proposals: inter-bank; intra-group, connected lending and credit risk mitigation. In addition there are two significant process issues we would like to raise: clarity and location of text.

### ***Inter-bank exposures***

Members strongly believe that the existing exemption for inter-bank exposures should be retained. We do not believe that the 25% limit is the appropriate tool to address the concern of the regulatory community, because it provides no incentives to change the risk management behaviour of firms. Nor do we believe that post-insolvency issues should be the primary objective of the large exposures regime, although we recognise that it is an important consideration. The primary objective should be to reduce the risk of firm failure, resulting from idiosyncratic tail risk, to an acceptable level. As a result liquidity is a very important factor in determining the appropriate treatment. More so than for other entities, such as corporates, the absence or inability to access liquidity is a more significant factor in accelerating the

speed of firm failure. Therefore any restriction that artificially restricts liquidity is likely to increase rather than decrease the incidence of firm failure.

In addition there is no evidence that large exposures, much less those to other banks of less than one year maturity, have been the cause of firm failure. We would note that the existing exemption of inter-bank exposures below 1 year has been in place for over 15 years. Studies have shown that on the rare occasions on which bank failures occur it has been the result of internal control problems. We therefore oppose the removal of the 1 year inter-bank exposures exemption.

Whilst we welcome the Commission's attempt to mitigate the impact of its proposals on small and medium size banks by introducing a threshold - being the higher of 25% of a bank's own funds or EUR150m – at best it will be of limited benefit but is more likely to have unintended consequences. Small banks, in the UK at least, tend to collect retail deposits and be net lenders to larger banks. Requiring them to split their deposits into smaller amounts and spread them between a greater number of credit institutions would require them to diversify their risks but at the cost of lending to counter-parties with a lower credit rating than they would currently accept. A further adverse consequence would be the probability of the smaller banks receiving a lower return on their deposits because of the lower nominal size of the deposits placed.

### ***Intra-group exposures***

We fully support the introduction of a generally available exemption for intra-group exposures. This exemption is extremely important to Members because intra-group transactions are essential to the liquidity and risk management of internationally active groups. They are the primary means of channelling funding around the group and are central to the ability to manage risk on a global basis. We therefore fully support the approach taken which focuses on the aspects that make a group a source of strength rather than weakness, i.e. integrated risk management, thereby creating a positive incentive structure. However we believe that there are some essential drafting changes necessary to ensure that the qualifying criteria of Article 80(7)(e) are effectively operational and therefore that firms can use this exemption.

### ***Connected clients***

We disagree with the introduction of the funding criterion and think that it should be removed. This criterion will be very difficult to establish in practice, because firms will not necessarily be able to obtain the information on the detail of how counterparties

are funded and by whom to determine whether they are subject to the same funding constraints as other counterparties. Even where this information is available, it will require a significant additional level of resource to perform the analysis. Such analysis, to the extent it is possible is more likely to identify sectoral or geographic concentrations, which will already be picked up in Pillar 2. We also note that the change may have been introduced to address issues raised recently with respect to contingent liquidity facilities to conduits. The risks inherent in these facilities are liquidity and concentration risk but not single name risk. As a result, we believe that international work focusing on liquidity and, for capital purposes, securitisation are more appropriate to take forward the analysis and devise proposals relating to liquidity facilities.

### ***Credit Risk Mitigation (CRM)***

There is currently a lack of clarity with respect to exposure value and credit risk mitigation. Given the fact that it is explicitly recognised in some provisions and implicitly in others (the IMM calculation takes account of mitigants), we believe that there should be consistency across the regime. As a result we propose that the definition of large exposure explicitly makes reference to the calculation being made after the CRM treatments have been applied.

### ***Clarity***

We find the large exposures provisions confusing and difficult to follow. The CRM provisions are particularly problematic. We believe that it would be more appropriate to restructure the proposals and in places re-draft them to make the desired outcomes clear and transparent to both firms and regulators. At the time of the CRD review, only minimal changes were made to the Large Exposures regime to amend a few key provisions, but there was recognition that a full-scale review would be necessary to more fully integrate the large exposures regime into the new CRD structure. We believe that this is the appropriate opportunity to ensure that the regulations relating to large exposures can be credibly linked to the objectives, proportionate, clear and transparent and do not cause EU firms a competitive disadvantage. While we have made some suggestions we would be happy to work with the Commission further in developing the draft text.

### ***Consistency with Lamfalussy Principles***

As legacy text from older directives (Large Exposures Directive and the Consolidated Banking Directive), the large exposures section does not conform to the Lamfalussy style of much of the rest of the CRD. As a result we believe that inappropriate material is contained within the Level 1 text and that further thought should be given to the designation across the three levels. We have made recommendations in relation to moving some material to the Annexes (for example systems and controls and the calculation of exposure value post CRM) and to Level 3 (the provisions relating to the detail of the reporting package).

## Detailed comments

### Directive 2006/48/EC

<b>Article 4(45)</b>	
<b>Consultation text</b>	<b>Recommended amendment</b>
<p>'group of connected clients' means</p> <p>(a) two or more natural or legal persons, who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly , has control over the other or others; or</p> <p>(b) two or more natural or legal persons between whom there is no relationship of control as set out in point (a) but who are to be regarded as constituting a single risk because they are so interconnected , if one of them were to experiences financial problems, <u>in particular funding or repayment difficulties</u>, the other , or all of the others would be likely to encounter <u>funding or</u> repayment difficulties.</p>	<p>'group of connected clients' means</p> <p>(c) two or more natural or legal persons, who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly , has control over the other or others; or</p> <p>(d) two or more natural or legal persons between whom there is no relationship of control as set out in point (a) but who are to be regarded as constituting a single risk because they are so interconnected , if one of them were to experiences financial problems, <del>in particular funding or repayment difficulties</del>, the other , or all of the others would be likely to encounter <del>funding or</del> repayment difficulties.</p>
<b>Justification</b>	
<p><u>Connected clients</u> - What matters from a credit risk perspective is the fact that a counterparty might encounter payment difficulties, rather than the cause of those difficulties. Such analysis, to the extent it is possible is more likely to identify sectoral or geographic concentrations. A funding squeeze is just one of a vast array of potential causes of defaults. Economic slump in a particular region or industry could also generate widespread payment problems. We therefore believe that it is unnecessary to include this criterion as it is already addressed in Pillar 2. A funding criterion will also be very difficult to establish in practice, because firms will not necessarily be able to obtain the information on the detail of how counterparties are</p>	

funded and by whom to determine whether they are subject to the same funding constraints as other counterparties. Even where this information is available, it will require a significant additional level of resource to perform the analysis and as noted is likely to pick up concentration rather than single name issues.. Therefore not only will it not be possible to identify at a single counterparty level envisaged, at the portfolio level it will already be addressed.

We understand from the CEBS consultation that this requirement may have been inserted in response a specific incident (regarding Industriekreditbank -IKB). We do not believe that it is appropriate to require all liquidity facilities to off balance sheet vehicles to be aggregated together because the risk inherent is not one of single name credit risk. The provision of such liquidity facilities obviously entails a degree of liquidity risk that must be managed carefully, but this risk should be addressed as part of the liquidity review. The risk of loss, however, relates to the underlying assets and therefore depends on the correlation between the assets and the correlation between transactions. As such this is a concentration risk that is more appropriately dealt with under Pillar 2.

Definition of large exposure - We would also note that as an alternative to Article 108, the definition of a large exposure could be included within Article 4.

<b>Article 106(1)</b>	
<b>Consultation text</b>	<b>Recommended amendment</b>
<p>'Exposures', for the purposes of this Section, shall mean any asset or off-balance-sheet item referred to in Section 3, Subsection 1, without application of the risk weights or degrees of risk there provided for.</p> <p>Exposures arising from the items referred to in Annex IV shall be calculated in accordance with one of the methods set out in Annex III. For the purposes of this Section, Annex III, Part 2, point 2 shall</p>	<p>'Exposures', for the purposes of this Section, shall mean any asset or off-balance-sheet item referred to in Section 3, Subsection 1, without application of the risk weights or degrees of risk there provided for. <u>Exposure value should be measured net of provisions and credit risk mitigants and calculated in accordance with [Annex XV]</u></p> <p>Exposures arising from <u>securities financing transactions and</u> the items referred to in Annex IV shall be</p>

<p>also apply.</p>	<p>calculated in accordance with one of the methods set out in Annex III. For the purposes of this Section, Annex III, Part 2, point 2 shall also apply.</p> <p><u>A credit institution permitted to use its own estimates of conversion factors for an exposure class under Article 84 to 89, shall be permitted to use these estimates for the purposes of calculating exposure value under Article 106 (1).</u></p> <p><u>Exposures to central counterparties should be calculated in accordance with Annex III part 2 point 6</u></p>
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**Justification**

Provisions – For purposes of clarity, given the insertion of the third paragraph in Article 106(1), we think that the text should make clear that exposure value should be recorded net of provisions.

Credit risk mitigation – the current position with regard to CRM is unclear. We believe exposure value for the purposes of determining whether an exposure is large and in relation to whether the limit is breached should be calculated net of CRM. Article 111 specifically states that exposure value should take account of CRM but Article 108 does not indicate whether this is the case. Article 110 requires that exposures be reported prior and post some forms credit risk mitigation (it would appear that exposures subject to netting would be considered prior to CRM). Article 30 of the CAD specifically states that some forms of CRM may be recognised in determining exposure for securities financing transactions.

In addition, we would note that CRM is inherent in the calculation of some exposures. For example, the IMM approach to derivatives and securities financing transactions, will, by its very nature, include credit risk mitigation.

Securities financing transactions – This Article should also make clear that exposure value for securities financing transactions can also be calculated using the methods in Annex III, to be consistent with the calculation of capital requirements.

EAD - The current text is unclear as to whether EAD is an acceptable measure of

exposure and we think that it should be included explicitly. EAD is a conservative measure and is consistent with the solvency calculation. We therefore believe that it is appropriate to use this measure because it is prudent and to do so will reduce the administrative burden on firms of generating multiple exposure values.

Central counterparties – For the sake of clarity, additional text has been inserted to clarify the position regarding central counterparties

<b>Article 106(3)</b>	
<b>Consultation text</b>	<b>Recommended amendment</b>
<p><u>In respect of exposures referred to in Article 79, paragraph 1, points m, o and p, where there is an exposure to underlying assets, a credit institution shall look through to the underlying exposures where it is aware of them in order to determine the existence of a group of connected clients.</u></p>	<p><u>In respect of exposures referred to in Article 79, paragraph 1, points m, and o and p, institutions should identify whether the risk of incurring a loss from an exposure to a scheme arises from to the probability of default of the where there is an exposure to underlying assets, the scheme, or both. The institution should record the exposure to the scheme or look through to the underlying assets or record both as appropriate. In determining this assessment, institutions must evaluate the economic substance of the transaction. a credit institution shall look through to the underlying exposures where it is aware of them in order to determine the existence of a group of connected clients</u></p> <p><u>Institutions may look through exposures in other asset classes where they do so for risk management purposes on the basis of economic substance.</u></p>

**Justification**

It is not appropriate to require look-through in all cases; the decision to look-through to the underlying assets should align with risk management practice. Structuring transactions can change the risk profile. For example by tranching the risk becomes a blend of the underlying assets and their correlations. Requiring such look-through where the assets are known will create a perverse incentive not to obtain more information on the underlyings where it would be appropriate to do so to inform the risk assessment, but where it is not appropriate to record exposures to the underlying assets from a risk management perspective. We think that the CEBS proposal outlined in CP 16 where look-through is determined by regard to certain factors will result in a more appropriate outcome. We think that guidance on the factors should be included in level three guidance, i.e. from CP 16:

‘Examples of factors that institutions might take into account in determining this assessment include: sources of repayment, including recourse provisions; size, nature, quality and granularity of the underlying credit exposures; tenor; and the sustainability of the cash flow.’

