German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Position paper

on adjustment of the European large exposure rules in the CRD/CRR review

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

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Position paper on adjustment of the European large exposure rules

Preliminary remarks

The large exposure rules are currently being revised at European level. Firstly, the large exposures framework published by the Basel Committee on Banking Supervision in April 2014 is to be implemented and, secondly, the European Commission is reviewing in accordance with Article 507 of the CRR whether the exemptions in Article 400 (2) and Article 493 (3) of the CRR applied by the competent authorities or Member States on a discretionary basis should be retained.

The proposals under discussion for adjustment of the European large exposure rules would, as a whole, tighten the current regime considerably. Large exposure limits are likely to at least be reached more quickly and in fact exceeded in a number of cases. Overall, banks' lending capacity would be curtailed significantly.

It is particularly important to refrain from issuing a single legislative proposal for a CRD IV/CRR review before the end of this year which covers the trading book review, counterparty credit risk, plus the large exposure requirements relating to these areas and the new standardised approach for credit risk. The latter one expected to be finalised by the end of this year.

With this in mind, the German Banking Industry Committee (GBIC) would like to outline its main positions on the future European large exposures regime. The present position paper is divided into two sections:

1. Remarks on implementation of the Basel large exposure rules
2. Remarks on exemptions from the definition of 'exposure' and exemptions from the application of Article 395 (1) of the CRR (large exposure limit).

We wish to make clear that the order of these positions does not indicate any prioritisation on our part but instead merely reflects the order of the relevant articles in the CRR.

Position paper on adjustment of the European large exposure rules

1. Remarks on implementation of the Basel large exposure rules

Retain definition of 'eligible capital' (Article 4 (1) (71) (b) of the CRR)

Whilst, until the CRR entered into force, a bank's entire own funds could be taken as the basis for calculating the large exposure limit, the inclusion of Tier 2 capital was, in particular, gradually restricted to a significant extent by the CRR. This posed a considerable challenge to some banks when it came to complying with their large exposure limit and curtailed their lending capacity. In its work, the Basel Committee focuses on international banks that are active in the capital markets. This has to be borne in mind when translating Basel proposals into European law. On no account should – as proposed by the Basel Committee – the basis for calculating the large exposure limit be reduced any further. Some institutions without corresponding access to the capital markets (e.g. savings banks under public law or banks organised as partnerships, cooperative banks) can only create Tier 1 capital to a limited extent to flexibly cushion against capital squeezes. Taking solely Tier 1 capital as the basis for calculating the large exposure limit is not appropriate either, as in the event of default by a borrower Tier 2 capital can also be used to cover losses where an annual loss is involved.

Allow cross-product offsetting of long and short positions in the trading book (Article 390 (3) of the CRR)

Under the Basel large exposures framework, long and short positions in different issues from the same counterparty may be offset only when the short position is junior to the long position, or if the positions are of the same seniority (paragraph 52). From a prudential perspective, it is difficult to understand why creation of the issuer-related net position should be based on the seniority of positions. We therefore recommend not implementing the Basel proposals in this respect. Apart from that, it must at any rate be ensured that – as envisaged by the Basel Committee – cross-product netting of trading book positions is possible. The scope for netting under Article 390 (3) of the CRR should not be restricted to the same securities. It seems to us that the EBA adopts such a strict interpretation in its Q&A 2015_1873. Many banks would otherwise exceed their large exposure limit. Cross-product offsetting of long and short positions is, moreover, materially justified. The focus of the large exposure rules is not on the probability of default but on idiosyncratic risk. A short position generally reduces the exposure to a borrower and thus idiosyncratic risk, i.e. the potential loss in the event of default by the borrower.

