Annex : FBF response to EBA Consultation on the determination of the overall exposure to a client in respect of transactions with underlying assets

General comments:

We appreciate the opportunity to comment on the consultative document on the determination of the overall exposure to a client in respect of transactions with underlying assets. We share the objective of the EBA to improve the monitoring of large exposures. Significant improvements have already been achieved in that field with the recent implementation of the 2009 December CEBS guidelines that came into force on December 31st 2010. In particular, the December 2009 CEBS guidelines strengthen the previous framework introducing more conservative risk weights, capturing a wider range of exposures and requiring to perform a look through approach for new non granular schemes.

This draft RTS introduces a set of new highly prescriptive provisions related to schemes at a time where banks have just implemented the above mentioned CEBS guidelines on the Large Exposures.

In this context, we wish to express our overarching concern on the timing of this draft RTS and its lack of coordination with other on-going regulatory developments undertaken at the international level, in particular the Basel proposal for reshaping the Large Exposures regime published in March 2013[1].

In addition, we consider it is premature to undertake a reshaping of the current LE framework in such a tight timeframe as we do not have enough hindsight on the shortcomings of the current rules. We therefore advocate the EBA RTS should stick as closely as possible to the 2009 CEBS guidelines.

Going one step further, we would like to express our deep concern on a few proposals in this new EBA RTS:

1. The systematic use of the look through approach is not appropriate for a large part of bank's exposure to schemes

We regret that EBA omitted some of the alternatives to the look-through approach such as the one applicable to exposures that benefit from its granularity or the approach based on the mandate of the scheme and credit enhancement.

We recognize that if the application of the look-through approach is appropriate when funds and securitisation vehicles involve exposures to large customers. However, we think such a treatment is not justified when schemes hold granular portfolios such as retail exposures, auto loans or even SME (typically RMBS: pools are so granular that the amount of RWA that would result from the application of the look through would be non-significant and would not substantially contribute to the institution's exposure to an existing group of connected clients). Besides, some structures are sufficiently diversified in order to be more exposed to a risk on a sector or a region than to a group of connected clients. For instance, derivatives on CMBX are designed in a way that limits exposure to a group of connected clients but that creates exposition on the American sector.

As far as the look-through requirements are concerned:

[1] See http://www.bis.org/publ/bcbs246.pdf

- we suggest to exempt securitisation of retail and SME exposures (RMBS, auto loans, student loans…) as well as CMBX positions and
- we support EBA's suggestion to introduce in the RTS' framework a granularity/materiality threshold (Details in question 4).

2. The initial intent of the Large Exposure regime is misrepresented

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 time frame. 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 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".*

On securitisation structures where institutions are 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 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 invest in a securitisation tranche whose credit enhancement was to disappear after one or two defaults.

3. A too restrictive regulation on securitisation could have a negative impact on banks' clients

Securitisation makes possible for banks to be refinanced and for corporates to improve their liquidity.
Securitisation settled in conformity and correctly controlled (quality of the assets, monitoring …) constitute a key component of the durable financing of the economy. Securitisation has to be considered in its current regulatory framework (CRD2, article 122a). If the regulatory requirements become too restrictive banks will reduce the securitisation production which will have a negative impact on their clients, especially companies for instance car manufacturers.

4. The impact on the unknown client

If the RTS was to be applied under its current version, 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.

Answer to specific questions

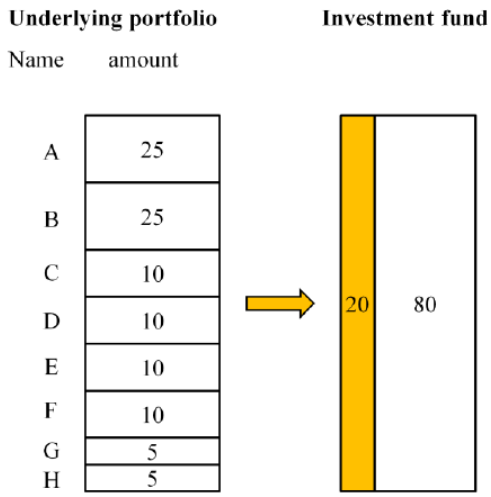
Q1: Is the treatment provided in Article 5 sufficiently clear and do the examples provided appropriately reflect this treatment?

Yes, it is clear enough, but we strongly disagree with the proposed methodology.
Example 4 raises several issues on the appropriateness of the proposed framework:

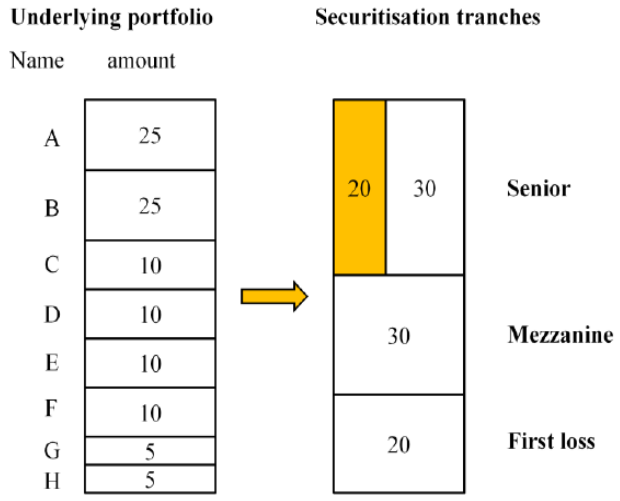
1. Indeed the situation described in this example assumes that the institution knows in detail the level of credit enhancement (because the institution is investing in the junior and the senior tranche), in this situation, the credit institution should be allowed to recognise the credit protection provided 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 suggests that institutions would be unable to know the amount of the subordinated tranches which is surprising.

