European Banking Federation

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Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of some 4,500 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU alone.

EBF Draft Response to EBA consultation on the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets(EBA/CP/2013/07)

The EBF welcomes that the EBA has developed its draft RTS on the determination of the overall exposure to a client or a group of connected clients in respect of transactions based on the CEBS Guidelines and the more recent experience gathered by national supervisory authorities in the application of these Guidelines and other relevant market developments. However, we would like to provide the following comments on where we think the proposed standards exceed the principles of Large Exposures as defined in the CRR and previous CEBS guidelines and describe anunjustifiably "super-prudent" conservative regime whose conclusions are not logical or reasonable for the reasons explained below:

General Remarks

- If the RTS does not set agranularity threshold for the consideration of underlying assets, the exposure to the unknown client would exceed the 25% limit because of multiple portfolios on which institutions are confident that they are not connected. We think that 0% granularity for unknown underlying exposures is logically unjustified and will either entail huge additional operating costs and excessive workloads or a large "Single Unknown Client".In finding the right limit for the level of granularity we think it is important to consider what theoretically can happen under the present granularity conditions which are set at 5% and to contrast them to lower levels of granularity thresholds. Consider the following example in the box below:

Example 1:

Assumption: A Bank with EUR 10bn own funds and a LE-Limit EUR 2.5bn (= 25%) and EUR 100bn in RWA (max) invests in 100 Funds, each investment EUR1bn (very ambitious with only EUR 10bn own funds).

Given a 5% granularity threshold this would mean that per Fund, there can be only oneborrower (A) with EUR 50m exposure. Theoretically there can be 100, but those cannot be identical, otherwise they would be above the granularity threshold. Assuming A is in each one the largest unknown borrower the maximum risk would be: A= 100 Funds x EUR 50m = EUR5bn.

Under these extremely theoretical assumptions, the maximum unknown amount would be twice the LE limit (25%).

Reducing the threshold to 2.5% would result in exactly EUR 2.5bn (= max LE limit!)

Given, this extreme example we would argue that any threshold below 2.5% is simply not justified. But even the existing 5% granularity threshold wouldappear acceptable in light of the theoretic nature of the assumptions. Furthermore, it is also noted that by implementing no granularity threshold at all the administrative burden and cost to perform a look through approach will be considerable for no value added in terms of risk management.**We therefore strongly recommend retaining the existing 5% threshold.**

- Furthermore, it shouldbe noted that there are certain scenarios where the number of unknown clients can logically be reduced as, while the clients as such cannot be identified,they can be differentiated by investment restrictions. Consider the following example in the box below:

Example 2

A Bank invests in a securitisation where an investment restriction by the fund manager restricts the maximum exposure to a borrower to 1%. This means that borrower A and B each cannot go beyond 1% and thereby it is also assured that A and B cannot be the same obligor with an exposure greater than1%.

Thereby it would be sufficient to only add 1% to the ‘unknown client.’

We therefore advocate that the EBA reintroduce a similar provision to the one provided for in the CEBS 2009 Guidelines (i.e. the structure-based approach) to take account of the investment mandate to reduce the unknown client that would be otherwise unduly inflated.

Specifically we do not believe that the application of the look-through approach is justified when schemes hold granular portfolios such as retail exposure, auto loans or even SME (typically RMBS: pools are so granular that the amount that would result from the application of the look through would be non-significant and would not significantly contribute to the institution’s exposure to an existing group of connected clients.) Taking for example a multi-seller conduit whose underlying assets are a very large number of auto loans to retail customers, in practice these loans will never be connected to a large exposure customer and will be virtually impossible if not impossible to gather adequate information on under current arrangements. So the imposition of this proposal as is could result in reduced funding to the market, including to European manufacturers.Furthermore, issuers may be restricted under certain data protection and privacy laws from disclosing personal information of retail customers which could significantly impact issuance of securitisations backed by retail exposures. Thus,we suggest to exclude securitisations of retail and SME exposures (e.g. RMBS, credit card receivables.auto loans, student loans) from other exposure securitisation and we support EBA’s suggestion to introduce in the RTS’ framework a granularity/materiality threshold.