To this list we would also add ‘position in the waterfall’.

Item ‘p’ in Article 79 is unlikely to contain exposures that would be appropriate for look through. However, we believe that where firms look through exposures in other asset classes for risk management purposes, based on the factors above, they should also do so for large exposures purposes. This may be the case for some SPV exposures that fall within the corporate category because they are not tranching.

**Article 107**

<b>Consultation text</b>	<b>Recommended amendment</b>
<p><u>Notwithstanding Article 4 paragraph (1),</u>  <u>For the purposes of calculating the value</u>  <u>of exposures in accordance with</u> applying                      this Section, the term 'credit institution'                      shall <u>also</u> cover <del>the following:</del></p>	<p><del><u>Notwithstanding Article 4 paragraph (1),</u></del>  <del><u>For the purposes of calculating the value</u></del>  <del><u>of exposures in accordance with</u></del> applying                      this Section, the term 'credit institution'                      shall <u>also</u> cover the following:</p>

<p><del>(a) a credit institution, including its branches in third countries; and</del></p> <p><del>(b) any private or public undertaking, including its branches, which meets the definition of 'credit institution' and has been authorised in a third country.</del></p>	<p><del>(a) a credit institution, including its branches in third countries; and</del></p> <p><del>(b) any private or public undertaking, including its branches, which meets the definition of 'credit institution' and has been authorised in a third country</del></p>
<p><b>Justification</b></p> <p>The amendment proposed has helpfully clarified that the intention of this Article is not to apply the large exposures framework to branches. We agree that this is the right outcome, since branches are not separate legal entities. As a result the Article is redundant; exposures to third country institutions will already be captured by the general provisions of the CRD.</p>	

<p align="center"><b>Article 108</b></p>	
<p><b>Consultation text</b></p>	<p><b>Recommended amendment</b></p>
<p>A credit institution's exposure to a client or group of connected clients shall be considered a large exposure where its value is equal to or exceeds 10 % of its own funds.</p>	<p>A credit institution's exposure to a client, or group of connected clients, <u>after taking into account the effect of the credit risk mitigation in accordance with [Annex XV] but before taking account of exemptions</u>, shall be considered a large exposure where its value is equal to or exceeds 10 % of its own funds.</p>
<p align="center"><b>Justification</b></p> <p><u>CRM</u> – as outlined in Article 106(1) we believe that exposure should be measured consistently on a post CRM basis (see comments above).</p> <p><u>Exemptions</u> – there is a current lack of clarity with respect to the treatment of exempt exposures, but the intention of Article 110 seems to be that exemptions should be disregarded for the purposes of determining whether an exposure is large or not. We think it would be helpful to clarify this point.</p>	

<b>Article 109</b>	
<b>Consultation text</b>	<b>Recommended amendment</b>
<p>The competent authorities shall require that every credit institution have sound administrative and accounting procedures and adequate internal control mechanisms for the purposes of identifying and recording all large exposures and subsequent changes to them, in accordance with this Directive, and for that of monitoring those exposures in the light of each credit institution's own exposure policies.</p>	<p><del>The competent authorities shall require that every credit institution have sound administrative and accounting procedures and adequate internal control mechanisms for the purposes of identifying and recording all large exposures and subsequent changes to them, in accordance with this Directive, and for that of monitoring those exposures in the light of each credit institution's own exposure policies.</del></p> <p>Annex V, <u>11 Large Exposures</u></p> <p><u>16 The competent authorities shall require that every credit institution have sound administrative and accounting procedures and adequate internal control mechanisms for the purposes of identifying and recording all large exposures and subsequent changes to them, in accordance with this Directive, and for that of monitoring those exposures in the light of each credit institution's own exposure policies.</u></p>
<b>Justification</b>	
<p>The requirement for systems and controls to address the risks resulting from large exposures sits more naturally with the other risks identified in Pillar 2. We therefore believe that this requirement should be moved to Annex V.</p>	

<b>Article 110 (1) and (2)</b>	
<b>Consultation text</b>	<b>Recommended amendment</b>
<p>1. A credit institution shall report <u>the following information about every large exposure to the competent authorities, including those exempted from the application of Article 111(1):-</u></p> <p><u>a) the identification of the client or the group of connected clients to which a credit institution has a large exposure;</u></p> <p><u>b) the exposure value before taking into account the effect of the credit risk mitigation, to the extent possible;</u></p> <p><u>c) where used, the type of funded or unfunded credit protection;</u></p> <p><u>d) the exposure value after taking into account the effect of the credit risk mitigation calculated for the purpose of Article 111(1).</u></p> <p><u>If a credit institution is subject to Articles 84 to 89, its 20 largest exposures on a consolidated basis, excluding those exempted from the application of Article 111(1), shall be made available to the competent authorities.</u></p> <p>2. Member States shall provide that reporting is to be carried out <u>not less than twice each year,</u> at their discretion, in accordance with one of the following two methods:</p> <p><u>(a) reporting of all large exposures at</u></p>	<p>1. A credit institution shall report <del>the following information about</del> every large exposure to the competent authorities <u>according to the format and frequency specified by them,</u> including those <del>exempted from the application of Article 111(1):-</del></p> <p><del>a) the identification of the client or the group of connected clients to which a credit institution has a large exposure;</del></p> <p><del>b) the exposure value before taking into account the effect of the credit risk mitigation, to the extent possible;</del></p> <p><del>c) where used, the type of funded or unfunded credit protection;</del></p> <p><del>d) the exposure value after taking into account the effect of the credit risk mitigation calculated for the purpose of Article 111(1).</del></p> <p><del>If a credit institution is subject to Articles 84 to 89, its 20 largest exposures on a consolidated basis, excluding those exempted from the application of Article 111(1), shall be made available to the competent authorities.</del></p> <p><u>2. Member States shall provide that reporting is to be carried out not less than twice each year,</u> at their discretion, in accordance with one of</p>

<p><del>least once a year, combined with reporting during the year of all new large exposures and any increases in existing large exposures of at least 20 % with respect to the previous communication; or</del></p> <p><del>(b) reporting of all large exposures at least four times a year.</del></p> <p><del>2. Except in the case of credit institutions relying on Article 114 for the recognition of collateral in calculating the value of exposures for the purposes of paragraphs 1, 2 and 3 of Article 111, exposures exempted under Article 113(3)(a) to (d) and (f) to (h) need not be reported as laid down in paragraph 4 and the reporting frequency laid down in point (b) of paragraph 1 of this Article may be reduced to twice a year for the exposures referred to in Article 113(3)(e) and (i), and in Articles 115 and 116.</del></p> <p><del>Where a credit institution invokes this paragraph, it shall keep a record of the grounds advanced for at least one year after the event giving rise to the dispensation, so that the competent authorities may establish whether it is justified.</del></p>	<p><del>the following two methods:</del></p> <p><del>(a) reporting of all large exposures at least once a year, combined with reporting during the year of all new large exposures and any increases in existing large exposures of at least 20 % with respect to the previous communication; or</del></p> <p><del>(b) reporting of all large exposures at least four times a year.</del></p> <p><del>2. Except in the case of credit institutions relying on Article 114 for the recognition of collateral in calculating the value of exposures for the purposes of paragraphs 1, 2 and 3 of Article 111, exposures exempted under Article 113(3)(a) to (d) and (f) to (h) need not be reported as laid down in paragraph 4 and the reporting frequency laid down in point (b) of paragraph 1 of this Article may be reduced to twice a year for the exposures referred to in Article 113(3)(e) and (i), and in Articles 115 and 116.</del></p> <p><del>Where a credit institution invokes this paragraph, it shall keep a record of the grounds advanced for at least one year after the event giving rise to the dispensation, so that the competent authorities may establish whether it is justified.</del></p>
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**Justification**

Location of text - We entirely agree that competent authorities require sufficient information about the risks that a firm is running, including large exposures, for them

to be able to form a judgement on the institution and undertake efficient supervision. However, we do not believe that detailed reporting requirements or their frequency should be laid down in Level 1 text, but should be at Level 3. We think that any amendments to the CRD should be mindful that it was intended to be developed as a Lamfalussy Directive and therefore appropriately designate requirements to different levels. Nowhere else in the CRD are reporting requirements specified; elsewhere they are under the purview of CEBS and the COREP package. We can see no reason for differentiating large exposures for reporting purposes.

Detailed requirements - In terms of the detail of the reporting requirements themselves we would highlight that we do not believe that it is appropriate to require IRB firms to provide detail on the 20 largest exposures. If they meet the definition of 'large', they will automatically be reported. If they are not 'large' then we believe that the risk associated with them is minimal and therefore it is not necessary for them to be reported to enable regulators to perform their supervisory functions. Such a requirement, therefore, imposes an administrative burden that is not justified by cost benefit analysis or the need to meet the regulatory objective.

As a result of our comments above in Articles 106 and 108, regarding the need to be consistent in the approach to CRM, we do not believe it is appropriate to require exposures to be reported gross of CRM in (b). Members also note that (c) would be very difficult to implement in practice. It is not clear what is expected (amounts associated with each method or merely general notification of methods used) and firms use many forms of CRM to mitigate exposures to a single counterparty. We therefore believe that only (a) and (d) are appropriate reporting requirements.

<b>Article 110 (3)</b>	
<b>Consultation text</b>	<b>Recommended amendment</b>
Member States <del>shall</del> may require credit institutions to analyse, <u>to the extent possible,</u> their exposures to collateral issuers <u>and providers of unfunded credit protection</u> for possible concentrations and where appropriate take action <u>and</u> report any significant findings to their	<del>Member States shall</del> may require credit institutions to analyse, <u>to the extent possible,</u> their exposures to collateral issuers <u>and providers of unfunded credit protection</u> for possible concentrations and where appropriate take action <u>and</u> report any significant findings to their

competent authority.	<del>competent authority.</del>
<b>Justification</b>	
<p>We do not think that this Article is necessary or appropriate to meet the objectives of the large exposures regime. As noted above the approach to CRM has changed and in most methods, the level of collateral provided is calculated as a cash equivalent on a prudent basis, as such the risk of single name exposure resulting from funded protection from a regulatory perspective is already addressed. Also the precise nature of the requirement imposed on firms by Article 110 (3) has always been unclear. We think that it is more appropriate to consider any concentrations that result as a result of funded CRM as part of Pillar 2. Annex V already addresses this point. We believe that further guidance on the convergent application of the Pillar 2 requirement can be provided by CEBS.</p>	

<b>Article 111</b>	
<b>Consultation text</b>	<b>Recommended amendment</b>
<p>1. A credit institution may not incur an exposure, <u>after taking into account the effect of the credit risk mitigation in accordance with Articles 112 to 117,</u> to a client or group of connected clients the value of which exceeds <u>25 %</u> of its own funds.</p> <p><u>(i) Where that client is an institution, this value may not exceed 25% of its own funds or the amount of EUR [X] million, whichever is higher.</u></p> <p><u>(ii) Where a group of connected clients includes one or more institutions, a credit institution may not incur an exposure, after taking into account the effect of the credit risk mitigation in</u></p>	<p>1. A credit institution may not incur an exposure, <u>subject to Article 113 and after taking into account the effect of the credit risk mitigation in accordance with [Articles 442 to 447-Annex XVI],</u> to a client or group of connected clients the value of which exceeds <u>25 %</u> of its own funds.</p> <p><del><u>(i) Where that client is an institution, this value may not exceed 25% of its own funds or the amount of EUR [X] million, whichever is higher.</u></del></p> <p><del><u>(ii) Where a group of connected clients includes one or more institutions, a credit institution may not incur an exposure, after taking into account the effect of the credit risk mitigation in accordance with</u></del></p>

accordance with Articles 112 to 117, to all connected institutions the value of which exceeds the difference between 25% of its own funds or the amount of EUR [X] million, whichever is higher, and the sum of exposure values to the other connected clients that are not institutions. The sum of exposure values, after taking into account the effect of the credit risk mitigation in accordance with Articles 112 to 117, to other connected clients that are not institutions may not exceed 25% of a credit institution's own funds.