Retain specific large exposure limit for interbank exposures (Article 395 (1) of the CRR)

Since the Basel Committee focuses on international banks that are active in the capital markets, the large exposures framework naturally cannot take adequate account of the interests of small and medium-sized institutions, so that no specific limit for interbank exposures is provided for under the Basel framework. Because of the reduction of the calculation basis and thus of the large exposure limit through the CRR, as well as the largely dropped exemptions for interbank exposures under CRD II, this regulatory relief for small and medium-sized institutions is already of great practical importance today. It ensures that institutions with eligible capital of less than EUR 600 million can smoothly handle interbank business. The importance of the specific large exposure limit would increase further if – as currently discussed – further exemptions for interbank exposures were to be dropped in the future (see in this connection separate remarks below). This specific large exposure limit for interbank exposures as provided in Article 395 (1) of the CRR should therefore definitely be retained in the European regime.

No recognition of exposures to collateral providers on application of the Financial Collateral Comprehensive Method (Article 401 of the CRR)

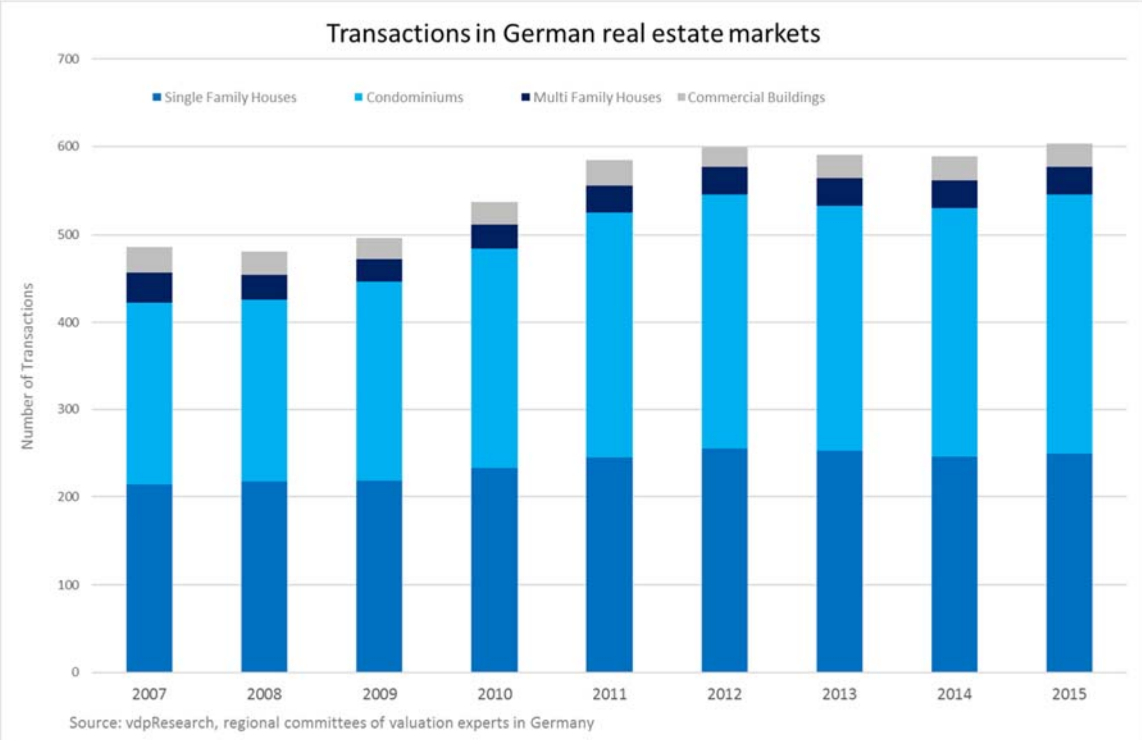
According to the Basel proposals, a bank that makes use of the Financial Collateral Comprehensive Method is also to recognise an exposure to the credit risk mitigation (CRM) provider. The amount assigned to the collateral provider is to be the amount by which the exposure to the original counterparty is reduced (paragraph 43). We expressly reject any substitution by the collateral provider under the comprehensive method and call for retention of the current provisions of Article 401 of the CRR.