- One of our main concerns lies in the non-recognition of credit enhancement to measure the direct exposure on underlying assets. EBA mentions that defaults can happen simultaneously and thus credit enhancement could disappear in a very short timeframe. The assumption behind such a statement is that the purpose of the Large Exposures regime is to set limits on losses that could arise from the joint default of several counterparties or groups of connected clients. This is at odds with the initial Large Exposure regime's intent "which is to ensure that a bank can absorb losses resulting from the sudden failure of a single counterparty or group of connected counterparties without itself failing".

  We note that on securitisation structures where institutions are the sponsor or originator, they have a clear and timely knowledge of the level of the defaults on the underlying pool and thus of the resulting credit enhancement.

  For instance, on pools of purchased receivables held on ABCP conduits, the credit enhancement is monitored at least on a monthly basis and is dynamically adjusted according to the realised losses. The credit enhancement is structured to avoid any losses to the first default, whatever its rating.

  EBA states that institutions could not be able to reassess the level of credit enhancement as defaults in the underlying pool arise. It is contradictory with the due diligence requirement developed in Article 395 of CRR that requires institutions to monitor and record, among other, the level of credit enhancement when they can materially impact the performance of the institution's securitisation position, which is the case when an institution invests in a securitisation tranche whose credit enhancement was to disappear after one or two defaults.

- Large Exposure reporting is designed to monitor concentration risks on a client or a group of connected clients. The proposed new rules would result in including some transactions with underlying assets which are:

  - more exposed to a risk on a sector or a region, and
  - by design have a level of underlying granularity that makes it very improbable to be connected to a large exposure. For instance, a structure such as a Residential Mortgage Backed Security (RMBS) stands first for a risk on the real estate sector and by design its level of underlying granularity causes very limited risks connected with large exposures.

  Therefore, it seems appropriate to introduce exemptions based on structural nature which would decrease the cost of implementation without impacting the benefits of the proposed approach.

- As a general comment, we express our deep concern on this new change in the EU large exposure framework. The CEBS revisited this framework in 2009 and EU banks have spent a lot of money and time to adapt their IT systems and reporting tools to this new environment, which entered into application in December 2010. After less than three years, the EBA is now proposing new rules for the determination of the overall exposure to a client or a group of connected clients with respect to transactions with underlying assets. In parallel, the Basel

Committee has started to review its large exposure framework, including new rules for transactions with underlying assets, which differ from the EBA's proposal. As a result of this fast moving regulatory environment, banks cannot stabilise their risk management procedures and tools and continuously need to dedicate important resources to these new regulations. These resources are very often diverted from other projects which are critical for the improvement of internal risk management.

- The draft RTS does not include transitional arrangements:
  - The ITS is supposed to come into force on 1 January 2014. However, the rules proposed are complex and institutions will need time to adapt their IT-systems and procedures accordingly. We would therefore suggest to introduce adequate phase-in arrangements.
  - The CEBS Guidelines of 2009 implied transitional arrangements for transactions bought before 31 January 2010. These transactions are supposed to be treated under the rules valid until 31 December 2015.For the assurance of confidence we would find it necessary to also include these transitional arrangement in the EBA ITS. Banks can have significant backlogs of transactions that currently benefit from the grandfathering clause. Applying the new rules to all these transactions would be extremely time-consuming and some transitional arrangements are necessary to allow banks to progressively apply the look-through approach to this backlog.

- We are concerned that according to Article 4there could be a never ending look through in the case of funds within fund transactions (umbrella funds). The EBF proposes to include a materiality threshold for transactions where no further look through would be required (instead of funds to be considered as a client). A prudent materiality threshold would be 1.25 % of eligible capital.

  Finally, we are concerned that the EBA proposals are materially different to the current Basel consultation on large exposures. Whilst we understand the EBA's rationale that the Basel consultation is at much early stage in order to derive any meaningful direction from the proposals, we would caution deviating significantly from the proposals which could potentially lead to inconsistent approaches being applied across different jurisdictions.

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Related documents: http://eba.europa.eu/documents/10180/205075/CP-on-RTS-on-Large-Exposures---Art--379-8--CRR.pdf

<u>Response to Discussion Questions:</u>

Q.1 Is the treatment provided in Article 5 sufficiently clear and do the examples provided appropriately reflect this treatment?

