EBA European Banking Authority

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Consultation Paper

Draft Regulatory Technical Standards

On the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets under Article 379 of the proposed Capital Requirements Regulation

Consultation Paper on Draft Regulatory Technical Standards on the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets under Article 379 of the proposed Capital Requirements Regulation

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1. Responding to this Consultation

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Please send your comments to the EBA by email to EBA-CP-2013-07@eba.europa.eu **by 16.08.2013**, indicating the reference 'EBA/CP/2013/07' on the subject field. Please note that comments submitted after the deadline, or sent to another e-mail address will not be processed.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please indicate clearly and prominently in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an e-mail message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.eba.europa.eu under the heading 'Legal Notice'.

2. Executive Summary

The proposed Capital Requirements Regulation (CRR) sets out requirements concerning large exposures which are expected to apply from 1 January 2014 and mandates the EBA to prepare draft regulatory technical standards (RTS) in this area. These standards will be part of the single rulebook enhancing regulatory harmonisation in Europe.

The EBA has developed these RTS proposals on the basis of the legislative texts for the CRR agreed by the European Parliament and the Council in April 2013.[1] These texts will be subject to legal-linguistic review before being formally adopted and the final text published in the Official Journal of the European Union. The EBA will review the RTS proposals to ensure that they take account of any changes made in the final text of the CRR, as well as to take account of any changes arising out of the consultation process.

Main features of the draft RTS

In order to determine the overall exposure to a client or a group of connected clients, in respect of clients to which the institution has exposures through collective investment undertakings (CIUs), securitisations, or other transactions where there is an exposure to underlying assets (also referred to as 'transactions with underlying assets' or 'transactions'), Article 379(7) of the draft CRR requires that an institution assesses the underlying exposures taking into account the economic substance of the structure of the transaction and the risks inherent in the structure of the transaction itself.

Article 379(8) of the draft CRR mandates the EBA to develop draft RTS that define the conditions and methodologies used to determine the overall exposure referred above and also the conditions under which the structure of the transaction does not constitute an additional exposure. The EBA is requested to submit this draft RTS to the European Commission (EC) by 1 January 2014.

The *Guidelines on the implementation of the revised large exposures regime* issued by the Committee of European Banking Supervisors in December 2009[2] ('CEBS Guidelines') include detailed guidance on the treatment of exposures to schemes with underlying assets and tranched products for large exposures purposes. Therefore the EBA has developed the draft RTS having the CEBS Guidelines as a starting point, but has also considered the experience gathered by national supervisory authorities in the application of these Guidelines and other relevant market developments.

Article 3 of the draft RTS requires institutions to follow the approaches set out in Articles 5 and 6 for the identification of the overall exposure to a certain client or group of connected clients resulting from a transaction with underlying assets.

Article 4 deals with the case of funds of funds and requires that the institution looks-through up to the last layer of underlying assets as this is the only way to identify all exposures to all obligors which are relevant

[1] The CRD/CRR text as agreed by the Council can be found at
http://register.consilium.europa.eu/pdf/en/13/st07/st07746.en13.pdf /
http://register.consilium.europa.eu/pdf/en/13/st07/st07747.en13.pdf

[2] The CEBS Guidelines can be found at: http://www.eba.europa.eu/News--Communications/Archive/2009/CEBS-today-publishes-its-guidelines-on-the-revised.aspx

for large exposures purposes. This article also requires that the exposure to a transaction is replaced by the exposures underlying this transaction.

Article 5 and 6 set out the calculation method for the overall exposure to a client or group of connected clients which results from a transaction with underlying assets.

The calculation of the total exposure to a certain obligor that results from exposures to a transaction with underlying assets requires that, as a first step, the exposure value is indentified separately for each exposure. In the cases where the exposures of other investors rank pari passu with the institution's exposure – as in the case of CIUs – the determination of the exposure value of an exposure to an underlying asset reflects the pro-rata distribution of losses. In cases where the exposures rank differently – as in the case of securitisations – losses are distributed first to a certain tranche and then, where there is more than one investor in this tranche, amongst the investors on a pro-rata basis. In this case, the maximum loss to all investors in a certain tranche is limited by the total exposure value of this tranche and it cannot exceed the exposure value of the exposure formed by the underlying asset. This limitation of maximum loss is reflected by using the lower of the two exposure values and then applying the procedure for recognising the pro-rata distribution of losses amongst all exposures that rank pari passu in this tranche, where there is more than one investor in this tranche.