Member States may impose a lower amount than EUR [X] million.

~~2. Where that client or group of connected clients is the parent undertaking or subsidiary of the credit institution and/or one or more subsidiaries of that parent undertaking, the percentage laid down in paragraph 1 shall be reduced to 20 %. Member States may, however, exempt the exposures incurred to such clients from the 20 % limit if they provide for specific monitoring of such exposures by other measures or procedures. They shall inform the Commission and the European Banking Committee of the content of such measures or procedures.~~

~~3. A credit institution may not incur large exposures which in total exceed 800 % of its own funds.~~

~~Articles 112 to 117, to all connected institutions the value of which exceeds the difference between 25% of its own funds or the amount of EUR [X] million, whichever is higher, and the sum of exposure values to the other connected clients that are not institutions. The sum of exposure values, after taking into account the effect of the credit risk mitigation in accordance with Articles 112 to 117, to other connected clients that are not institutions may not exceed 25% of a credit institution's own funds.~~

~~Member States may impose a lower amount than EUR [X] million.~~

~~2. Where that client or group of connected clients is the parent undertaking or subsidiary of the credit institution and/or one or more subsidiaries of that parent undertaking, the percentage laid down in paragraph 1 shall be reduced to 20 %. Member States may, however, exempt the exposures incurred to such clients from the 20 % limit if they provide for specific monitoring of such exposures by other measures or procedures. They shall inform the Commission and the European Banking Committee of the content of such measures or procedures.~~

~~3. A credit institution may not incur large exposures which in total exceed 800 % of its own funds.~~

~~24. A credit institution shall at all times comply with the limits laid down in~~

<p>24. A credit institution shall at all times comply with the limits laid down in paragraphs 1, 2 and 3 in respect of its exposures. If in an exceptional case exposures exceed these limits, the fact <u>value of the exposure</u> shall be reported without delay to the competent authorities which may, where the circumstances warrant it, allow the credit institution a limited period of time in which to comply with the limits.</p>	<p>paragraphs 1, 2 and 3 in respect of its exposures. If in an exceptional case exposures exceed these limits, the <u>fact value of the exposure</u> shall be reported without delay to the competent authorities which may, where the circumstances warrant it, allow the credit institution a limited period of time in which to comply with the limits.</p>
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## Justification

Supervisory limits - We continue to believe that where a firm's risk controls for single name risk are deemed adequate that the most appropriate approach to tail event idiosyncratic risk is an internal limits based approach, as outlined in our submission to CEBS on CP16 (copied to the European Commission). 'We think that the ILBA would be credible, proportionate, clear and transparent, and is in line with the Better Regulation agenda. We believe that, in meeting the supervisory objective, a large exposures regime should target the issues that are not already addressed by the regulatory framework and encourage firms to manage the risk appropriately. It is questionable whether a supervisory limits based regime, because of its backstop nature, will achieve these aims.' However, we acknowledge that regulators are not prepared to pursue this option at this time and have stated that the objective is to create a backstop regime with the supervisory limits. We therefore think that a sunset clause would be appropriate (see Article 119) to assess other legitimate options to meet the regulatory objectives. Our comments on the rest of the regime are addressed in the context of the supervisory limits acting as a backstop.

Inter-bank exposures – We strongly oppose the automatic application of the 25% limit to exposures to banks and investment firms regardless of maturity. We acknowledge the attempt to mitigate the impact and remove some of the distortions to behaviour that the proposed change would have on smaller institutions. However, this issue is not just a serious concern for smaller institutions, it is also a material issue for medium and larger firms. Our proposed amendment, to reinstate the under 1 year exemption, is contained in Article 113 (below).

It is important to understand that banks and investment firms are different from other entities such as corporates. Access to liquidity is extremely important to these entities, and anything that artificially restricts liquidity is likely to exacerbate firm failure. BIS working paper 243 would tend to support this conclusion: 'illiquidity may not only amplify contagion, it may even cause it. The Muller study also highlighted in that working paper concluded that there were two effects of liquidity lines:

- (a) providing a source of liquidity thereby reducing the risk of banks not being able to meet their commitments; and
- (b) draws on liquidity lines introducing a liquidity shock at banks that have to provide the liquidity.

Of these effects the study indicated that (a) was by far the more important. In other words introducing a potential barrier to liquidity is likely to have the opposite effect to that intended.

We agree that in terms of the perfect market assumption that underpins all Market Failure Analysis, banks and investment firms could be the subject of tail event idiosyncratic risk and that it is relevant to consider exposures between these entities when developing the large exposures regime. However, we do not think that the market failure analysis holds in the same way as for other types of entities, nor has there been any actual evidence of problems caused by inter-bank exposures.

The negative externalities of failing to internalise the cost of systemic failure are relevant and contagion is an appropriate consideration. The cost of failure to consumers, while obviously a legitimate concern of regulators, is a second order issue because the objective of the large exposures regime is to pre-emptively reduce the risk of failure to an acceptable level, thereby minimising the cost. We also agree that moral hazard is a relevant regulatory failure.

However we do not believe that a regulatory limit is the most appropriate tool to address these failures. A limit will not cause firms to internalise the systemic risk. It is arguable that the CRD has already addressed this risk by imposing a floor on probability of default. Neither will a limit cause firms to take account of the risk of contagion within their systems, as these entities will not meet the definition of connected (nor should be considered connected, such sectoral concentration should be addressed in Pillar 2). A limits based regime will not serve to address the moral hazard resulting from other parts of the regulatory framework such as deposit guarantee schemes, because a limit provides no incentive to do so (we acknowledge it will restrict the level of exposures in a post insolvency state, although we do not believe it will cure the problem of unwinding a complex large institution because it will serve to increase the number of counterparties). However, there are other mitigating actions taken by management such as stress testing of significant counterparties, which will more appropriately address the risk, as these will directly influence firm behaviour.

There is no evidence that large exposures, and particularly inter-bank exposures, have been the cause of firm failure<sup>1</sup>. The Basel and Groupe de Contact studies

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<sup>1</sup> We do not regard Rhineland Funding as being an example of a large exposure failure because the risk related to liquidity draw and asset concentrations that should be addressed under Pillar II.

found that most firm failures were the result of internal control problems. Additionally, the large exposures regime, including the various exemptions for inter-bank exposures, has been in place for over 15 years without evidence of any problems arising.

Therefore we believe there is no reason to remove the existing exemption, for exposures of less than one year's maturity, on either theoretical or empirical grounds.

In terms of practical impact, the change would increase the use made of collateral and repo type transactions (at an increased cost and where this is possible) and in some cases, profitable business may simply be scaled back or future growth foregone. The limit would also affect credit risk mitigation activity. Here the requirements on eligible protection providers in the solvency framework encourage firms to take exposures to other credit institutions.

As well as increasing the cost, there are also limits to the amount of collateral that is available and there are some types of transactions that it would be impossible to collateralise. Members would particularly highlight exposures arising from clearing as falling within this concept. While there are some exemptions from the capital and large exposures framework that address this issue (fx transactions and securities settlement subject to DvP). These would not capture the full range of activities that could not be secured but would be affected. For example BACS (Bankers Automated Clearing System) processing is very important to the smooth running of the financial system, but can lead to large unpredictable exposures overnight. We would also note that the nature of the exposures to some counterparties is such that it will be very difficult to increase the level of secured or repo-style transactions that make up the balance.

Determining the cost impact with any accuracy is difficult, not least because of the potential for second order effects (e.g. prices changing as a result of firms pursuing a limited supply of collateral to secure their exposures). We believe the initial results suggest that the incremental cost impact could be significantly greater than the ?89m suggested by the CEBS consultation. The proposal will have a disproportionate impact on the UK because it does not fully apply the discretion available under Article 69 (1) and 69(3), hence legal entities within the group (including parent credit institutions) are subject to large exposures limits on a solo basis, measured relative to their solo capital resources. Impact data regarding the proposed change is being sent to the European Commission under separate cover.

As noted earlier we acknowledge the attempt to address the perverse incentives

created by the limit on smaller firms. However, we think that the threshold amount may cause problems for medium sized firms, who will also be impacted by this change. The cliff effect that this amendment therefore creates is not desirable. It is unclear whether this approach can be implemented by individual entities that are part of larger groups. Where this is the case, the differentiated approach may cause implementation problems for groups.

Finally we oppose the introduction of national discretion to introduce lower thresholds as this would create an unlevel playing field across Europe.

<b>Article 112</b>	
<b>Consultation text</b>	<b>Recommended amendment</b>
<p>1. For the purposes of Articles 113 to 117, the term 'guarantee' shall include credit derivatives recognised under Articles 90 to 93 other than credit linked notes.</p> <p>2. Subject to paragraph 3, where, under Articles 113 to 117, the recognition of funded or unfunded credit protection <del>is</del> may be permitted, this shall be subject to compliance with the eligibility requirements and other minimum requirements, set out under Articles 90 to 93 <del>for the purposes of calculating risk-weighted exposure amounts under Articles 78 to 83.</del></p> <p>3. Where a credit institution relies upon Article 114(2), the recognition of funded credit protection shall be subject to the relevant requirements under Articles 84 to 89.</p> <p>4. For the purpose of this Section, a</p>	<p><u><i>Annex XV – Large Exposures.</i></u></p> <p><b><u>Part 1 – credit risk mitigation</u></b></p> <p><b><u>1.1 Eligibility and operational requirements for credit risk mitigation</u></b></p> <p><u>1. credit institutions with exposures subject to on or off balance sheet netting shall meet the operational requirements contained in []</u></p> <p><u>2. credit institutions that calculate their capital requirements according to articles 78 to 83 or that have permission to estimate probability of default, but not own estimates of conversion factors or LGD under Articles 84 to 89, should recognise credit risk mitigants in accordance with the eligibility criteria and minimum operational requirements in Articles 90 to 93 and Annex VIII and the credit risk mitigation method used for capital purposes.</u></p>

<p><u>credit institution shall not take account of the collateral referred to in Annex VIII, Part 1, points 20-22, unless permitted under Article 115.</u></p>	<p><u>3. credit institutions that have permission to use their own estimates of probability of default, conversion factors and LGD, under Articles 84 to 89 should recognise credit risk mitigation according to the eligibility criteria and minimum operational criteria contained in those articles and where appropriate Annex VIII.</u></p> <p><del>For the purposes of Articles 113 to 117, the term 'guarantee' shall include credit derivatives recognised under Articles 90 to 93 other than credit linked notes.</del></p> <p><del>2. Subject to paragraph 3, where, under Articles 113 to 117, the recognition of funded or unfunded credit protection is may be permitted, this shall be subject to compliance with the eligibility requirements and other minimum requirements, set out under Articles 90 to 93 for the purposes of calculating risk weighted exposure amounts under Articles 78 to 83.</del></p> <p><del>3. Where a credit institution relies upon Article 114(2), the recognition of funded credit protection shall be subject to the relevant requirements under Articles 84 to 89.</del></p> <p><del>4. For the purpose of this Section, a credit institution shall not take account of the collateral referred to in Annex VIII, Part 1, points 20-22, unless permitted under Article 115.</del></p>
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## **Justification**

Location of text - As noted earlier, we think that amendments to the CRD for large exposures should also take account of the intent to create a Lamfalussy style Directive. As such we think it would be appropriate to move the provisions relating to the detail of how to apply credit risk mitigation to Level 2 text, which would require the creation of a new Annex.