Whilst the examples illustrating the exposures to CIUs and first loss exposure are clear, the examples which illustrate exposures totranched schemes critically miss the benefit afforded by the subordinated tranches under the tranched structure.

More specifically, the examples should correctly reflect the economic certainty that where all subordinated tranches which are considered to be exhausted in the event of a total underlying default, the corresponding residual exposure applicable to the senior tranche is already reduced by the sum total of all the subordinated tranches.

In example 3 therefore, recognising exposure to the senior tranche in the same way as the exposure to the most subordinated tranche significantly overstates the magnitude of the exposure and unfairly penalises the senior tranche.

The examples also suggest a perverse outcome where an investor investing the same amount in two different tranches will result in recognising different exposures. As an example, consider firm A that invests EUR10m taking up an entire senior tranche and a firm B which investsEUR10m in a mezzanine tranche of the same scheme, which represents 10% of the mezzanine tranche. Consider further, that the underlying is made up of 20 exposures of EUR20m each.

Under this example, firm A which invests in the senior tranche will report EUR10m exposure to all underlying, whilst firm B investing the same total amount in a more subordinated tranche will report exposures of EUR1m (10% x EUR10) to each underlying.

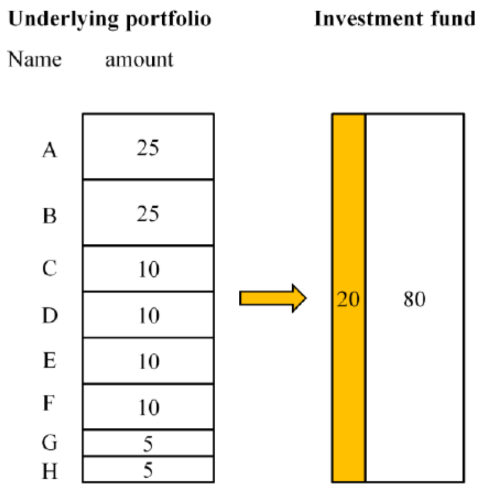
Furthermore, example 4 raises several issues on the appropriateness of the proposed framework:

Indeed the situation described in this example assumes that the institution knows in detail the level of credit enhancement (because the institution is investing in the junior and the senior tranche), in this situation, the credit institution should be allowed to recognise the credit protection provided by the equity piece in the structure and thus not report any exposure in regard to the senior exposure, EBA assumes that institutions are able to know the total amount issued on their investment but suggest that institutions would be unable to know the amount of the subordinated tranches which is surprising.

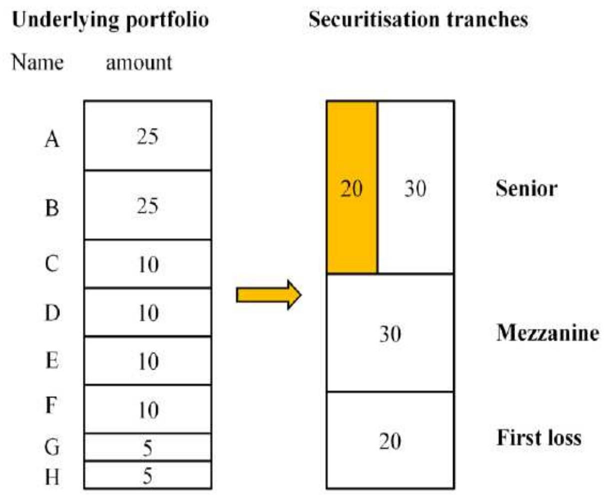
In addition we think that the pro-rata approach on securitisation structures can lead to inconsistent results because the amount of the exposure reported on the underlying asset depends not only on the amount invested in the structure and the amount of each underlying exposure but also on the proportion of a given investment in the issuance of the tranche.

The examples provided by the EBA illustrate this inconsistency:

Example 1:



Example 3:



EBA's proposal leads to the following results in term of exposure assignment:

	Example 1	Example 3
	CIU (pari passu exposure)	Senior tranche exposure
A to B	5	10
C to F	2	4
G and H	1	2

The result is that, for a same amount invested in the same portfolio, to a two times higher exposure amount reported for a senior tranche exposure, which is counterintuitive in term of credit risk management.