The starting point for Article 6 is to require institutions to take all reasonable steps to look-through and identify the obligors of all credit risk exposures underlying the transaction. The institution is then required to determine the exposure value and add it to the client or group of connected clients.

Although it is expected that institutions that invest in transactions always identify the obligors of all indirect exposures, it is acknowledged that there might be circumstances that prevent this from happening in practice and different treatments are envisaged for these cases. However, the choice of approaches is not left to the institutions, as was the case in the CEBS Guidelines; instead there is a clear hierarchy of approaches in the application of Article 6, which is considered more prudent from a supervisory perspective. Hence, where an institution is not able to identify the obligors of underlying exposures, it has to add all these exposures to the same hypothetical 'unknown client'. Where an institution is not able to distinguish between the underlying assets of a transaction, it cannot be excluded that the total investment creates a single exposure to a certain obligor. Therefore, the institution has to add the total exposure to the transaction also to the hypothetical 'unknown client'. The large exposures limit applies to the 'unknown client' in the same way that it applies to any other single client. This approach should prevent having an unlimited overall exposure resulting from information deficiencies.

Article 7 fulfils the second part of EBA's mandate and sets out the conditions under which the transaction does not constitute an additional exposure. The draft RTS proposes that this is the case when it can be ensured that losses on an exposure to this transaction can only result from events of default for underlying assets and therefore no additional exposure exists.

For the finalisation of this draft RTS the EBA will consider the responses to this consultation paper as well as any opinion of the Banking Stakeholder Group. The EBA envisages submitting the draft RTS to the EC by the end of this year.

This draft RTS will replace Part II '*Treatment of exposures to schemes with underlying assets according to Article 106(3) of Directive 2006/48/EC*' of the CEBS Guidelines.

3. Background and rationale

On 20 July 2011, the EC issued its legislative proposals on a revision of the Capital Requirements Directive (CRD) which seeks primarily to apply the Basel III framework in the EU. These proposals have recast the contents of the CRD into a revised CRD and a new CRR – which are commonly referred to as the CRR/CRD IV proposals.

The proposed CRR sets out requirements concerning large exposures which are expected to apply from 1 January 2014 and mandates the EBA to prepare draft RTS in this area. These standards will be part of the single rulebook enhancing regulatory harmonisation in Europe.

The EBA has developed the RTS proposals on the basis of the legislative texts for the CRR agreed by the European Parliament and the Council in April 2013.[3] These texts will be subject to legal-linguistic review before being formally adopted and the final text published in the Official Journal of the European Union. The EBA will review the RTS proposals to ensure that they take account of any changes made in the final text of the CRR, as well as to take account of any changes arising out of the consultation process.

The nature of RTS under EU law

Draft RTS are produced in accordance with Article 10 of the EBA Regulation[4]. According to Article 10(4) thereof, they shall be adopted by means of Regulations or Decisions.

According to EU law, EU Regulations are binding in their entirety and directly applicable in all Member States. This means that, on the date of their entry into force, they become part of the national law of Member States and that their implementation into national law is not only unnecessary but also prohibited by EU law, except insofar as this is expressly required by them.

Shaping these rules in the form of a Regulation would ensure a level-playing field and would facilitate the cross-border provision of services.

Background on this draft RTS

Exposures can arise not only through direct investments, but also through investments in transactions like CIUs or structured finance vehicles (e.g. securitisations), which themselves invest in underlying assets. From a supervisory perspective these investments can be considered in two different ways: on the one hand there may be true diversification benefits, on the other hand the excessive or imprudent use of such investment opportunities may lead to single name credit risk concentration which needs to be limited by the large exposures regime.

[3] The CRR text as agreed by the Council can be found at http://register.consilium.europa.eu/pdf/en/13/st07/st07747.en13.pdf

[4] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC.

This supervisory concern was addressed in the course of the revision of the large exposures regime in the CRD II process. As general principle institutions were required to look through to the individual assets and recognise them as clients or groups of connected clients. This is because the large exposures regime aims at capturing and limit the maximum loss caused by the default of a certain obligor. The objective of the large exposures regime differs from the prudential objective of the capital requirements for credit risk which protect against average losses caused by defaults within a group of obligors having a comparable risk of default. Therefore it is justified that the single name related large exposures regime does not simply adopt the approach taken by the solvency regime but sets out its own solution. In addition the look-through approach is considered as the most appropriate approach to detect single name credit risk concentration comprehensively and to prevent institutions circumventing the large exposures limit by concealing exposures to a certain obligor in opaque structures. In the event of a default it does not make any difference whether an institution is exposed to the obligor directly or indirectly via a transaction with underlying assets.

