

ESRB response to the EBA Consultation Paper on Draft Implementing Technical Standards on Large Exposures (CP 51)

Introductory remarks

The European Systemic Risk Board (ESRB) welcomes the publication by the European Banking Authority (EBA) of the draft Implementing Technical Standards (ITS) on supervisory reporting requirements for large exposures (LE hereinafter), CP 51. As indicated in the reply to the ITS on supervisory reporting (CP50), the ESRB is legally mandated to determine and collect from the European Supervisory Authorities (ESAs) the information necessary to conduct macroprudential oversight in the European Union¹. In the case of banks, some of the information submitted to the ESRB will be collected according to the ITS on LE, hence the strong interest from the ESRB to ensure that macroprudential requirements are duly considered.

As the work on assessing the ESRB information requirements is still at an early stage of development, the ESRB may need to review them at regular intervals, as knowledge on these requirements develops.

Since the nine questions raised in this Consultation Paper are mainly addressed to reporters from a cost perspective, the ESRB prefers not to address these questions directly, rather it would like to raise the following policy views and technical comments from the perspective of the merits of the provisions contained in the draft ITS on LE.

Policy views

It is widely acknowledged that financial markets are strongly interconnected and that such interconnection plays a decisive role in the transmission mechanisms of tensions amidst financial institutions and to the real economy. Connectedness, in addition to overall size and concentration of operations in a single market, has also been used as a metric to identify systemically important financial institutions (SIFIs), where the notion of systemically important institutions is not only confined to largest ones, but includes also others that are strongly interconnected and can impair the normal functioning of financial markets. Moreover, recital 27 of the ESRB Regulation² acknowledges the importance for the ESRB to be able to analyse, from a macro-prudential perspective, the potential systemic risks which may be created via interconnectedness of financial institutions.

Some key features of the analysis of interconnectedness from a macro-prudential angle include: i) the potential for contagion risk (spillover effect of a single intermediary or a group

¹ See article 3 of the Regulation 1092/2010 of the European Parliament and of the Council: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0001:0011:EN:PDF>.

² See footnote above.

of institutions' distress on the rest of the financial system); and ii) the risk of fire sales and non-linear cliff or feedback effects. A key aim is for a more thorough investigation of the full impact of a shock on the financial system, that is, to capture second round effects as well as direct/indirect impacts. The impact on the financial system can be further augmented with connections to the real economy and the adverse feedbacks between the two. Furthermore, a flipside of this use of network analysis for risk assessment purposes is its potential use in the design and calibration of potential macro-prudential policies.

In the specific case of banks, in spite of some methodological issues, the ITS on LE will much contribute to cover the current information gap in this area and hence the strong interest by the ESRB in having the macro-prudential requirements of information fully considered in the final text of the ITS on LE.

The draft ITS on LE explicitly mentions its dual aim to meet both micro- and macro-prudential requirements. However, the legal basis is rather weak, as article 381 of the draft CRR clearly states that only exposures exceeding 10% of institutions' eligible capital will fall under the reporting requirement of LE. Since it is important that the reporting of LE stays on a firm legal basis, some members of the ESRB have expressed the view that this legal basis should be reinforced and that EBA should consider making a proposal for a proper legal basis for the collection of information on LE for macro-prudential purposes and to introduce this proposal in the ongoing CRR negotiations. The need for the ITS on LE to meet the ESRB macro-prudential requirements is also reflected in the recent ECB opinion to the CRD IV amendments³. This issue has never been previously discussed at the policy level by the ESRB but merits consideration.

Technical comments

1. The ESRB requirements are described in the report of the Joint Group on Data exchange (JGD), which has been endorsed by the ESRB and EBA in summer 2011. In the JGD report, the requirements regarding large exposures mainly concern the so-called Large Banking Groups (LBGs). Some of these requirements, which are expected to be implemented once the ITS on LE enters into force, have been translated in the short-term into four indicators for two samples of 35 and 55 LBGs⁴, which are required on a best efforts basis, as specified in

³ See http://www.ecb.int/ecb/legal/pdf/en_con_2011_5_f.pdf.