Clarity – We find the CRM requirements for large exposures generally unclear. We advocate that they are located together in an Annex (as suggested above) and re-structured so as to more clearly signpost eligibility and operational requirements, exposure values and counterparties. In respect of this particular provision, Members would find it helpful if the eligibility and operational requirements for credit risk mitigation make reference to the approaches to credit risk. Netting should also be explicitly covered.

Physical collateral - We disagree that the recognition of physical collateral should be restricted to commercial and residential real estate. We think that use of credit risk mitigants should be encouraged as good risk management practice. Conventional work outs of unsecured exposures can take 2 to 3 years. Financial collateral can be liquidated in a matter of days and even physical collateral in a matter of months. Therefore the taking of collateral, even physical collateral, increases the likelihood of a better outcome than not taking it. We think it is particularly important to be able to recognise physical commodities, where there is a ready market.

The approach to recognition of physical collateral for capital purposes is already conservative and rigorous; and includes the ability to liquidate in a timely manner. It will also reduce the ability of firms to use this form of collateral, thereby undermining the extended recognition of this CRM technique for capital purposes.

The prohibition on recognition of physical collateral will also add to the systems costs borne by firms because it will be necessary to hold two sets of valuation data for exposures collateralised in this way. It will also increase the cost of doing business in some areas, as this collateral is less likely to be deemed acceptable by firms as they will not be able to use it for regulatory purposes.

Finally, the prohibition is likely to be extremely detrimental to commodities firms and this issue should be raised as part of the Commodities Review currently underway.

**Article 113**

Consultation text	Recommended amendment
<p><del>1. Member States may impose limits more stringent than those laid down in Article 111.</del></p> <p><del>2. Member States may fully or partially exempt from the application of Article 111(1), (2) and (3) exposures incurred by a credit institution to its parent undertaking, to other subsidiaries of that parent undertaking or to its own subsidiaries, in so far as those undertakings are covered by the supervision on a consolidated basis to which the credit institution itself is subject, in accordance with this Directive or with equivalent standards in force in a third country.</del></p> <p><del>13. Member States may fully or partially exempt</del> <u>The following exposures shall be exempted</u> from the application of Article 111(1):</p> <p>(a) asset items constituting claims on central governments or central banks which, unsecured, would be assigned a 0 % risk weight under Articles 78 to 83;</p> <p>(b) asset items constituting claims on international organisations or multilateral development banks which, unsecured, would be assigned a 0 % risk weight under Articles 78 to 83;</p> <p>(c) asset items constituting claims carrying the explicit guarantees of</p>	<p><del>1. Member States may impose limits more stringent than those laid down in Article 111.</del></p> <p><del>2. Member States may fully or partially exempt from the application of Article 111(1), (2) and (3) exposures incurred by a credit institution to its parent undertaking, to other subsidiaries of that parent undertaking or to its own subsidiaries, in so far as those undertakings are covered by the supervision on a consolidated basis to which the credit institution itself is subject, in accordance with this Directive or with equivalent standards in force in a third country.</del></p> <p><del>13. Member States may fully or partially exempt</del> <u>The following exposures shall be exempted</u> from the application of Article 111(1):</p> <p>(a) <u>asset items constituting claims on exposures to, or protected by, central governments or central banks, which, unsecured, would be assigned a 0 % risk weight under Articles 78 to 83, including those in a third country, which applies supervisory and regulatory arrangements at least equivalent to those applied in the Community, denominated and funded in the domestic currency;</u></p> <p>(b) <del>asset items constituting claims on</del></p>

<p>central governments, central banks, international organisations, multilateral development banks or public sector entities, where unsecured claims on the entity providing the guarantee would be assigned a 0 % risk weight under Articles 78 to 83;</p> <p>(d) other exposures attributable to, or guaranteed by, central governments, central banks, international organisations, multilateral development banks or public sector entities, where unsecured claims on the entity to which the exposure is attributable or by which it is guaranteed would be assigned a 0 % risk weight under Articles 78 to 83;</p> <p>(e) <del>asset items constituting claims on and other exposures to central governments or central banks not mentioned in point (a) which are denominated and, where applicable, funded in the national currencies of the borrowers;</del> <u>asset items constituting claims on Member States' regional governments and local authorities where those claims would be assigned a 0 % risk weight under Article 78 to 83 and to other exposures to or guaranteed by such governments and authorities claims on which would be assigned a 0 % risk weight under Articles 78 to 83;</u></p> <p>(f) <del>asset items and other exposures secured, to the satisfaction of the competent authorities, by collateral in</del></p>	<p><u>exposures to, or protected by</u> international organisations or multilateral development banks which, <del>unsecured</del>, would be assigned a 0 % risk weight under Articles 78 to 83;</p> <p>(c) <u>exposures to, or protected by, regional governments, local authorities or public sector entities</u> <del>that asset items constituting claims carrying the explicit guarantees of central governments, central banks, international organisations, multilateral development banks or public sector entities, where unsecured claims on the entity providing the guarantee would be assigned a 0 % risk weight under Articles 78 to 83;</del></p> <p>(d) <del>other exposures attributable to, or guaranteed by, central governments, central banks, international organisations, multilateral development banks or public sector entities, where unsecured claims on the entity to which the exposure is attributable or by which it is guaranteed would be assigned a 0 % risk weight under Articles 78 to 83;</del></p> <p>(e) <del>asset items constituting claims on and other exposures to central governments or central banks not mentioned in point (a) which are denominated and, where applicable, funded in the national currencies of the borrowers;</del> <u>asset items constituting claims on Member States' regional governments and local authorities</u></p>
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~~the form of debt securities issued by central governments or central banks, international organisations, multilateral development banks, Member States' regional governments, local authorities or public sector entities, which securities constitute claims on their issuer which would be assigned a 0 % risk weighting under Articles 78 to 83 exposures to counterparties referred to in Article 80(7) or 80(8). For this purpose, point (d) of Article 80(7) shall not be applied. Exposures that do not meet these criteria, whether exempted from Article 111(1) or not, shall be treated as exposures to a third party;~~

(g) asset items and other exposures secured, to the satisfaction of the competent authorities, by collateral in the form of cash deposits placed with the lending credit institution or with a credit institution which is the parent undertaking or a subsidiary of the lending institution; and

(h) asset items and other exposures secured, to the satisfaction of the competent authorities, by collateral in the form of certificates of deposit issued by the lending credit institution or by a credit institution which is the parent undertaking or a subsidiary of the lending credit institution and lodged with either of them;

~~(i) asset items constituting claims on and other exposures to institutions, with~~

~~where these claims would be assigned a 0 % risk weight under Article 78 to 83 and to other exposures to or guaranteed by such governments and authorities claims on which would be assigned a 0 % risk weight under Articles 78 to 83;~~

(f) ~~asset items and other exposures secured, to the satisfaction of the competent authorities, by collateral in the form of debt securities issued by central governments or central banks, international organisations, multilateral development banks, Member States' regional governments, local authorities or public sector entities, which securities constitute claims on their issuer which would be assigned a 0 % risk weighting under Articles 78 to 83 exposures to counterparties referred to in Article 80(7) or 80(8). For this purpose, the highest level of consolidated supervision, including where this is undertaken by an equivalent third country, should be used for point (b); and point (d) of Article 80(7) shall not be applied. Exposures that do not meet all these criteria but which are within the consolidation, whether exempted from Article 111(1) or not, shall be treated as exposures to a third party but the exposure should be measured relative to the aggregated own funds of the entities that meet the requirements of 80(7);~~

(g) asset items and other exposures

<p><del>a maturity of one year or less, but not constituting such institutions' own funds;</del></p> <p><del>(j) asset items constituting claims on and other exposures to those institutions which are not credit institutions but which fulfil the conditions referred to in Annex VI, Part 1, point 85, with a maturity of one year or less, and secured in accordance with the same point;</del></p> <p><del>(k) bills of trade and other similar bills, with a maturity of one year or less, bearing the signatures of other credit institutions;</del></p> <p><del>(l) covered bonds falling within the terms of Annex VI, Part 1, points 68 to 70;</del></p> <p><del>(m) pending subsequent coordination, holdings in the insurance companies referred to in Article 122(1) up to 40 % of the own funds of the credit institution acquiring such a holding;</del></p> <p><del>(n) asset items constituting claims on regional or central credit institutions with which the lending credit institution is associated in a network in accordance with legal or statutory provisions and which are responsible, under those provisions, for cash-clearing operations within the network;</del></p> <p><del>(o) exposures secured, to the satisfaction of the competent authorities, by collateral in the form of</del></p>	<p>secured, to the satisfaction of the competent authorities, by collateral in the form of cash deposits placed with the lending credit institution or with a credit institution which is the parent undertaking or a subsidiary of the lending institution; <u>and</u></p> <p>(h) asset items and other exposures secured, to the satisfaction of the competent authorities, by collateral in the form of certificates of deposit issued by the lending credit institution or by a credit institution which is the parent undertaking or a subsidiary of the lending credit institution and lodged with either of them;_</p> <p><u>(i) asset items constituting claims on and other exposures to institutions, with a maturity of one year or less, but not constituting such institutions' own funds;</u></p> <p><del>(j) asset items constituting claims on and other exposures to those institutions which are not credit institutions but which fulfil the conditions referred to in Annex VI, Part 1, point 85, with a maturity of one year or less, and secured in accordance with the same point;</del></p> <p><del>(k) bills of trade and other similar bills, with a maturity of one year or less, bearing the signatures of other credit institutions;</del></p> <p><del>(l) (i) covered bonds falling within the terms of Annex VI, Part 1, points 68 to</del></p>
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<p><del>securities other than those referred to in point (f);</del></p> <p><del>(p) loans secured, to the satisfaction of the competent authorities, by mortgages on residential property or by shares in Finnish residential housing companies, operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation and leasing transactions under which the lessor retains full ownership of the residential property leased for as long as the lessee has not exercised his option to purchase, in all cases up to 50 % of the value of the residential property concerned;</del></p> <p><del>(q) the following, where they would receive a 50 % risk weight under Articles 78 to 83, and only up to 50 % of the value of the property concerned:</del></p> <p><del>(i) exposures secured by mortgages on offices or other commercial premises, or by shares in Finnish housing companies, operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation, in respect of offices or other commercial premises; and</del></p> <p><del>(ii) exposures related to property leasing transactions concerning offices or other commercial premises;</del></p> <p><del>for the purposes of point (ii), until 31 December 2011, the competent authorities of each Member State may allow credit institutions to recognise 100</del></p>	<p><u>70:</u></p> <p><del>(m) pending subsequent coordination, holdings in the insurance companies referred to in Article 122(1) up to 40 % of the own funds of the credit institution acquiring such a holding;</del></p> <p><del>(n) asset items constituting claims on regional or central credit institutions with which the lending credit institution is associated in a network in accordance with legal or statutory provisions and which are responsible, under those provisions, for cash-clearing operations within the network;</del></p> <p><del>(o) exposures secured, to the satisfaction of the competent authorities, by collateral in the form of securities other than those referred to in point (f);</del></p> <p><del>(p) loans secured, to the satisfaction of the competent authorities, by mortgages on residential property or by shares in Finnish residential housing companies, operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation and leasing transactions under which the lessor retains full ownership of the residential property leased for as long as the lessee has not exercised his option to purchase, in all cases up to 50 % of the value of the residential property concerned;</del></p> <p><del>(q) the following, where they would receive a 50 % risk weight under</del></p>
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~~% of the value of the property concerned. At the end of this period, this treatment shall be reviewed. Member States shall inform the Commission of the use they make of this preferential treatment;~~