Article 106(3) of Directive 2006/48/EC[5], as transposed by each Member State, sets out this approach. In order to ensure the harmonised implementation of this provision, the Committee of European Banking Supervisors issued the '*Guidelines on the implementation of the revised large exposures regime*' on 11 December 2009 ('CEBS Guidelines'). These Guidelines have been implemented by the EU national supervisory authorities in their jurisdictions.

Article 379(7) of the draft CRR continues to require an institution, which has exposures through securitisation positions or in the form of units or shares in CIUs or through other transactions with underlying assets, to assess its underlying exposures. The wording of Article 379(7) of the draft CRR has been modified from that in Article 106(3) of Directive 2006/48/EC in order to provide further clarity. As there are no significant changes in terms of content, the CEBS Guidelines served as a starting point for preparing this draft RTS, although the EBA has also taken into account the experience gathered by the national supervisory authorities in the application of the CEBS Guidelines and other market developments.

One important difference from the CEBS Guidelines is the proposed treatment for securitisation positions. The CEBS Guidelines considered that credit enhancements should be taken into account for large exposure purposes. However, those Guidelines also highlighted two concerns with respect to the treatment of tranched products: (i) it is not easy to reassess the underlying portfolio on a continuous basis, and thus subordinated tranches may have been exhausted without the institution having time to recognise the increase in the exposure to certain names (as well as the decrease in others); and (ii) the risk of sudden breaches of large exposures due to the exhaustion of subordinated tranches, and the need to reduce positions regardless of the market conditions, with the risk of selling at a loss. In order to address these concerns, the EBA considered it necessary to establish a more prudent treatment for securitisations.

In this draft RTS, the EBA tries to address the shortcomings of the treatment of securitisations as set out in the CEBS Guidelines and proposes not to recognise any protection provided by subordinated tranches

[5] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions.

to the other tranches. In particular, all tranches in a securitisation will be treated equally, as if they were a first loss tranche, fully exposed to the underlying names in the pool. In a worst case scenario, as there is uncertainty on which names will default first, subordinated tranches may be absorbed to cover losses of certain names while leaving others totally uncovered. While the EBA acknowledges that this will happen sequentially, there is no certainty that the institution will be able to reassess its large exposures as defaults in the portfolio arise and as the credit enhancement extinguishes.

In sum, the fact that defaults may happen simultaneously, or in a very short period of time, leading to the unintended effects already signalled in CEBS Guidelines (sudden breaches of limits, need to reduce exposures very quickly), has lead the EBA to propose a more conservative and prudent treatment. The EBA considers it more prudent not to recognise these mitigation effect of tranches from inception, assuming investors in any tranche are fully exposed to any underlying name (although, obviously, in proportion of the amount they hold in a given securitisation tranche). In other words, not recognising the risk mitigation of subordinated tranches is the most appropriate treatment compatible with the objectives of the large exposures regime as a back-stop regime.

This draft RTS makes clear that only credit risk exposures need to be considered for large exposures purposes as only the idiosyncratic risk posed by a client is relevant for this purpose, i.e. the overall loss resulting from the default of a client is what the large exposures regime aims to prevent. As a result, underlying exposures where there is no risk of default of an obligor of the underlying assets do not need to be considered for large exposures purposes. This applies to the case of funds which have real estate or commodities as underlying assets, which, although exposed to market risk, do not pose risk of default.

The EBA notes that exposures which are deducted from own funds in accordance with the rules set out in the draft RTS on own funds Articles 33(1), 53(a) and 63(a) of the draft CRR (Draft RTS on own funds - Part Three)[6] should not be considered for large exposures purposes according to the provisions of Article 379(6)(e) of the draft CRR.

The EBA considers that the identification of the obligors of all the underlying exposures of a transaction is the most risk-sensitive approach for determining interconnections between the indirect underlying exposures and the institution's direct exposures to clients or groups of connected clients. As a general rule, institutions which invest in transactions with underlying assets should always identify the obligors of all underlying exposures of their investments, search for interconnections between clients and assign all exposures to one client or a group of connected clients. Adding indirect exposures to the ones that are directly held by the institution as well as recognising all interconnections is key for the compliance with the large exposures limit and for ensuring that the large exposures regime achieves its objectives as a back-stop regime.