Use of the comprehensive method is tied to a number of strict requirements. Collateral has to be stress-tested and included in concentration risk management. Changes in the value of collateral caused by market or credit risk are already accommodated sufficiently by way of haircuts. Additionally assigning an exposure amount to the collateral provider would clearly overstate the risk of the collateral defaulting. Furthermore, mandatory substitution by the collateral provider would pose considerable process-related challenges for banks. It would make daily monitoring of large exposures much more difficult, especially for repo and securities lending transactions. Prior to any trade, banks would have to negotiate with the counterparty on potential collateral providers and comply with internal limits. Repo transactions that are executed via a repo platform such as EurexRepo would no longer be possible in future, as banks would not know the collateral pool beforehand in the case of triparty repo transactions and would also not be able to influence its composition. The repo market is a major source of short-term funding for banks. Implementation of the Basel proposals is therefore likely to have a dramatic impact on banks' liquidity.

Not least, this provision sets 'wrong' management incentives. Collateral received would burden banks' credit limits, without generating any corresponding income. With their income situation in mind, banks would therefore dispense with accepting collateral and increasingly conduct uncollateralised transactions. This effect is reinforced by the fact that under the Basel proposals an eligible credit risk mitigating technique must be recognised in the calculation of an exposure whenever this technique has been used to calculate the risk-based capital requirements, and provided the conditions for recognition under the large exposures framework are met (paragraph 38). Should they be in danger of exceeding the large exposure limit, banks would therefore have to dispense with accepting financial collateral also for solvency regime purposes. As a result of the mandatory substitution on application of the comprehensive method, banks' credit risk would also increase because the avoidance of losses through collateralisation would no longer take effect. For a loss to arise despite collateralisation, a highly unlikely "double default" has to occur.

Continue to recognise real estate collateral (Article 402 of the CRR)

Completely dispensing with the recognition of real estate collateral for reducing exposure values for large exposure purposes – as basically proposed by the Basel Committee – goes too far, in our view. Germany, in particular, has a long tradition of finance secured by real estate. For example, loans to small and medium-sized businesses are typically secured by residential or commercial real estate. In addition, real estate valued conservatively and meeting high qualitative standards in accordance with the supervisory requirements, constitutes valuable collateral that can be liquidated in the event of a customer's default. Measured in terms of the number of actual transactions on the German real estate market, liquidity has increased significantly since 2007. This is shown by vdpResearch analysis based on the property market reports published by the regional surveyor committees:



We therefore believe that recognition of this type of collateral in the large exposures regime is justified and covers the risks involved, provided correspondingly strict requirements are met. The stability of the German real estate market is also evidenced by a number of publications. For example, hard tests have been conducted and passed in every case since 1988, demonstrating the very low losses from real estate finance. We therefore call for recognition of both commercial and residential real estate collateral as risk-mitigating in the large exposures regime, provided such hard tests are passed.

We should also like to point out that dropping the recognition of real estate collateral would be accompanied by changes in the structure of finance. For one thing, many banks would no longer be able to operate as the initiator of a loan syndication in the case of large-scale real estate finance, e.g. infrastructure projects, since the loan volume would have to be recognised in full in the first step. Only very large banks would be able to assume this position, leading to systemic concentrations. For another thing, small banks would quickly reach their limits in real estate finance. In view of the envisaged limitation of eligible capital to Tier 1 capital, dropping the recognition of real estate collateral would seriously restrict lending, further aggravating the strained situation on the German real estate market.

Align (current) implementation in the EU with the Basel rules

i)
Application of the so-called ‘materiality threshold’ of 0.25% of eligible capital, which constitutes relief compared with the full look-through to the underlying assets, is tied under Article 6 (2) of delegated Regulation (EU) No 1187/2014 to the condition that the obligor has not been identified. Such an – additional – condition for application does not exist at Basel level; the Basel ‘materiality threshold’

provision is solely amount-based. At present, there is considerable uncertainty among banks about the concrete applicability of the ‘materiality threshold’ provision under Article 6 (2) of delegated Regulation (EU) No 1187/2014. The ‘materiality threshold’ provision thus ultimately threatens to miss the mark for investment funds in particular and fails to create the hoped-for relief especially for small and medium-sized banks. In the course of the review of the European large exposure rules, the delegated Regulation should be modified as regards the condition for application of the ‘materiality threshold’ provision and adjusted to the Basel rules.