~~(r) 50 % of the medium/low-risk off-balance sheet items referred to in Annex II;~~

~~(s) subject to the competent authorities' agreement, guarantees other than loan guarantees which have a legal or regulatory basis and are given for their members by mutual guarantee schemes possessing the status of credit institutions, subject to a weighting of 20 % of their amount; and~~

~~(t) the low risk off balance sheet items referred to in Annex II, to the extent that an agreement has been concluded with the client or group of connected clients under which the exposure may be incurred only if it has been ascertained that it will not cause the limits applicable under Article 111(1) to (3) to be exceeded.~~

Cash received under a credit linked note issued by the credit institution and loans and deposits of a counterparty to or with the credit institution which are subject to an on-balance sheet netting agreement recognised under Articles 90 to 93 shall be deemed to fall under point (g).

~~For the purposes of point (e), the~~

Articles 78 to 83, and only up to 50 % of the value of the property concerned:

~~(i) exposures secured by mortgages on offices or other commercial premises, or by shares in Finnish housing companies, operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation, in respect of offices or other commercial premises; and~~

~~(ii) exposures related to property leasing transactions concerning offices or other commercial premises;~~

~~for the purposes of point (ii), until 31 December 2011, the competent authorities of each Member State may allow credit institutions to recognise 100 % of the value of the property concerned. At the end of this period, this treatment shall be reviewed. Member States shall inform the Commission of the use they make of this preferential treatment;~~

~~(r) (k) 50 % of the medium/low-risk off-balance-sheet items referred to in Annex II;~~

~~(s) subject to the competent authorities' agreement, guarantees other than loan guarantees which have a legal or regulatory basis and are given for their members by mutual guarantee schemes possessing the status of credit institutions, subject to a weighting of 20 % of their amount; and~~

~~securities used as collateral shall be valued at market price, have a value that exceeds the exposures guaranteed and be either traded on a stock exchange or effectively negotiable and regularly quoted on a market operated under the auspices of recognised professional operators and allowing, to the satisfaction of the competent authorities of the Member State of origin of the credit institution, for the establishment of an objective price such that the excess value of the securities may be verified at any time. The excess value required shall be 100 %. It shall, however, be 150 % in the case of shares and 50 % in the case of debt securities issued by institutions, Member State regional governments or local authorities other than those referred to in sub-point (f), and in the case of debt securities issued by multilateral development banks other than those assigned a 0 % risk weight under Articles 78 to 83. Where there is a mismatch between the maturity of the exposure and the maturity of the credit protection, the collateral shall not be recognised. Securities used as collateral may not constitute credit institutions' own funds.~~

~~For the purposes of point (p), the value of the property shall be calculated, to the satisfaction of the competent authorities, on the basis of strict valuation standards laid down by law,~~

~~(t)–(l) the low-risk off-balance-sheet items referred to in Annex II, to the extent that an agreement has been concluded with the client or group of connected clients under which the exposure may be incurred only if it has been ascertained that it will not cause the limits applicable under Article 111(1) to (3) to be exceeded.~~

Cash received under a credit linked note issued by the credit institution and loans and deposits of a counterparty to or with the credit institution which are subject to an on-balance sheet netting agreement recognised under Articles 90 to 93 shall be deemed to fall under point (g).

~~For the purposes of point (o), the securities used as collateral shall be valued at market price, have a value that exceeds the exposures guaranteed and be either traded on a stock exchange or effectively negotiable and regularly quoted on a market operated under the auspices of recognised professional operators and allowing, to the satisfaction of the competent authorities of the Member State of origin of the credit institution, for the establishment of an objective price such that the excess value of the securities may be verified at any time. The excess value required shall be 100 %. It shall, however, be 150 % in the case of shares and 50 % in the case of debt securities issued by institutions,~~

<p><del>regulation or administrative provisions. Valuation shall be carried out at least once a year. For the purposes of point (p), residential property shall mean a residence to be occupied or let by the borrower.</del></p> <p><del>Member States shall inform the Commission of any exemption granted under point (s) in order to ensure that it does not result in a distortion of competition.</del></p> <p><u>2. Member States may fully or partially exempt covered bonds falling within the terms of Annex VI, Part 1, points 68 to 70 from the application of Article 111(1).</u></p>	<p><del>Member State regional governments or local authorities other than those referred to in sub-point (f), and in the case of debt securities issued by multilateral development banks other than those assigned a 0 % risk weight under Articles 78 to 83. Where there is a mismatch between the maturity of the exposure and the maturity of the credit protection, the collateral shall not be recognised. Securities used as collateral may not constitute credit institutions' own funds.</del></p> <p><del>For the purposes of point (p), the value of the property shall be calculated, to the satisfaction of the competent authorities, on the basis of strict valuation standards laid down by law, regulation or administrative provisions. Valuation shall be carried out at least once a year. For the purposes of point (p), residential property shall mean a residence to be occupied or let by the borrower.</del></p> <p><del>Member States shall inform the Commission of any exemption granted under point (s) in order to ensure that it does not result in a distortion of competition.</del></p> <p><u>2. Member States may fully or partially exempt covered bonds falling within the terms of Annex VI, Part 1, points 68 to 70 from the application of Article 111(1).</u></p> <p>Article 80</p> <p>7. With the exception of exposures giving</p>
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	<p>rise to liabilities in the form of the items referred to in paragraphs (a) to (h) of Article 57, competent authorities may exempt from the requirements of paragraph 1 of this Article the exposures of a credit institution to a counterparty which is its parent under taking, its subsidiary, a subsidiary of its parent under taking or an under taking linked by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC, provided that the following conditions are met:</p> <p>(a) the counterparty is an institution or a financial holding company, financial institution, asset management company or ancillary services under taking subject to appropriate prudential requirements on a consolidated basis;</p> <p>(b) the counterparty is included in the same consolidation as the credit institution on a full basis;</p> <p>(c) the counterparty is subject to the same risk evaluation, measurement and control procedures as the credit institution;</p> <p>(d) the counterparty is established in the same Member State as the credit institution; and</p> <p>(e) there is no current or <u>known future</u> <del>foreseen</del> material practical or legal impediment to the prompt transfer of <u>surplus</u> own funds or repayment of liabilities, <u>when they fall due</u>, from the</p>
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counterparty to the credit institution.

### **Justification**

We are pleased to note that there has been a rationalisation of national discretions in favour of general exemptions.

(a) to (e) – items qualifying for 0% risk weight under the standardised approach: Drafting has been rationalised so that anything that would qualify for 0% risk weight under the standardised approach would also qualify for an exemption for large exposures. We also believe that the exemption previously permitted for local currency exposures should be retained to be consistent with the capital framework and to enable firms to continue to operate competitively in markets outside the EU. This is important to many of our Members because they have global operations rather than purely EU based operations. The removal of this exemption could also potentially restrict a firm's ability to accept collateral in such jurisdictions, thereby hampering risk mitigation.

(f) – intra-group: We fully support the introduction of a general exemption for intra-group exposures within the CRD amendments. Intra-group exposures play an extremely important role in reducing the risk of failure of group entities, because they are the way in which funding is channelled around the group. They are also central to efficient risk management on a global basis and are the key to enabling this to be done in a centralised way. Restricting intra-group exposures would increase the likelihood of liquidity problems (particularly in light of the proposal to restrict inter-bank exposures) and make it difficult to operate global risk management strategies. It would also increase the costs of doing business because local treasury activities would need to be set up, which would not be able to fund themselves as efficiently. It would also require hedging to be conducted at the local level, which would be more costly.

We fully agree that the basis for exemption should focus on integrated risk management and inclusion within the regulatory consolidation and not the geographic location of the exposures. Integrated risk management is key to a group being a source of strength for the individual entities within it rather than weakness, and while groups operate on this basis beyond the regulatory consolidation, we appreciate the need for supervisors to have sufficient oversight. We therefore support the use of Article 80(7) as an appropriate basis for this oversight to be conducted. We also highlight that supervisors can gain additional comfort regarding

the risk management in this area by using their powers under Pillar 2.

However, we continue to have concerns with the precise wording used in Article 80(7) as follows:

- ? We believe it would aid clarity if 80(7) (a) included 'on a consolidated basis'. Financial institutions may not necessarily be regulated individually but will be subject to appropriate prudential regulation on a consolidated basis.
- ? The application of (b) should be clarified to encompass groups where the consolidated supervision is undertaken by an equivalent third country. This is necessary to ensure that the current scope of the exemption still applies. As noted above we believe that the correct focus for the exemption is integrated risk management rather than geographic location. And groups with non-EEA parents should be accorded an equivalent treatment where they are subject to the same level of rigour in their consolidated supervision.
- ? As currently drafted, a strict interpretation of 80(7)(e) would prevent all regulated entities from meeting the requirements because there will be always be an impediment to the movement of the minimum capital that must be maintained for regulated purposes. Therefore the requirement should be amended such that it is clear that the absence of impediments applies only to the 'surplus' of own funds.
- ? In addition Members consider the use of 'foreseen' in 80(7)(e) difficult to apply in practice. Many issues may be potential impediments and therefore 'foreseeable', however, this does not mean that they are necessarily likely to come to pass. Therefore we would suggest replacing this term with 'known'
- ? It is also necessary to insert 'when due' into 80(7)(e) to address the fact that even intra-group transactions are subject to contractual arrangements. Where entities meet some but not all of the requirements in 80(7) and are within the group, we believe that the exposures should be measured against the group that does meet the requirements rather than solo capital base because these funds are freely transferable.

(i) – inter-bank: As noted in Article 111 above, we strongly oppose the removal of the exemption for inter-bank exposures of less than one year maturity and recommend its re-instatement. We believe that such a move will carry wide ranging consequences for the banking system, as not only will it significantly impact firms' liquidity management, it may also increase the risk of failure of firms. Liquidity is

extremely important to the smooth running of the financial system. Members have indicated that inter-bank exposures that go beyond the 25% can often relate to payment systems issues and other unavoidable reasons. As such large exposures restrictions may force them to restrict their participation in business such as BACS payments, which play an important role in the market but which are low margin activities. From a market failure analysis perspective, we also consider maturity to be an important factor in determining whether there is a material market failure. This reasoning appears to be accepted in the trading book, where it is proposed to continue with the differentiated approach.