⁴ The four short term indicators are 1) Number and distribution (average, median, percentiles) of large exposures of the 35/55 LBG; 2) Amount and distribution of large exposures broken down by country and sector of counterparty (Government, other LBG, other banks, other financial intermediaries, non-financial corporations, retail); 3) Amount (exposure before credit risk mitigation (CRM)) and distribution of large exposures of the 35/55 LBG broken down by instrument (assets, derivatives, off-balance sheet, indirect exposures) and % of own funds; 4) Amount (exposure value after CRM, of which banking book) and distribution of large exposures of the 35/55 LBG, and % of own funds. The additional two indicators for the medium-term are: 1) LBGs' large exposures to other LBGs and LIGs, and 2) LBIG common exposures.

the dataset A3 of Annex II of the ESRB Decision 2011/6⁵. However, the ESRB observes that some of the information required from National Supervisory Authorities (NSAs) under the short-term approach, based on ESRB Decision 2011/6, seems not to be reflected in the draft ITS on LE. In particular, the sector breakdown of borrowers is not complete as large exposures towards other LBGs, other banks, and other financial intermediaries⁶ are not yet separately identified. Since the framework of large exposures consists of a borrower-by-borrower⁷ reporting, NSAs and EBA should in principle be able to aggregate the individual information received from banks into the sector aggregates requested by the ESRB, possibly using the ESCB Register of Institutions and Affiliates Database (RIAD). In addition to that, the ESRB would be interested in separately receiving information on the exposures towards Large Insurance Groups (LIGs), as part of the cross-sectoral conduct of macro-prudential oversight. Given the limited time available to national and EBA compilers to transmit large exposures information to the ESRB and fully aware of the time required to carry out these aggregations, the ESRB recommends the aggregation of large exposures into the following categories: government, other LBGs, other banks, other LIGs, other financial intermediaries, non-financial corporations, retail.

2. Due to the LE reporting methodologies, under certain circumstances the same credit might be reported several times. Consequently, the process of aggregation of LE information, for example by sector or country, may lead to an overestimation of the exposure and of the risk, making it not optimal for cluster risk related analysis⁸. Thus, the EBA is invited to consider how this information could be collected more effectively to address both micro and macro-prudential interests so that aggregations can be more accurately performed.

3. Additionally, the ESRB would like to highlight that the proposed classification of non-financial counterparties following the NACE classification system would be valuable for macro-prudential analysis as it allows the analysis of concentration and interconnectedness towards sectors of activities in the real economy. The methodology for this classification should be very carefully defined, especially in those cases where a group is present at the same time in various sectors (“bancassurance” business model, for example).

4. The aggregation of the information in sectors as envisaged in point 1 above requires the use of group identification codes. The ESRB notes that this code currently depends on the national reporting system in place, as a uniform codification system is not available at an EU level. For that purpose, the ESRB strongly believes that the future availability of common Legal Entity Identifiers (LEI) will facilitate the aggregation of the single name counterparty

⁵ See <http://www.esrb.europa.eu/pub/pdf/ESRB-2011-6.pdf?303d31167c8402d4f3c21402a2818132>.

⁶ The composition of the sector “other financial intermediaries” envisaged by ESRB differs from the sector “financial corporations other than institutions”, incorporated in the ITS on LE (e.g. the latter additionally includes insurance companies)..

⁷ Notion of “borrower” according to article 4 (46) of CRR (Group of Connected Clients)

⁸ This holds true, for example, in the case of a counterparty belonging to more than one group of connected clients. According to the draft version of Article 4 (46) CRR as of 28/02/2012, central governments and the government-controlled entities constitute not one single but several small groups of connected clients, with the government included in each group. This means that the exposure to the government is recognised in all groups of connected clients to which it belongs and reported accordingly

risk at the level of the system and will help in the identification of inadequate building-up of concentrations towards single counterparties and, at the same time, will reduce the reporting burden and enhance the quality of the information. The ESRB thus invites EBA to move forward in the adoption of the LEI.

5. The ESRB is interested for the conduct of macro-prudential oversight in receiving information on the LBGs' exposures towards other LBGs and to LIGs. However, this information can be compiled only if the lists of LBGs-LIGs and the management of this list are disclosed to reporting agents, so that they are aware of their additional reporting obligations of LBGs or LIGs. Considering that the proposal under paragraph 1 above is reflected in the final ITS on LE, the reporting agents should be made aware of the groups against which they should report their large exposures information. In this case, a public list of LBGs and their compositions, possibly provided by RIAD, could in ESRB's view significantly reduce the reporting burden for compilers.