2. In addition we think that the pro-rata approach on securitisation structure 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, an exposure twice the amount is reported for a senior tranche exposure, which is counterintuitive in term of credit risk management.

Q2: 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?

The large exposures risk mitigation framework as set out by the CRR allows banks for a reduction of their exposures by adjusting the exposure value in case of financial collateral (As a reminder by using the Financial Collateral Simple Method or Financial Collateral Comprehensive Method). To be consistent, the credit enhancement has to be taken into account.

- As it is mentioned in the introduction, we urge EBA to reconsider its position not to take in account the Credit enhancement as a credit risk mitigant : the reasons developed by 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".*

- On Securitisation structure of purchased receivables held on ABCP conduits for instance, the credit enhancement is assimilated to a credit risk mitigation mechanism in term of risk management since it prevents the institution from a sudden default of a single obligor.
  In addition, the sponsor or originator of the structure performs a regular monitoring of the credit enhancement following market practices and of the losses occurred to the underlying pool. The level of credit enhancement is an important parameter of the credit decision at each review level.

Therefore, 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. At least the benefit of collateral should be spread among investors in one single tranche using a pro rata ratio.

Q3: 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.

1. As mentioned above, we consider that it is not justified and possible (as a reminder the CEBS guidelines §65 said "*because it is not possible or feasible to look-through the scheme, the guidelines should provide prudent alternative*") in term of risk management to apply a look through approach on schemes where the underlying asset is a retail class (RMBS, Student loan, consumer loan, credit card, auto loan) or highly granular portfolio (SME):

   a. The amount to be reported would be non-significant, as a proportion of 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 ultimately not be reported.

   Excluding this type of structure because their underlying assets cannot be linked to bigger groups of connected clients is a reasonable way to avoid adding such exposures 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 not applying the look through requirement on schemes where the underlying assets are:
   - **a retail exposure : RMBS, Student loan, consumer loan, credit card, auto loan**
   - **a highly granular portfolio : SME**

   As an illustration of the high granularity of securitisation structure, the following table shows the concentration of some securitisation structures used to illustrate FBF answer to the Basel Committee's new securitisation framework proposal:

Structure name	Arran Residential Mortgages Funding 2010-1 plc	CLARIS ABS 2011 S.R.L.	FIRST FRANKLIN MORTGAGE LOAN TRUST	HOLLAND MORTGAGE BACKED SERIES (HERMES) XVI B.V.	Phedina Hypotheken 2011-I B.V.
Structure Type	RMBS	Auto loan	RMBS	RMBS	RMBS
Total portfolio	£4 647 089 317	2 616 577 280 €	$1 705 534 713	3 075 145 557 €	1 546 745 823 €
Highest exposure	£2 493 891	4 909 940 €	NC	1 500 000,00 €	NC
Highest exposure %portfolio	0,0537%	0,1876%	NA	0,0488%	NA
Number of loans	33 155	23 411	7 770	14 669	6 786

2. 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)

The two proposals (1&2) have to be combined.

Q4: 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.

Our proposal:
We think indeed that setting a materiality threshold where the reference value would be the institution's eligible capital is more appropriate than taking the underlying portfolio as a reference.

An approach where the institution exposure does not exceed 0,25% of its eligible capital seems acceptable.

This materiality threshold has to be combined with our suggestion (2) under question 3 proposing the exclusion of highly granular portfolios: indeed institutions could have exposure to RMBS structure that exceeds 0,25% of their eligible capital while transparency remains inappropriate for the reasons developed here above.

Justification of our proposal:

- A 0,25% threshold would mean that an institution would not be compliant with the Large Exposure limit if it holds exposure to 100 schemes all investing in the same customer which is very unlikely to occur.

- 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 the look-through would have to be performed).
b. The notion of connected clients 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 takes in account, when known, the concentration rules of schemes. Concentration rules, as well as investment and borrowing power limits, are mandatory for all regulated schemes, such as UCITS. For instance if a scheme cannot invest more than 10% of its assets on one issuer/borrower (maximum possible concentration), and the underlying names can't be known (for operational or banking secrecy reasons), we suggest to report this amount (10%), amount invested by the institution rather than the full amount invested. Indeed this will reflect the real maximum possible risk in term of large exposure.

Q5: 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.

The monitoring requirement is not consistent with the reporting frequency of most securitisation structures who publish quarterly reports rather than monthly reports. In these reports, the legal concentration level admitted is mentioned.
In addition we advocate the EBA to take in consideration the risk of breaching the limit : if the largest exposure of an institution is far from the limit (for instance at 10%), monitoring monthly exposures to schemes that are negligible in regard to the total balance sheet of an institution would be useless. Shouldn't the frequency of monitoring be linked to the risk of breaching the LE limit?

For instance the recent securitisation structures have concentration rules. In an average size CIB bank, there are around 100 000 underlying to deal with under the look-through approach applied on commercial loan securitisation programs. About 25% of these underlying portfolios are renewed each quarter. The look through approach would thus lead to process about 8000 underlying

counterparts each month. As there is no industrial process in order to make this analysis, this would result in an unbearable workload for a result which is of no value for risk management purposes.

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 all 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.