(j) – covered bonds: We see no reason why covered bonds should not be subject to a general exemption rather than a national discretion.

(k) and (l) – medium and low risk items under Annex II: Members regard a 100% conversion factor for all off balance sheet commitments as overly conservative, implying as it does that not only will the full amount be drawn but also that it will be lost. Such reasoning fails to take account of the fact that firms actively manage their credit exposures, including undrawn facilities, and these will be reduced if a counterparty is showing evidence of difficulties. The current exemption also recognises the reduced information asymmetry inherent in shorter term exposures that qualify and low or medium risk and the extent of mitigation embedded within others (but which would be unlikely to be able to take advantage of the credit risk mitigation rules). Members using the AIRB approach consider that EAD is the appropriate measure for exposure Article 106). For those firms on the standardised approach, however, the existing exemption prudently addresses the risk inherent in these exposures. We would also note that the current exemptions are used in the majority of Member States and therefore their removal is likely to have a significant impact.

<b>Article 114</b>	
<b>Consultation text</b>	<b>Recommended amendment</b>
1. Subject to paragraph 3, for the purposes of calculating the value of exposures for the purposes of Article 111(1) to (3) Member States may, in	<del>Article 114</del> <u>Annex XV – Large Exposures, Part 1 – Credit risk mitigation</u> <u>1.2 Exposure value after credit risk</u>

~~respect of credit institutions using the Financial Collateral Comprehensive Method under Articles 90 to 93, in the alternative to availing of the full or partial exemptions permitted under points (f), (g), (h), and (e) of Article 113(3), permit such credit institutions to use a value lower than the value of the exposure, but no lower than the total of the fully adjusted exposure values of their exposures to the client or group of connected clients. For these purposes, a credit institution may use the 'fully adjusted exposure value' means that as~~ calculated under Articles 90 to 93 taking into account the credit risk mitigation, volatility adjustments, and any maturity mismatch (E\*).

~~Where this paragraph is applied to a credit institution, points (f), (g), (h), and (e) of Article 113(3) shall not apply to the credit institution in question.~~

2. Subject to paragraph 3, a credit institution permitted to use own estimates of LGDs and conversion factors for an exposure class under Articles 84 to 89 ~~shall~~ may be permitted, where it is able to the satisfaction of the competent authorities to estimate the effects of financial collateral on their exposures separately from other LGD-relevant aspects, to recognise such effects in calculating the value of exposures for the purposes of Article 111(1) ~~to (3)~~.

#### mitigation

1. ~~Subject to paragraph 3, for the purposes of calculating the value of exposures for the purposes of Article 111(1) to (3) Member States may, in respect of credit institutions using the Financial Collateral Comprehensive Method under Articles 90 to 93, in the alternative to availing of the full or partial exemptions permitted under points (f), (g), (h), and (e) of Article 113(3), permit such credit institutions to use a value lower than the value of the exposure, but no lower than the total of the fully adjusted exposure values of their exposures to the client or group of connected clients. For these purposes, exposures which meet the requirements for on or off balance sheet netting should be recorded net~~

A credit institution, which calculates its capital requirements for credit risk under Articles 79 to 83 or 84 to 89, and uses the Financial Collateral Comprehensive Method may use the 'fully adjusted exposure value' means that as calculated under Articles 90 to 93 taking into account the credit risk mitigation, volatility adjustments, and any maturity mismatch (E\*).

A credit institution that calculates its capital requirements for credit risk under Articles 79 to 83 and uses the Financial Collateral Simple Method should continue to record E. The

<p>Competent authorities shall be satisfied as to the suitability of the estimates produced by the credit institution for use for the reduction of the exposure value for the purposes of compliance with the provisions of Article 111.</p> <p>Where a credit institution is permitted to use its own estimates of the effects of financial collateral, it shall do so on a basis consistent with the approach adopted in the calculation of capital requirements.</p> <p>Credit institutions permitted to use own estimates of LGDs and conversion factors for an exposure class under Articles 84 to 89 which do not calculate the value of their exposures using the method referred to in the first subparagraph <del>shall</del> <u>may</u> be permitted to use <u>the Financial Collateral Comprehensive Method</u> or the approach set out in <del>paragraph 1 or the exemption set out in Article 117(b)3(3)(e)</del> for calculating the value of exposures. <del>A credit institution shall use only one of these two methods.</del></p> <p>3. A credit institution that <u>makes use of the Financial Collateral Comprehensive Method</u> or is permitted to use the methods described in paragraphs <del>1 and 2</del> in calculating the value of exposures for the purposes of Article 111(1) <del>to (3)</del>, shall conduct periodic stress tests of their credit-risk concentrations, including in relation to the realisable</p>	<p><u>collateralised portion of E may be recorded as to the collateral counterparty.</u></p> <p><del>Where this paragraph is applied to a credit institution, points (f), (g), (h), and (e) of Article 113(3) shall not apply to the credit institution in question.</del></p> <p>2. <del>Subject to paragraph 3,</del> a credit institution permitted to use own estimates of LGDs and conversion factors for an exposure class under Articles 84 to 89 <del>shall</del> <u>may</u> be permitted, <del>where it is able to the satisfaction of the competent authorities to estimate the effects of financial collateral on their exposures separately from other</del> <u>to use</u> LGD-relevant aspects, to recognise <del>such effects</del> in calculating the value of exposures for the purposes of Article 111(1) <del>to (3)</del>.</p> <p><del>Competent authorities shall be satisfied as to the suitability of the estimates produced by the credit institution for use for the reduction of the exposure value for the purposes of compliance with the provisions of Article 111.</del></p> <p><del>Where a credit institution is permitted to use its own estimates of the effects of financial collateral, it shall do so on a basis consistent with the approach adopted in the calculation of capital requirements.</del></p> <p>Credit institutions permitted to use own estimates of LGDs and conversion factors for an exposure class under</p>
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<p>value of any collateral taken.</p> <p>These periodic stress tests shall address risks arising from potential changes in market conditions that could adversely impact the credit institutions' adequacy of own funds and risks arising from the realisation of collateral in stressed situations.</p> <p>The credit institution shall satisfy the competent authorities that the stress tests carried out are adequate and appropriate for the assessment of such risks.</p> <p>In the event that such a stress test indicates a lower realisable value of collateral taken than would be permitted to be taken into account <u>while making use of the Financial Collateral Comprehensive Method or the method described in</u> <del>under</del> paragraphs 1 and 2 as appropriate, the value of collateral permitted to be recognised in calculating the value of exposures for the purposes of Article 111(1) <del>to (3)</del> shall be reduced accordingly.</p> <p>Such credit institutions shall include the following in their strategies to address concentration risk:</p> <p>(a) policies and procedures to address risks arising from maturity mismatches between exposures and any credit protection on those exposures;</p> <p>(b) policies and procedures in the event that a stress test indicates a lower</p>	<p>Articles 84 to 89 <del>which do not calculate the value of their exposures using the method referred to in the first subparagraph shall</del> may be permitted to use <u>the Financial Collateral Comprehensive Method</u> or the approach set out in <del>paragraph 1 or the exemption set out in</del> Article 117(b) <del>3(3)(e)</del> for calculating the value of exposures. <del>A credit institution shall use only one of these two methods.</del></p> <p><del>3. A credit institution that makes use of the Financial Collateral Comprehensive Method or is permitted to use the methods described in paragraphs 1 and 2 in calculating the value of exposures for the purposes of Article 111(1) to (3), shall conduct periodic stress tests of their credit risk concentrations, including in relation to the realisable value of any collateral taken.</del></p> <p><del>These periodic stress tests shall address risks arising from potential changes in market conditions that could adversely impact the credit institutions' adequacy of own funds and risks arising from the realisation of collateral in stressed situations.</del></p> <p><del>The credit institution shall satisfy the competent authorities that the stress tests carried out are adequate and appropriate for the assessment of such risks.</del></p> <p><del>In the event that such a stress test indicates a lower realisable value of</del></p>
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realisable value of collateral than taken into account while making use of the Financial Collateral Comprehensive Method or the method described in ~~under paragraphs 1 and 2~~; and

(c) policies and procedures relating to concentration risk arising from the application of credit risk mitigation techniques, and in particular large indirect credit exposures, for example to a single issuer of securities taken as collateral.

~~4. Where the effects of collateral are recognised under the terms of paragraphs 1 or 2, Member States may treat any covered Part of the exposure as having been incurred to the collateral issuer rather than to the client.~~

~~collateral taken than would be permitted to be taken into account while making use of the Financial Collateral Comprehensive Method or the method described in under paragraphs 1 and 2 as appropriate, the value of collateral permitted to be recognised in calculating the value of exposures for the purposes of Article 111(1) to (3) shall be reduced accordingly.~~

~~Such credit institutions shall include the following in their strategies to address concentration risk:~~

~~(a) policies and procedures to address risks arising from maturity mismatches between exposures and any credit protection on those exposures;~~

~~(b) policies and procedures in the event that a stress test indicates a lower realisable value of collateral than taken into account while making use of the Financial Collateral Comprehensive Method or the method described in under paragraphs 1 and 2; and~~

~~(c) policies and procedures relating to concentration risk arising from the application of credit risk mitigation techniques, and in particular large indirect credit exposures, for example to a single issuer of securities taken as collateral.~~

~~4. Where the effects of collateral are recognised under the terms of paragraphs 1 or 2, Member States may treat any covered Part of the exposure as~~

~~having been incurred to the collateral issuer rather than to the client.~~

**ANNEX V - TECHNICAL CRITERIA CONCERNING THE ORGANISATION AND TREATMENT OF RISKS**

**4 Residual risk**

The risk that recognised credit risk mitigation techniques used by the credit institution prove less effective than expected shall be addressed and controlled by means of written policies and procedures. In particular, credit institutions shall include scenarios within their stress tests that take account of credit risk mitigation proving less effective than expected. Policies and procedures shall address risks arising from maturity mismatches between exposures and any credit protection on those exposures.

**Alternative formulation**

**Annex XV – Large Exposures.**

**1.2 Exposure value and counterparty for exposures subject to netting agreements.**

1 On or off-balance sheet netting should be taken account of consistently with the approach to capital requirements.

**1.3 Exposure value and counterparty for exposures subject to funded credit risk mitigation.**

	<p><u>1. Credit institutions using the Financial Collateral Simple Method should continue to use E, but record the exposure to the provider of credit risk mitigation.</u></p> <p><u>2. Credit institutions using the Financial Collateral Comprehensive method should use E*, and continue to record the exposure to the original counterparty.</u></p> <p><u>3. Credit institutions that have permission to use their own estimates of LGD and conversion factors, shall be permitted to use their own estimates of LGD consistent with the approach adopted in the calculation of capital requirements and continue to record the exposure to the original counterparty.</u></p>
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**Justification**

Location of text – We believe that moving the text in this Article to an Annex is appropriate to in order to meet the demands of Directive structured on Lamfalussy principles.