The EBA considers it reasonable to expect that in most cases institutions will be able to identify and monitor over time the obligors of all underlying exposures of transactions in which they invest. However, the EBA recognises that this identification might not always be technically possible or economically justifiable and has identified two situations where a treatment different from the one set out in Article 6(2) of this draft RTS can apply:

[6] These draft RTS are also published for public consultation.

a) The institution is unable to identify the obligors of some (or all) underlying assets held indirectly through the transactions. This is the case when the institution invests in a transaction for which it only has aggregated information (average quality of the underlying assets, number of assets, average maturity, etc), but has no information on the names of the obligors of the underlying assets and is unable to obtain this information.

b) It is too costly for the institution to identify, on an ongoing basis, the obligors of some (or all) underlying assets held indirectly through the transactions. This is the case when the institution invests in transactions whose underlying consists of a multitude of names (traditional securitisations) or also when the underlying assets are short term (e.g. ABCP or revolving securitisations), which imply that every month the obligors of the underlying assets are significantly different.

Where an institution cannot identify the obligors and cannot therefore ensure that there are no interconnections between its clients and the underlying exposures of the transaction, the prudential treatment cannot allow for such exposures and transactions to be considered as independent clients. Such an approach would open the door to regulatory arbitrage because the number of transactions in an institution's portfolio is not limited. Thus an institution would always be able to avoid breaches of its large exposure limits by doing small investments in a large number of transactions. Therefore, as a general rule all unknown exposures stemming from all transactions should be considered as a single risk and should, therefore, be considered as one hypothetical unknown client.

In the development of its proposals, the EBA has considered whether underlying exposures that only contribute immaterially to the overall exposure to the respective client or groups of connected clients could warrant a treatment less stringent than its assignment to the one hypothetical unknown client. The EBA has considered whether the treatment proposed in CEBS Guidelines – an exemption for unknown underlying exposures smaller than 5% of the total transaction ('granularity threshold') – was still appropriate from a prudential point of view. The experience of national supervisory authorities in the application of this granularity threshold in the different jurisdictions allowed the EBA to conclude that a more stringent approach is necessary to ensure that all relevant exposures are captured by the large exposures rules.

In this context, the EBA has considered whether it would be adequate to design a threshold on the basis of eligible capital instead of the value of the transaction, which would be more consistent with the measurement of large exposures and would not give the wrong incentives for the institutions to invest in larger transactions just to avoid identifying underlying exposures. The EBA has also considered whether it would be appropriate to calibrate this threshold in a way that would ensure that at least 100 of such exposures would be needed to reach the large exposures limit for the overall exposure to the client or group of connected clients, i.e. to consider an exposure as immaterial enough for assigning it to the transaction as a separate client instead of the one hypothetical unknown client if the exposure value does not exceed 0.25% of the institution's eligible capital.

However, due to the lack of evidence on the costs and benefits of this more lenient treatment of the underlying exposures and lack of data for its correct calibration the EBA proposes not to apply a granularity threshold.

The EBA acknowledges that its proposal deviates from the proposals of the Basel Committee which are currently being consulted on and which provide for a granularity threshold of 1% of the total value of the transaction. Where the granularity threshold is met the Basel Committee's proposals would allow institutions not to apply the look-through approach and to recognise the transaction itself as a separate client.[7] The EBA will closely monitor the developments of the Basel Committee's proposals.

The EBA believes that the institutions need to give due attention to the changes in the underlying assets of a transaction. For static portfolios, where the underlying assets do not change over time, the ongoing monitoring will not entail additional work and will have no material additional costs. For dynamic portfolios the treatment is more complicated as the relative portions of underlying assets as well as the composition of the transaction itself can change. In these cases, the institution has to monitor the composition of the transaction on an ongoing basis. 'On-going' in this context means that the monitoring frequency must be appropriate to the frequency and materiality of the changes in the underlying assets of the transactions, and that such monitoring must be done at the minimum once every month.

This draft RTS will replace Part II '*Treatment of exposures to schemes with underlying assets according to Article 106(3) of Directive 2006/48/EC*' of the said CEBS Guidelines. The EBA will consider further whether Part I 'Connected Clients' of those Guidelines needs to be reviewed.