ii)
Under the Basel large exposures framework, off-balance-sheet items (loan commitments) are to be captured in future, like in calculation of capital requirements, via credit conversion factors (CCFs) instead of via exemptions. The review of the credit risk standardised approach, with a probable recalibration of the CCFs, has not yet been completed at Basel level, however. As a result, the impact of a switch of approach to CCFs for the large exposures regime cannot be reliably assessed. A switch to CCFs for off-balance-sheet items in the large exposures regime is therefore premature at present and should therefore be deferred. As explained in the GBIC’s letter to the European Commission dated 5 August 2016, it is particularly important that the trading book review, counterparty credit risk and at least the large exposure rules relating to these areas of regulation and the review of the credit risk standardised approach are not incorporated in a legislative proposal at the end of this year.

2. Remarks on exemptions from the definition of ‘exposure’ and exemptions from application of Article 395 (1) of the CRR (large exposure limit)

Retain exemption for interbank exposures (Article 390 (6) (a)-(c) and Article 400 (2) (f) of the CRR)

We believe that the exemptions in Article 390 (6) (a)-(c) and Article 400 (2) (f) are necessary and appropriate. We consider it essential to provide further interbank exemptions in order to ensure the smooth functioning of clearing and settlement and of payment transactions, especially with respect to exposures resulting from short-term clearing, custody and cash management (CCC exposures). Especially the settlement of financial market transactions and payments would be interfered with. CCC exposures resulting from securities clearing and settlement or payments, in particular, are by their nature very difficult for the bank to predict and fully control. We strongly recommend excluding short-term CCC exposures from the calculation of large exposures. The reasons can be summarised as follows:

- CCC exposures are different in nature from usual interbank lending. They are not actively entered into by institutions, but mainly the result of client activity. As a result, they are beyond the control of the institutions involved.
- Usually, there is a direct link with underlying real-economy flows, which could potentially be constrained.
- At the same time, there is additional complexity generated by technical issues, different time zones and unknown client flows, for example (as outlined above).
- Non-exemption would primarily impact relatively small banks or banks in special situations (name or country stress).

Retain exemption for covered bonds (Article 400 (2) (a) and Article 493 (3) (a) of the CRR)

We believe that covered bonds as defined in Article 129 of the CRR should not be subject to the large exposure limit but should be subject to the current exemption regime in Article 400 (2) (a) and Article 493 (3) (a) of the CRR. Covered bond markets proved to be resilient during the financial crisis. This is due in particular to the fact that these bonds are subject to strong legal safeguard mechanisms, as a result of which the covered bond creditors have preferential claims even if the bank becomes insolvent. In addition, covered bonds are covered by a definitive list of low-risk assets whose measurement – in the case of real estate finance – is subject to specific valuation rules and special qualitative requirements. Moreover, these are often diversified cover pool assets. It should be noted in this context that the assets serving as collateral for the covered bonds are recognised in the institutions’ balance sheets and are therefore subject not only to the general prudential requirements but also to qualitative and quantitative lending and credit risk processes. As the second-largest market for fixed-income securities, covered bonds also represent a considerable proportion of the liquidity buffers to be maintained for LCR purposes. Because of the small number of issuers, the large exposure limit could be exceeded very quickly if the covered bonds held in the liquidity buffer were to be recognised in full for the issuer in question. Another point to be considered is that restricting the limit could lead to problems in institutions’ treasury operations because there are currently very few investment alternatives with a similarly low risk exposure.

Retain exemption for intragroup exposures (Article 400 (2) (c) and Article 493 (3) (c) of the CRR)

The exemption under Article 400 (2) (c) and Article 493 (3) (c) of the CRR should be retained because it is vital for ensuring the supply and management of adequate intragroup capital/liquidity in order to preserve the existing structures and financing arrangements within groups of institutions or (mixed) financial holding groups. This applies in particular to groups that include entities which do not themselves have access to a central bank, such as the ECB, or the capital markets. In many cases, funding would not be possible for group entities – or only at considerably higher cost – without the adequate provision of liquidity by the credit institution. It would no longer be possible to leverage synergy effects resulting from central liquidity management. This would considerably restrict the group's financial flexibility and unreasonably increase its funding costs. In turn, high funding costs would reduce the financial resilience of groups. In addition, eliminating the preferential treatment of intragroup exposures would also result in the first instance in very high breaches of the large exposure limit.