Simple method – The inclusion of the financial collateral simple method in Article 117 is confusing. It would be clearer to members if the treatment of funded and unfunded protection were outlined separately in accordance with the structure of the CRD more generally. We also provide an alternative formulation for the CRM provisions for consideration

AIRB firms – LGD as a downturn measure is already conservative under the capital framework. As such we believe it is appropriate to use this measure for large exposures purposes on the grounds that it is prudent and reduces the administrative burden on firms of running an additional valuation system for large exposures purposes.

Stress testing – The requirement regarding stress testing of collateral values was introduced at a late stage in the CRD negotiation process and has never been consulted upon. While we agree that proper risk management of collateral is a

desirable aim, we do not think that the inclusion of a requirement to stress test and adjust collateral values as part of Pillar 1 is the appropriate way of achieving this objective. The capital framework already requires collateral subject to a conservative haircut to address the risk that the full amount may not be realised. We contend that any remaining residual risks associated with credit risk mitigation are more appropriately addressed under Pillar 2. To emphasise that fact we propose that stress testing scenarios, mandated under Pillar 2, should include scenarios where credit risk mitigants do not perform as expected should be included within annex V. We would also note that a Pillar 1 requirement to stress individual collateral items is very burdensome from an implementation perspective and does not accord with firms' stress testing practices, which are on a more holistic basis, i.e. looking at particular scenarios and the impact that this will have on the firm's business. Backward engineering to look at the impact of a shift in a particular collateral instrument will not provide management with risk information that is as useful. Finally, we would note that this requirement will result in a lack of comparability of Pillar 1 results for supervisors, as stress tests will be undertaken using different assumptions, scenarios and confidence levels. Such differences can more appropriately be accounted for within the more flexible Pillar 2 approach.

Maturity mismatch – We also believe that policies and procedures relating to the risks associated with maturity mismatch are also more appropriately dealt with under Pillar 2 as these also relate to residual risks associated with credit risk mitigation.

Concentration risks associated with indirect exposures – We do not believe that this requirement is necessary because Annex V already requires concentration risks associated with collateral issuers to be addressed.

<b>Article 115</b>	
<b>Consultation text</b>	<b>Recommended amendment</b>
1. <del>For the purposes of Article 111(1) to (3), Member States may assign a weighting of 20 % to asset items constituting claims on Member States' regional governments and local authorities where these claims would be</del>	<p><del>Article 115</del> <u>Annex XV – Large Exposures</u></p> <p><u>1.4 Exposures secured by physical collateral including residential and commercial real estate</u></p>

~~assigned a 20 % risk weight under Articles 78 to 83 and to other exposures to or guaranteed by such governments and authorities claims on which are assigned a 20 % risk weight under Articles 78 to 83. However, Member States may reduce that rate to 0 % in respect of asset items constituting claims on Member States' regional governments and local authorities where these claims would be assigned a 0 % risk weight under Article 78 to 83 and to other exposures to or guaranteed by such governments and authorities claims on which are assigned a 0 % risk weight under Articles 78 to 83.~~

For the purpose of this section, a credit institution may reduce the exposure value by up to [50%] of the value of the residential property concerned, either:

- if the exposure is secured, to the satisfaction of the competent authorities, by mortgages on residential property or by shares in Finnish residential housing companies, operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation, or
- if the exposure relates to a leasing transaction under which the lessor retains full ownership of the residential property leased for as long as the lessee has not exercised his option to purchase.

~~1. For the purposes of Article 111(1) to (3), Member States may assign a weighting of 20 % to asset items constituting claims on Member States' regional governments and local authorities where these claims would be assigned a 20 % risk weight under Articles 78 to 83 and to other exposures to or guaranteed by such governments and authorities claims on which are assigned a 20 % risk weight under Articles 78 to 83. However, Member States may reduce that rate to 0 % in respect of asset items constituting claims on Member States' regional governments and local authorities where these claims would be assigned a 0 % risk weight under Article 78 to 83 and to other exposures to or guaranteed by such governments and authorities claims on which are assigned a 0 % risk weight under Articles 78 to 83.~~

For the purpose of this section, a credit institution may reduce the exposure value by up to [50%] of the value of the residential property concerned, either:

- if the exposure is secured, to the satisfaction of the competent authorities, by mortgages on residential property or by shares in Finnish residential housing companies, operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation, or

For the purposes of the above, the value of the property shall be calculated, to the satisfaction of the competent authorities, on the basis of strict valuation standards laid down by law, regulation or administrative provisions. Valuation shall be carried out at least once a year. For the purposes of this paragraph, residential property shall mean a residence to be occupied or let by the borrower.

~~2. For the purposes of Article 111(1) to (3), Member States may assign a weighting of 20 % to asset items constituting claims on and other exposures to institutions with a maturity of more than one but not more than three years and a weighting of 50 % to asset items constituting claims on institutions with a maturity of more than three years, provided that the latter are represented by debt instruments that were issued by a institution and that those debt instruments are, in the opinion of the competent authorities, effectively negotiable on a market made up of professional operators and are subject to daily quotation on that market, or the issue of which was authorised by the competent authorities of the Member State of origin of the issuing institutions. In no case may any of these items constitute own funds.~~

For the purpose of this section, a credit institution may reduce the exposure value by up to [50%] of the value of the

- if the exposure relates to a leasing transaction under which the lessor retains full ownership of the residential property leased for as long as the lessee has not exercised his option to purchase.

For the purposes of the above, the value of the property shall be calculated in accordance with the capital requirements, to the satisfaction of the competent authorities, on the basis of strict valuation standards laid down by law, regulation or administrative provisions. Valuation shall be carried out at least once a year. For the purposes of this paragraph, residential property shall mean a residence to be occupied or let by the borrower.

~~2. For the purposes of Article 111(1) to (3), Member States may assign a weighting of 20 % to asset items constituting claims on and other exposures to institutions with a maturity of more than one but not more than three years and a weighting of 50 % to asset items constituting claims on institutions with a maturity of more than three years, provided that the latter are represented by debt instruments that were issued by a institution and that those debt instruments are, in the opinion of the competent authorities, effectively negotiable on a market made up of professional operators and are subject to daily quotation on that market, or the issue of which was authorised by the~~

commercial property concerned, only if the following exposures would receive a 50% risk weight under Articles 78 to 83:

(i) exposures secured by mortgages on offices or other commercial premises, or by shares in Finnish housing companies, operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation, in respect of offices or other commercial premises  
or

(ii) exposures related to property leasing transactions concerning offices or other commercial premises.

For the purpose of the above, commercial property shall be fully constructed.

~~competent authorities of the Member State of origin of the issuing institutions. In no case may any of these items constitute own funds.~~

For the purpose of this section, a credit institution may reduce the exposure value by up to [50%] of the value of the commercial property concerned, only if the following exposures would receive a 50% risk weight under Articles 78 to 83:

(i) exposures secured by mortgages on offices or other commercial premises, or by shares in Finnish housing companies, operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation, in respect of offices or other commercial premises  
or

(ii) exposures related to property leasing transactions concerning offices or other commercial premises.

For the purpose of the above, commercial property shall be fully constructed.

3. Exposures secured by other physical collateral should be treated consistently with Articles [] and Annexes [].

### **Justification**

Location of text – We believe that this text is more appropriately located within Level 2, within a new Annex for large exposures, to make the large exposures framework more compliant with the Lamfalussy structure.

Valuation – We see no reason why it should not be possible to merely refer to the solvency requirements regarding valuation.

Physical collateral – As indicated above we believe that physical collateral should be recognised for large exposures purposes because it is an effective risk mitigant and thus its use should be encouraged rather than discouraged. We favour alignment of the capital and large exposures frameworks as far as possible to minimise the administrative burden on firms and so as not to undermine the decision to extend the range of eligible collateral under the capital framework. Prohibition of the use of physical collateral would have a significant detrimental impact on commodities firms that are subject to the current review.

<b>Article 117</b>	
<b>Consultation text</b>	<b>Recommended amendment</b>
<p><i>Article 117</i></p> <p>1. Where an exposure to a client is guaranteed by a third party, or <u>secured</u> by collateral <del>in the form of securities issued by a third party under the conditions laid down in Article 113(3)(e),</del> a <u>credit institution</u> <del>Member States</del> may:</p> <p>(a) treat <u>the portions of the exposure which is guaranteed</u> as having been incurred to the guarantor rather than to the client <u>provided that the unsecured exposure to the guarantor would be assigned an equal or lower risk weight than a risk weight of the unsecured exposure to the client under Articles 78 to 83;</u> or</p> <p>(b) treat <u>the portions of the exposure collateralised by the market value of recognised collateral</u> as having been</p>	<p><i>Article 117 Annex XV – Large Exposures</i></p> <p><u>1.3 exposures subject to unfunded protection</u></p> <p>1. Where an exposure to a client is guaranteed by a third party, <del>or secured</del> by collateral in the form of securities issued by a third party under the conditions laid down in Article 113(3)(e), a <u>credit institution</u> <del>Member States</del> may:</p> <p><del>(a)</del> treat <u>the portions of the exposure which is guaranteed</u> as having been incurred to the guarantor rather than to the client <u>provided that the eligibility criteria and operational requirements in 1.1 are met. the unsecured exposure to the guarantor would be assigned an equal or lower risk weight than a risk weight of the unsecured exposure to the</u></p>

incurred to the third party rather than to the client, if the exposure ~~defined in Article 113(3)(e)~~ is secured/guaranteed by collateral and provided that the collateralised portion of the exposure would be assigned an equal or lower risk weight than a risk weight of the unsecured exposure to the client under Articles 78 to 83 ~~under the conditions there laid down~~. This approach shall not be used by a credit institution where there is a mismatch between the maturity of the exposure and the maturity of the protection.

For the purpose of this Section, a credit institution may use both the Financial Collateral Comprehensive Method and the treatment provided for in point (b) of paragraph 1 only where it is permitted to use both the Financial Collateral Comprehensive Method and the Financial Collateral Simple Method for the purposes of Article 75(a).

2. Where a credit institution ~~Member States~~ applies the treatment provided for in point (a) of paragraph 1:

(a) where the guarantee is denominated in a currency different from that in which the exposure is denominated the amount of the exposure deemed to be covered will be calculated in accordance with the provisions on the treatment of currency mismatch for unfunded credit protection in Annex VIII;

(b) a mismatch between the maturity of

client under Articles 78 to 83; or

~~(b) treat the portions of the exposure collateralised by the market value of recognised collateral as having been incurred to the third party rather than to the client, if the exposure defined in Article 113(3)(e) is secured/guaranteed by collateral and provided that the collateralised portion of the exposure would be assigned an equal or lower risk weight than a risk weight of the unsecured exposure to the client under Articles 78 to 83 under the conditions there laid down. This approach shall not be used by a credit institution where there is a mismatch between the maturity of the exposure and the maturity of the protection.~~

For the purpose of this Section, a credit institution may use both the Financial Collateral Comprehensive Method and the treatment provided for in point (b) of paragraph 1 only where it is permitted to use both the Financial Collateral Comprehensive Method and the Financial Collateral Simple Method for the purposes of Article 75(a).

2. Where a credit institution ~~Member States~~ applies the treatment provided for in point (a) of paragraph 1:

(a) where the guarantee is denominated in a currency different from that in which the exposure is denominated the amount of the exposure deemed to be covered will be calculated in accordance

the exposure and the maturity of the protection will be treated in accordance with the provisions on the treatment of maturity mismatch in Annex VIII; and

(c) partial coverage may be recognised in accordance with the treatment set out in Annex VIII.

with the provisions on the treatment of currency mismatch for unfunded credit protection in Annex VIII;

(b) a mismatch between the maturity of the exposure and the maturity of the protection will be treated in accordance with the provisions on the treatment of maturity mismatch in Annex VIII; and

(c) partial coverage may be recognised in accordance with the treatment set out in Annex VIII.