[7] See paragraphs 106-109 of the Basel Committee on Banking Supervision "Consultative Document on Supervisory framework for measuring and controlling large exposures"

4. Draft Regulatory Technical Standards on the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets under Article 379 of the proposed Capital Requirements Regulation

In between the text of the draft RTS/ITS/Guidelines/advice that follows, further explanations on specific aspects of the proposed text are occasionally provided, which either offer examples or provide the rationale behind a provision, or set out specific questions for the consultation process. Where this is the case, this explanatory text appears in a framed text box.

EUROPEAN COMMISSION

Brussels, XXX
[…](2012) XXX draft

COMMISSION DELEGATED REGULATION (EU) No …/..

of XXX

[…]

COMMISSION DELEGATED REGULATION (EU) No …/..

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[…]

supplementing Regulation (EU) No xx/2013 of the European Parliament and of the Council [CRR] with regard to regulatory technical standards on the conditions and methodologies used to determine the overall exposure to a client or a group of connected clients in respect of exposures in the form of units or shares in collective investment undertakings, through securitisation positions or through other transactions with exposures to underlying assets

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No xx/2013 of the European Parliament and of the Council of dd/mm/2013 on prudential requirements for credit institutions and investment firms[8] [CRR], and in particular Article 379(8) thereof,

Whereas:

(1) In order to identify the total exposure to a certain obligor that results from the institution's exposures to a transaction with underlying assets, it is necessary to first identify the exposure value separately for each of these exposures. The total exposure value should then be determined by the aggregate of these exposures, but should not be larger than the exposure value of the exposure formed by the underlying asset itself.

(2) If exposures of other investors rank pari passu with the institution's exposure, this ensures that losses are always distributed amongst these exposures according to the pro-rata ratio of each of these exposures. Hence, the maximum loss to be suffered by the institution in case of a total loss on an underlying asset is limited to the portion according to the ratio of the institution's exposure to the total of all the exposures that rank pari passu. This pro rata distribution of losses should be reflected when determining the exposure value of an exposure to an underlying asset.

(3) For some transactions with underlying assets all investors rank pari passu such that their resulting exposure to an underlying asset is solely dependent on the pro-rata ratio of the investor's exposure in relation to the exposures of all investors. While this in particular

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can occur in respect of collective investment undertakings, other transactions such as securitisations can involve tranching where exposures can rank differently in seniority. Losses are distributed first to a certain tranche and then, in case of more than one investor into this tranche, amongst the investors on a pro rata basis. In this case, and in line with a worst case scenario where subordinated tranches may disappear very quickly all tranches in a securitisation should be treated equally. In particular, the maximum loss to be suffered by all investors in a certain tranche in case of a total loss on an underlying asset should be recognised since no mitigation should be recognised from subordinated tranches. This treatment should be subject to two limits: (i) the total exposure value of this tranche (since the loss for an investor in a given tranche that stems from the default of an underlying asset can never be higher than the total exposure value of the tranche) and (ii) the exposure value of the exposure formed by the underlying asset (since the institution can never lose more than the amount of the underlying asset). This limitation of maximum loss should be reflected by using the lower of the two exposure values and then applying the procedure for recognising the pro-rata distribution of losses amongst all exposures that rank pari passu in this tranche, in case of more than one investor in this tranche.

(4) Although it is expected that institutions that invest in transactions with underlying assets should always identify the obligors of all credit risk exposures resulting from underlying assets held indirectly through these transactions, there may be cases where this would create unjustifiable costs for the institution or where other circumstances prevent in practice the institution from identifying a certain obligor, from identifying whether an underlying asset forms a credit risk exposure or even from distinguishing at all between the amounts of the underlying assets. Such limitations should be taken into account where an institution has undertaken all reasonable steps to identify the obligors, and provided that the limited information is taken into account in applying an appropriately prudent treatment to the underlying exposures.

(5) In order to prevent an unlimited overall exposure resulting from information deficiencies, it is necessary to assign exposures for which information is missing to a certain client such that the large exposures limit applies to the total exposure to this client. In the absence of information on the obligor, such exposures need to be assigned to a hypothetical obligor. Assigning all such exposures to the same hypothetical client (the ‘unknown client’) would be the most prudent approach.