Furthermore, it should also be made clear that the partial look-through is still available to banks (as was clearly stated by EBA representatives during the public hearing on 4th July 2013).

Q.2 Is there an appropriate alternative way of calculating the exposure values in the case of securitisations, which would be compatible with the large exposures risk mitigation framework as set out by the draft CRR?

Regarding the treatment of subordinated tranches in Article 5, EBA has chosen the most conservative approach, disregarding the risk mitigating factors which results in the risk reported for investments in senior tranches to be too high.

Given example 3 in the draft ITS, the exposure to be reported would amount to 10 for client A. However, this would only be the correct result under the assumption that the first loss and the mezzanine tranche have already been exhausted. In other scenarios the actual loss would be much lower. For example, if all underlying clients defaulted at the same time the losses would be distributed on all investors, so that the loss for client A for the reporting institution would only amount to 5. If, on the contrary, A was the first who defaults, the loss from the perspective of the reporting institutions would be zero.

The arguments presented in the consultation paper, and in the CEBS guidelines before,for not recognising the risk mitigating effect of subordinated tranches are only a question of good risk management processes. In practice itwillbe possible for institutions to realise the loss of first loss tranches in a timely manner, this is even a requirement under the new regulations on securitisation.

The large exposures risk mitigation framework as set out by the CRR allows banks to reduce their exposures by adjusting the exposure value in case of financial collateral. To be consistent, the credit enhancement should be taken into account. So, when the credit enhancement is funded, we propose to assimilate it to cash collateral and thus reduce the exposure of the underlying names up to the amount of collateral received.

As it is mentioned in the introduction, we urge the EBA to reconsider its position not to take into account the credit enhancement as a credit risk mitigant: the reasons developed by the EBA mentioning that multiple defaults can happen simultaneously and thus credit enhancement could disappear in a very short time frame is not appropriate with the large exposure initial intent "which is to ensure that a bank can absorb losses resulting from the sudden failure of a single counterparty or group of connected counterparties without itself failing".

Alternatively, to meet supervisory concernswhile recognising the protection provided by credit enhancement we would propose the following approaches:

- the distribution of credit enhancement on all underlying assets: in this option, all tranches of the transaction would be considered when applying the pro-rata method used in the RTS (e.g. in the example 3 on p.21, the investor would use a pro-rata ratio of 20/100 instead of 20/50, as currently proposed). This is consistent with the idea that all tranches in a securitisation should be treated equally, as it is mentioned in the RTS rationale.
- using the current 2009 CEBS Guideline approach with haircuts (e.g. 50%) in the amount of credit enhancement taken into account

We understand from the EBA public hearing on this consultation that the EBA's primary concern was the rapid deterioration of the protection provided by junior tranches in times of stress. Whilst we appreciate that this may have been a feature of specific types of securitisations in the past, the generalisation across all securitisations greatly undermines the economic features of vanilla structures and does not account for the significant amount of regulatory change that governs securitisations under the current framework.

Q.3 Would the application of requirements provided by Article 6 (3) and (4) imply unjustified costs to the institutions? Would the introduction of a materiality threshold be justified on a basis of a cost-benefit analysis? Please provide any evidence to support your response.

The granularity threshold was intensively discussed during the consultation on the CEBS Large Exposure guidelines. It is far too conservative to require all unknown exposures to be regarded as connected, hence assuming a highly unrealistic worst-case scenario. In fact, most schemes aim at a minimum level of diversification at least, which precludes interconnectedness in the sense of single risk.

EBF Members support the application of the principle of materiality as it is impracticaland unreasonable to look through highly diversified portfolios. However, institutions should be able to demonstrate that regulatory arbitrage is not the reason for waiving a look through approach.

A granularity threshold is absolutely necessary as otherwise there would be an intensive over utilisation of the synthetic address “unknown client.” This would be especially relevant for securitisations of retail loans (RMBS, Student loan, consumer loan, credit card, auto loan) or highly granular portfolios (SME). We note that:

a) The amount to be reported would be non-significant, according to the amount invested by the institution
b) The beneficiary would be reported on a single line without any connection with other group of connected clients and thus not reported.