A minority of members of the ESRB proposes a more pragmatic approach. In case the disclosure of this list of LBGs and LIGs, including their compositions, to the reporting agents is an issue, the reporting banks could be required to report their k largest exposures (e.g. $k=50$ or $k=100$). In case a large institution is not included in this list, the exposure versus this particular market participant could be considered as immaterial. This approach would reduce the problems raised by possible breaks in the data series resulting from changes in the list of LBGs and LIGs, as large exposures would always be reported irrespective of the counterparty's inclusion in the list⁹.

6. In case the reporting on LBG's exposures towards other LBGs and to LIGs (mentioned above) is implemented, consistency should be ensured with the usual LE reporting, in order to avoid a methodological break. To that aim, the ESRB would recommend EBA to apply consistent methodologies and requirements in both the usual LE reporting as well as in the specific reporting framework of LBG's exposures.

7. The use of an absolute threshold to identify large exposures, together with the legal threshold of 10% of eligible own funds, is welcomed by the ESRB, which also acknowledges the efforts by EBA to take into account the macro-prudential requirements in the ITS on LE. Nonetheless, the proposed threshold in absolute terms (EUR 150 million) may prove to be, in some cases, inappropriate to capture the relevant counterparties in an interconnected financial system. The ESRB invites EBA to consider the definition of a more meaningful threshold and how this threshold could improve the coverage of the collected information, acknowledging that many exposures of EUR 150 million, particularly to non-financial sectors,

⁹ A similar approach has been suggested by the FSB Data Gaps Working Group (see Consultation Document 'Understanding Financial Linkages: A Common Data Template for Global Systemically Important Banks (GSIBs)', p. 17, Table 2A. Bilateral credit exposures to top 50 counterparties) in order to collect information on bilateral interlinkages of GSIBs.

may not be of systemic importance and that a lower threshold may result in a supplementary administrative burden for institutions and in a loss of reporting quality¹⁰.

8. While the draft ITS foresees that NSAs are allowed to lower the threshold of EUR 150 million for national purposes, the ESRB needs to receive aggregated large exposures information which is comparable across countries. Therefore, if NSAs decide to apply the national discretion in an uncoordinated way, the quality of the information which the ESRB receives may be impaired. Some members of the ESRB then advocate that, given the impact that national discretion may have in the tasks of other institutions, cases when national discretion is applied should be well justified and stable over time, and should always follow objective criteria¹¹. Meanwhile, the ESRB acknowledges that such criteria must be legitimate to avoid the reporting of exposures which are not systematically relevant and which NSAs do not have the capacity to analyse. This regime would not prevent the ESRB from requesting further information on an ad-hoc basis, when necessary and according to the agreed procedures for these cases.

9. The ESRB notes that the Financial Stability Board work on Data Gaps being undertaken under its mandate from the G20 is also considering the information required from systemic firms to understand the network of exposures between them. The ESRB recommends EBA to discuss the LE templates with the FSB in order to ensure alignment, so that both can be reported without inefficient reporting burden on firms. More importantly, the alignment with the FSB templates could assist as well in the identification of risks on a global rather than on an EU basis only. For this to happen in operational terms, it is essential to ensure that EBA and NSAs are empowered to directly receive data on exposures to countries, sectors and instruments (Institutions-to-Aggregate data) of LBGs, which are currently collected in the context of the BIS International Banking Statistics, and on large bilateral counterparty exposures (Institution-to-Institution data), currently collected for LBGs in the context of the Senior Supervisors Group, and that both sets of information are shared with the ESRB.

The ESRB does not object to EBA publishing the ESRB response to the EBA Consultation Paper on draft ITS on large exposures (CP 51).

¹⁰ Members of the ESRB have proposed other possibilities which EBA could explore: the introduction of specific and harmonized reporting requirements on sectoral concentration, and the reporting of the largest exposures and liabilities (in terms of the x largest or as a percentage of own funds of each institution).

¹¹ One member of the ESRB notes that the establishment of a lower threshold at a national level would not have any negative effect on the information transmitted to the ESRB, as only those exposures over EUR 150 million would be transmitted.