(6) Where an institution is not able to distinguish between the underlying assets of a transaction in terms of their amount, it cannot be excluded that the total investment causes a single exposure to a certain obligor. Therefore, the institution should be required to add the total exposure to the transaction to the unknown client.

(7) A transaction cannot constitute an additional exposure where the circumstances of the transaction ensure that losses on an exposure to this transaction can only result from default events for underlying assets. Only two cases should be considered to cause additional exposures. The first is where the transaction involves a payment obligation of a certain person in addition to, or at least in advance of, the cash flows from the underlying assets such that the default of this person would cause losses although no default event has occurred for an underlying asset. The second is where investors could suffer additional losses, although no default event for an underlying asset has occurred, if the

circumstances of the transaction enable cash flows to be redirected to a person who is not entitled to receive them.

(8) Directive 2009/65/EU of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)[9] ensures for undertakings for collective investment in transferable securities (UCITS) that cash flows are not redirected to a person who is not entitled under the transaction to receive these cash flows. It can therefore be assumed that this source of an additional exposure does not exist for UCITS, nor for entities that are subject to equivalent requirements pursuant to Union legislative acts or to legislation of a third country.

(9) The existence and the exposure value of exposures to a client or group of connected clients resulting from exposures to a transaction with underlying assets is not dependent on whether the exposure to the transaction is assigned to the trading book or the non-trading book. Therefore, the conditions and methodologies to be used for identifying resulting exposures to underlying assets should be the same, irrespective of whether the exposure to the transaction is assigned to the trading book or the non-trading book of the institution.

(10) This Regulation is based on the draft regulatory technical standards submitted by the European Supervisory Authority (European Banking Authority) to the Commission.

(11) The European Supervisory Authority (European Banking Authority) has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the opinion of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010[10].

HAS ADOPTED THIS REGULATION:

[9] OJ L 302, 17.11.2009, p. 32.
[10] OJ L 331, 15.12.2010, p. 12.

Article 1

Subject matter

1. This Regulation specifies:

   a) the conditions and methodologies used to determine the overall exposure of an institution to a client or a group of connected clients in respect of exposures through transactions with underlying assets;

   b) the conditions under which the structure of transactions with underlying assets does not constitute an additional exposure.

Text for consultation purposes:

The subject matter of this Regulation is determined by Article 379(8) of the draft Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms (CRR). The text of this Article is replicated below in the version that it was agreed by the European Parliament and the Council in April 2013; references to other Articles in it are references to Articles of the CRR.

“7. In order to determine the overall exposure to a client or a group of connected clients, in respect of clients to which the institution has exposures through transactions referred to in points (l) and (n) of Article 107 or through other transactions where there is an exposure to underlying assets, an institution shall assess its underlying exposures taking into account the economic substance of the structure of the transaction and the risks inherent in the structure of the transaction itself, in order to determine whether it constitutes an additional exposure.

8. EBA shall develop draft regulatory technical standards to specify the following:

(a) the conditions and methodologies used to determine the overall exposure to a client or a group of connected clients in respect of the types of exposures referred to in paragraph 7;

(b) the conditions under which the structure of the transaction laid down in paragraph 7 does not constitute an additional exposure;

EBA shall submit those draft regulatory technical standards to the Commission by 1 January 2014. Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with the procedure laid down in Articles 10 to 14 of Regulation (EU) No. 1093/2010.”

Article 2

Definitions

1. For the purpose of this Regulation the following definitions shall apply:

   a) 'transactions with underlying assets' means, in accordance with Article 379(7) of Regulation (EU) No xx/2013 [CRR], transactions referred to in points (l) and (n) of Article 107 of that Regulation and other transactions where there is an exposure to underlying assets;

   b) 'unknown client' means a single hypothetical client to which are assigned all exposures for which the institution has not identified the obligor.

Article 3

Identification of exposures resulting from transactions with underlying assets

1. An institution shall determine the contribution to the overall exposure to a certain client or group of connected clients that results from a certain transaction with underlying assets in accordance with the methodology set out in Articles 4 to 6. For this purpose, the institution shall determine separately for each of the underlying assets its exposure to this underlying asset in accordance with Article 5.

2. An institution shall assess whether a certain transaction with underlying assets constitutes an additional exposure or additional exposures in accordance with Article 7.