#### ALTERNATIVE

#### **1.2 Exposure value and counterparty for exposures subject to unfunded credit risk mitigation.**

1 Credit institutions that calculation their capital requirements in accordance with Articles 79 to 83 should continue to report E, but may record the exposure to the credit risk mitigant provider, provided the eligibility and operational requirements in 1.1 are met.

2 Credit institutions that have permission to use their own estimates of PD or PD, LGD and conversion factors should continue to use E if PD is adjusted. Where this is the case the exposure may be recorded to the protection provider, provided the eligibility and operational requirements in 1.1 are met.

3 Credit institutions that have permission to use their own estimates of LGD and conversion factors and adjust LGD rather

	<p><u>than PD, may use LGD and may record the exposure to the protection provider, provided the eligibility and operational requirements in 1.1 are met.</u></p> <p><u>4 Where a credit institution applies the treatment provided for in paragraphs 1 and 2:</u></p> <p><u>(a) where the guarantee is denominated in a currency different from that in which the exposure is denominated the amount of the exposure deemed to be covered will be calculated in accordance with the provisions on the treatment of currency mismatch for unfunded credit protection in Annex VIII;</u></p> <p><u>(b) a mismatch between the maturity of the exposure and the maturity of the protection will be treated in accordance with the provisions on the treatment of maturity mismatch in Annex VIII; and</u></p> <p><u>(c) partial coverage may be recognised in accordance with the treatment set out in Annex VIII.</u></p>
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**Justification**

Location of text – As noted above, we believe that these provisions should be located in Level 2 text.

Credit risk mitigation – please see Article 114 above. Again we provide an alternative formulation for the CRM provisions for consideration.

<b>Article 119</b>	
<b>Consultation text</b>	<b>Recommended amendment</b>
<p><del>By 31 December 2007, the Commission shall submit to the European Parliament and to the Council a report on the functioning of this Section, together with any appropriate proposals.</del></p>	<p>By 31 December 201<u>[1 or 2]</u><del>07</del>, the Commission shall submit to the European Parliament and to the Council a report on the functioning of this Section, together with any appropriate proposals.</p>
<b>Justification</b>	
<p>We continue to believe that an internal limits based approach is an appropriate way to address the risk posed by single name large exposures. Firms have good incentives to manage this risk for themselves and do so to a loss severity much less than that suggested by the solvency requirements. We therefore believe that a sunset clause should be inserted to allow this proposal to be assessed once Member States have been able to gain experience with Pillar 2. Such a proposal would significantly reduce the administrative burden on those firms who have appropriate systems and controls to adopt such an approach. In addition we think that there should be a review to ensure that the requirements continue to be appropriate in light of the other reviews that are currently underway (such as capital, liquidity and commodities). It would also allow the issue of inter-bank exposures to be revisited once the implications of recent events have become clearer.</p>	

**Directive 2006/49/EC**

<b>Article 28</b>	
<b>Consultation text</b>	<b>Recommended amendment</b>
<p>1. Institutions, <u>except investment firms that fulfil the criteria set out in Article 20(2) and 20(3)</u>, shall monitor and control</p>	<p>1. Institutions, <u>except investment firms that fulfil the criteria set out in Article 20(2) and 20(3)</u>, shall monitor and control</p>

<p>their large exposures in accordance with Articles 106 to 118 of Directive 2006/48/EC.</p> <p>2. By way of derogation from paragraph 1, institutions which calculate the capital requirements for their trading-book business in accordance with Annexes I and II, and, as appropriate, Annex V to this Directive, shall monitor and control their large exposures in accordance with Articles 106 to 118 of Directive 2006/48/EC subject to the amendments laid down in Articles 29 to 32 of this Directive.</p> <p><del>3. By 31 December 2007, the Commission shall submit to the European Parliament and to the Council a report on the functioning of this Section, together with any appropriate proposals.</del></p>	<p>their large exposures in accordance with Articles 106 to 118 of Directive 2006/48/EC.</p> <p>2. By way of derogation from paragraph 1, institutions which calculate the capital requirements for their trading-book business in accordance with Annexes I and II, and, as appropriate, Annex V to this Directive, shall monitor and control their large exposures in accordance with Articles 106 to 118 of Directive 2006/48/EC subject to the amendments laid down in Articles 29 to 32 of this Directive.</p> <p><u>3. By 31 December 2011<sup>1</sup> or 2<sup>107</sup>, the Commission shall submit to the European Parliament and to the Council a report on the functioning of this Section, together with any appropriate proposals.</u></p>
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**Justification**

In line with our comments regarding Article 119 of Directive 2006/48/EC, we believe that a sunset clause should be inserted to provide for further review of the large exposures requirements (see above).

<b>Article 29</b>	
<b>Consultation text</b>	<b>Recommended amendment</b>
<p>1. The exposures to individual clients which arise on the trading book shall be calculated by summing the following items:</p> <p>(a) the excess — where positive — of an institution's long positions over its short positions in all the financial instruments issued by the client in question, the net position in each of the different instruments being calculated according to the methods laid down in Annex I;</p> <p>(b) the net exposure, in the case of the underwriting of a debt or an equity instrument; and</p> <p>(c) the exposures due to the transactions, agreements and contracts referred to in Annex II with the client in question, such exposures being calculated in the manner laid down in that Annex, for the calculation of exposure values.</p> <p>For the purposes of point (b), the net exposure is calculated by deducting those underwriting positions which are subscribed or sub-underwritten by third</p>	<p>1. The exposures to individual clients which arise on the trading book shall be calculated by summing the following items:</p> <p>(a) the excess — where positive — of an institution's long positions over its short positions in all the financial instruments issued by the client in question, the net position in each of the different instruments being calculated according to the methods laid down in Annex I;</p> <p>(b) the net exposure, in the case of the underwriting of a debt or an equity instrument; and</p> <p>(c) the exposures due to the transactions, agreements and contracts referred to in Annex II with the client in question, such exposures being calculated in the manner laid down in that Annex, for the calculation of exposure values.</p> <p><u>(d) the counterparty risk exposure value associated with the instruments outlined in Annex II point 5, including commodities borrowing and lending</u></p>

<p>parties on the basis of a formal agreement reduced by the factors set out in point 41 of Annex I.</p> <p>For the purposes of point (b), pending further coordination, the competent authorities shall require institutions to set up systems to monitor and control their underwriting exposures between the time of the initial commitment and working day one in the light of the nature of the risks incurred in the markets in question.</p> <p>For the purposes of point (c), Articles 84 to 89 of Directive 2006/48/EC shall be excluded from the reference in point 6 of Annex II to this Directive.</p> <p>2. The exposures to groups of connected clients on the trading book shall be calculated by summing the exposures to individual clients in a group, as calculated in paragraph 1.</p>	<p><u>transactions, shall be calculated in accordance with Annex II paragraph 6, without the application of risk weights.</u></p> <p>For the purposes of point (b), the net exposure is calculated by deducting those underwriting positions which are subscribed or sub-underwritten by third parties on the basis of a formal agreement reduced by the factors set out in point 41 of Annex I.</p> <p>For the purposes of point (b), pending further coordination, the competent authorities shall require institutions to set up systems to monitor and control their underwriting exposures between the time of the initial commitment and working day one in the light of the nature of the risks incurred in the markets in question.</p> <p>For the purposes of point (c), Articles 84 to 89 of Directive 2006/48/EC shall be excluded from the reference in point 6 of Annex II to this Directive.</p> <p><u>Exposure value should be calculated net of credit risk mitigation calculated in accordance with Annex XV of Directive 2006/48/EC</u></p> <p>2. The exposures to groups of connected clients on the trading book shall be calculated by summing the exposures to individual clients in a group, as calculated in paragraph 1.</p>
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### Justification

Securities financing transactions and OTC derivatives - For the sake of clarity, since this part of the directive was not amended at the time of the trading book review, we recommend referencing the treatment of counterparty risk exposures for securities financing transactions and OTC derivatives.

CRM - In line with our comments in respect of credit risk mitigation in the non-trading book, we believe that it is appropriate to calculate exposure value net of credit risk mitigation.

### Article 30

Consultation text	Recommended amendment
<p>1. The overall exposures to individual clients or groups of connected clients shall be calculated by summing the exposures which arise on the trading book and the exposures which arise on the non-trading book, taking into account Article 112 to 117 of Directive 2006/48/EC.</p> <p>In order to calculate the exposure which arises on the non-trading book, institutions shall take the exposure arising from assets which are deducted from their own funds by virtue of point (d) of the second subparagraph of Article 13(2) to be zero.</p> <p>2. Institutions' overall exposures to individual clients and groups of connected clients calculated in accordance with paragraph 4 shall be reported in accordance with Article 110 of Directive 2006/48/EC.</p>	<p>1. The overall exposures to individual clients or groups of connected clients shall be calculated by summing the exposures which arise on the trading book and the exposures which arise on the non-trading book, taking into account Article 112 to 117 of Directive 2006/48/EC.</p> <p>In order to calculate the exposure which arises on the non-trading book, institutions shall take the exposure arising from assets which are deducted from their own funds by virtue of point (d) of the second subparagraph of Article 13(2) to be zero.</p> <p>2. Institutions' overall exposures to individual clients and groups of connected clients calculated in accordance with paragraph 4 shall be reported in accordance with Article 110 of Directive 2006/48/EC.</p>

<p>Other than in relation to repurchase transactions, securities or commodities lending or borrowing transactions, the calculation of large exposures to individual clients and groups of connected clients for reporting purposes shall not include the recognition of credit risk mitigation.</p> <p>3. The sum of the exposures to an individual client or group of connected clients in paragraph 1 shall be limited in accordance with Articles 111 to 117 of Directive 2006/48/EC.</p> <p>4. By derogation from paragraph 3 competent authorities may allow assets constituting claims and other exposures on recognised third-country investment firms and recognised clearing houses and exchanges in financial instruments to be subject to the same treatment accorded to those on institutions laid out in Articles 111<del>3</del>(13)(i), 115(2) and 116 of Directive 2006/48/EC.</p>	<p><del>Other than in relation to repurchase transactions, securities or commodities lending or borrowing transactions, the calculation of large exposures to individual clients and groups of connected clients for reporting purposes shall not include the recognition of credit risk mitigation.</del></p> <p>3. The sum of the exposures to an individual client or group of connected clients in paragraph 1 shall be limited in accordance with Articles 111 to 117 of Directive 2006/48/EC.</p> <p>4. By derogation from paragraph 3 competent authorities may allow assets constituting claims and other exposures on recognised third-country investment firms and recognised clearing houses and exchanges in financial instruments to be subject to the same treatment accorded to those on institutions laid out in Articles 111<del>3</del>(13)(i), 115(2) and 116 of Directive 2006/48/EC.</p>
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**Justification**

Securities financing transactions – the treatment of securities financing transactions was amended as part of the trading book review, but this section of the Directive was not changed. We think it would aid clarity if an amendment reflecting this exposure value methodology was inserted.

Other CRM techniques – We believe that it is appropriate to recognise CRM techniques where these are validly reducing risk and therefore have amended Article 29.