The preferential CRR treatment under Article 400 (1) (f) of the CRR, in conjunction with Article 113 (6) (a) of the CRR, is not sufficient because the criteria there only permit a very narrowly defined scope and also only apply to the entities in a group that are established in the same Member State as the institution. We believe that permitting preferential treatment over and above this continues to be justified because the entities belonging to a group of institutions or a financial holding group are included in supervision on a consolidated basis under both Pillar I and Pillar II. Moreover, counting intragroup exposures in full towards the large exposure limit would implicitly restrict the business volume of a subsidiary. Eliminating the preferential treatment of comfort letters would additionally contradict the supervisory requirement for such guarantees for other supervisory and legal matters. Overall, eliminating the exemption would have a severe impact on the institutions concerned.

The discretionary option given to Member States under Article 493 (3) (c) of the CRR was exercised restrictively in Germany in Section 2 of the *Regulation governing Large Exposures and Loans of €1.0 million or more*. If the group entity is included in supervision on a consolidated basis, the following exemptions are permitted under German law:

- Full exemption of participations, unless the participation exceeds 25% of eligible capital
- Full exemption of comfort letters issued
- 75% exemption for other intragroup exposures; up to 93.75% exemption possible on request.

We call for full exemption of intragroup exposures, as provided for under Article 400 (2) (c) and Article 493 (3) (c) of the CRR respectively. On no account should the exemptions for intragroup exposures be tied to stricter requirements than those under German law.

Retain exemption for intragroup participations and other kinds of holdings (Article 400 (2) (d) and Article 493 (3) (d) of the CRR)

Article 400 (2) (d) and Article 493 (3) (d) of the CRR allow the competent authorities or Member States to fully or partially exempt, among other things, participations and other kinds of holdings to regional or central credit institutions from inclusion in the large exposure limit. In Germany, this national discretionary option is exercised under Section 2 (5) of the *Regulation governing Large Exposures and Loans of €1.0 million or more* in such a way that only 50% of participations or other kinds of holdings in central credit institutions have to be counted towards the large exposure limit of 25% of eligible capital, the specific interbank large exposure limit is not applicable. This regulatory relief is of great importance both materially and strategically. If it were dropped, many banks in Germany organised in networks would exceed the large exposure limit. Scope for participations and thus scope for designing network strategy would be seriously restricted. The exemption is also justified, as the participations or other kinds of holdings to regional or central credit institutions within a network are sustainable, long-term strategic risk exposures. They ensure the necessary influence of primary institutions on the regional and central institutions. We therefore urgently call for retention of this exemption in the review of the large exposures regime by way of a discretionary option for Member States.

Retain exemption for promotional loans provided through commercial banks (Article 400 (2) (e) and Article 493 (3) (e) of the CRR)

Article 400 (2) (e) and Article 493 (3) (e) of the CRR allow the competent authorities or Member States to exempt certain interbank exposures resulting from promotional loan business fully or partly from inclusion in the large exposures limit. This discretionary option was fully exercised for the German promotional banks, so that promotional loans provided through commercial banks are currently not subject to the large exposure limit (Section 1 of the *Regulation governing Large Exposures and Loans of €1.0 million or more*).

This exemption takes the special features of promotional business into account. German promotional banks provide their competitively neutral promotional loans to the final customers via a limited number of commercial banks. It is, therefore, in the nature of the specific business model, that the intermediary commercial bank becomes the promotional banks' borrower, i.e. interbank exposures are created.

So that the German promotional banks can perform their promotional mission, it is vital that the interbank exposures in question continue to be fully exempted from inclusion in the large exposure limit. If this exemption were to be dropped, many promotional banks would exceed their large exposure limit and, in fact, these excess amounts would be even higher than the own funds held by some promotional banks. The promotional banks' public mandate would thus generally be called into question.