Article 4

Underlying exposures to transactions which themselves have underlying assets

1. When assessing the underlying exposures of a transaction with underlying assets (transaction A) which itself has an underlying exposure to another transaction with underlying assets (transaction B) for the purpose of Articles 5 and 6, an institution shall treat the exposure to transaction B as replaced with the exposures underlying transaction B.

2. The treatment in paragraph (1) shall be applied to successive underlying exposures of transactions with underlying assets until the underlying exposures are not to such a transaction.

Article 5

Calculation of the relevant exposure value

1. The exposure of an institution to an underlying asset of a transaction with underlying assets is the lower of the following:

   a) the exposure value of the exposure arising from the underlying asset;

   b) the total exposure value of the institution's exposures to the underlying asset resulting from all exposures of the institution to the transaction.

2. For each exposure of an institution to a transaction with underlying assets, the exposure value of the resulting exposure to an underlying asset shall be determined as follows:

   a) if the exposures of all investors in this transaction rank pari passu, the exposure value of the resulting exposure to an underlying asset is the pro rata ratio for the institution's exposure to the transaction multiplied by the exposure value of the exposure formed by the underlying asset;

   b) otherwise, the exposure value of the resulting exposure to an underlying asset is the pro rata ratio for the institution's exposure to the transaction multiplied by the lower of:

      i. the exposure value of the exposure formed by the underlying asset;

      ii. the total exposure value of the institution's exposure to the transaction together with all other exposures to this transaction that rank pari passu with the institution´s exposure.

3. The pro rata ratio for an institution's exposure to a transaction is the exposure value of the institution's exposure divided by the total exposure value of the institution's exposure together with all other exposures to this transaction that rank pari passu with the institution's exposure.

Text for consultation purposes:

The following examples illustrate how institutions shall calculate the relevant exposure value according to Article 5.

All examples are based on a transaction with a total volume of 100 and assume that all underlying assets can default in an order which is unknown to the institution. The transaction consists of 8 underlying exposures. In each example, the institution invests an amount of 20 in the transaction.

Paragraph 2 a) Institution ranks pari passu with other investors

Example 1:

Underlying portfolio **Investment fund**

Name	amount
A	25
B	25
C	10
D	10
E	10
F	10
G	5
H	5

Investment fund: 20 | 80

The institution invests 20 into the transaction. The pro-rata ratio for the institution's exposure to the transaction according to Article 5(2)(a) in combination with paragraph (3) is 1/5 (20/100).

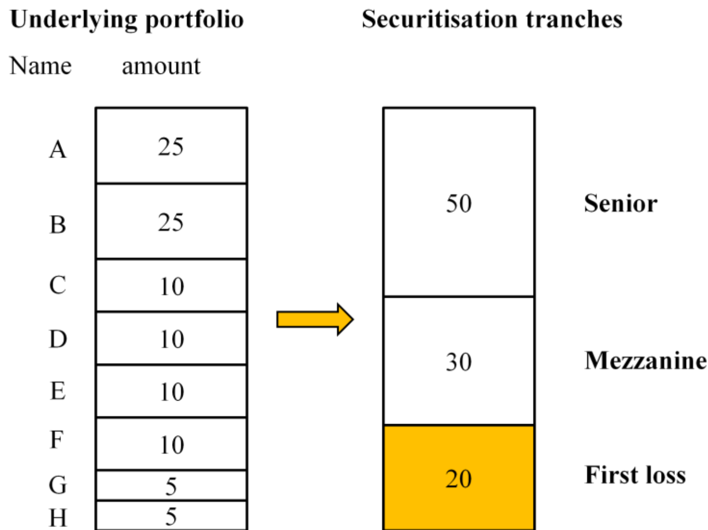
According to Article 5(2) the institution assigns an exposure of:

> 5 to underlyings A and B (1/5*25),
> 2 to underlyings C to F (1/5*10), and
> 1 to underlyings G and H (1/5*5).

In short, in transactions where all investors rank pari-passu, the losses are distributed among investors in accordance with the percentage of their participation in the transaction. This proportional loss-sharing affects all names in the underlying portfolio in an equal way and it is not dependent on which name defaults first.