Also, in some cases the Look Through approach is not always possibledue to data protection or technical reasons. Finally, we note that the administrative burden is not justified if the risk is immaterial.

Excluding these types of structures under the reason that their underlying asset cannot be linked to a bank’sbiggest groups of connected clients is a reasonable way to avoid adding such exposure to the unknown client group. This is particularly true for large financial institutions where the amount of eligible capital is sufficient to be comfortable with the absence of any connection with other retail or SME customers.

We suggest to not apply the look through requirement on the schemes where the underlying assets are:

- a retail class such as RMBS, Student loan, consumer loan, credit card, auto loan
- highly granular portfolio such as SMEs

In addition, we agree with the EBA suggestion to include materiality threshold for the application of the look-through approach (please refer to question 4 for more details).

Q.4 Keeping in mind that such materiality threshold would need to be sufficiently low in order to justify that all unknown underlying assets of a single transaction would be assigned to this transaction as a separate client, what would be the right calibration? Would the reference value (the institution's eligible capital) be appropriate for this purpose? Please provide any evidence to support your response.

The EBF is in favour of keeping the existing granularity thresholdof 5 %. An alternative proposal would be that the threshold is defined as a portion of eligible capital (e.g. 1% of eligible capital). This would ensure that a look through approach is only required for transactions with underlyingassetsthat might be material.

EBA suggests that institutions could "circumvent the large exposures limit by concealing exposures to a certain obligor in opaque structures." We think that this situation is unlikely to occur:

a) For accounting issues (even if an institution creates a scheme in order to book a large exposure, the scheme would have to be consolidated and thus mechanically a look through would be performed);
b) The notion of connected client is applicable to the structure itself and thus if the scheme was to be invested in one unique obligor, it should be connected to the group of connected clients of this obligor and thus if an institution was investing in multiple schemes with the same obligor, they should be connected altogether as a consequence, institutions would be compliant with the large exposure objectives.

In addition, we advocate the EBA to take into account, when known, the concentration rules of schemes. For instance, if a scheme cannot invest more than 10% of its asset on one issuer/borrower (maximum possible concentration), and that the underlying names are not known (for operational or banking secrecy reasons), we suggest to addthis amount (10%) invested by the institution rather than the full amount invested to the address "unknown client" (see example 2 on page 2). Indeed this will reflect the real maximum possible risk in terms of large exposure.

Q.5 Would the requirement to monitor the composition of a transaction at least monthly, as provided by Article 6 (5), imply unjustified costs to the institutions? Please provide any evidence to support your response.

Yes, it will imply unjustified costs to the institutions. We also note that the suggested monitoring requirement is out of sync with the reporting frequency of most of the securitisation structures who in majority publish quarterly reports rather than monthly reports.

In order to diminish costs, increase transparency and promote the level playing field, UCI and similar should be required to disclose investment portfolios periodically. The required periodicity should be considered the proper reference for large exposures monitoring. We note that this issue may be under discussion by the group dedicated to shadow banking.

We also believe that the obligation to look through on monthly basis is not alwaysproportional to the risk and would lead to unjustified costs in these cases where underlying risk is not material.

EBF Members suggest that the frequency should depend on the volatility and composition of a transaction, i.e. the EBA should take into consideration the risk to breach the limit. For example, if the largest exposure of an institution is far from the limit (for instance at 10%), monthly monitoringof exposures to schemes that are negligible in regard to the total balance sheet of an institution would be excessive. Reporting frequency should be linked to the risk of breaching the LE limit.By default a look through should only be required on an annual basis.

Q6: Are there other conditions that could be met by the structure of a transaction in order to not constitute an additional exposure according to Article 7?

In addition to the conditions listed in article 7.2 a) and b), we would like to allow any regulated investment vehicle authorised by a Member State or by a third country Competent Authority to be considered as not constituting an additional exposure.

Limiting the scope of article 7 to UCITS only seems overly restrictive as it would result in unduly excluding regulated investment structures already submitted to stringent investment mandate regulations.