Paragraph 2 b) otherwise

Example 2:

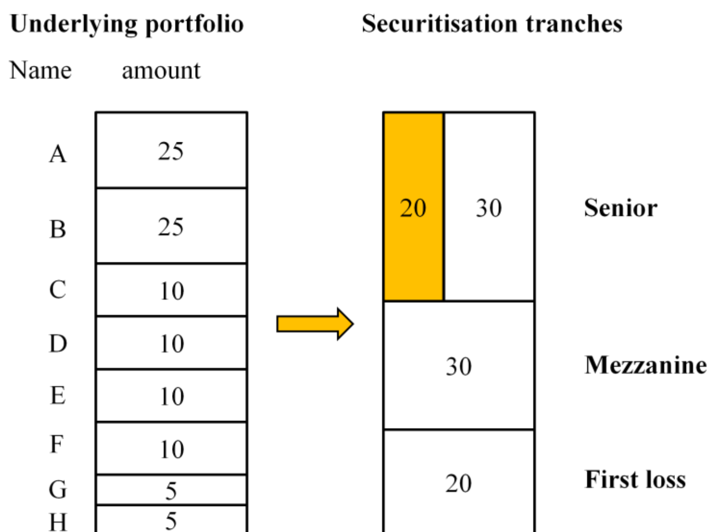


The institution invests 20 in the first loss tranche, i.e. it is the only investor in that tranche. Therefore, the pro-rata ratio is 1. Article 5(2)(b) requires to multiply this ratio with the lower of the exposure value of the underlying and the value of the first loss tranche.

Therefore, the institution assigns an exposure of:

20 to underlyings A and B (1*Min(25;20)),
10 to underlyings C to F (1*10), and
5 to underlyings G and H (1*5).

Example 3:



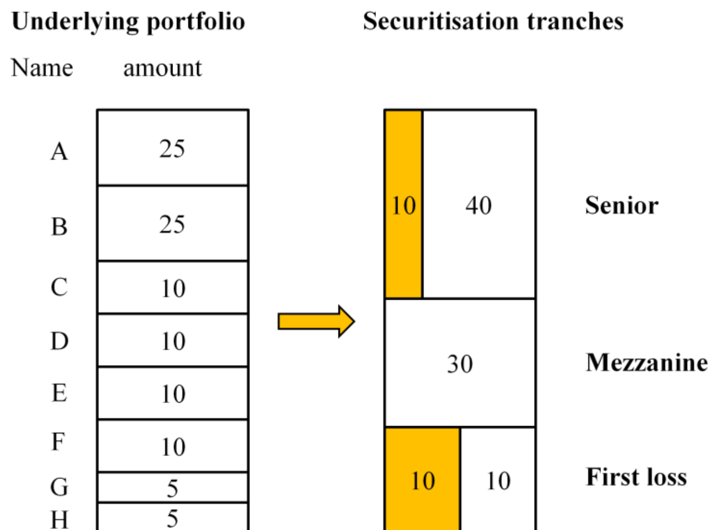
The institution invests 20 in the senior tranche. There are other investors participating in the senior tranche with 30 ranking pari passu. The pro-rata ratio for the institution's exposure to the transaction according to Article 5(2)(b) in combination with paragraph (3) is 2/5 (20/50). Article 5(2)(b) requires to

multiply this ratio with the lower of the exposure value of the underlying and the value of the senior tranche, which is in all cases the value of the underlying.

Therefore, the institution assigns an exposure of:

10 to underlyings A and B (2/5*25),
4 to underlyings C to F (2/5*10), and
2 to underlyings G and H (2/5*5).

Example 4:



Firstly, the institution invests 10 in the senior tranche. There are other investors participating in the senior tranche with 40 ranking pari passu. The pro-rata ratio for the institution's exposure to the transaction is 1/5 (10/50). Article 5(2)(b) requires to multiply this ratio with the lower of the exposure value of the underlying and the value of the senior tranche, which is in all cases the value of the underlying.

Secondly the institution invests 10 in the first loss piece. The first loss piece amounts to 20. The pro-rata ratio here is 1/2 (10/20). Again, the value of underlyings A and B (25) is higher than the value of the first loss piece (20).

The institution assigns an exposure of:

15 to underlyings A and B (1/5*25 + 1/2*Min(20;25)),
7 to underlyings C to F (1/5*10 + 1/2*10), and
3.5 to underlyings G and H (1/5*5 + 1/2*5).

In sum, considering that the EBA believes that subordinated tranches are not recognised as risk mitigant for large exposures' purposes the worst case scenario is considered in this draft RTS. The proposed treatment recognises that investors in a given tranche are virtually exposed to the loss of the total amount of each underlying exposure (in proportion to their investment in each tranche in the cases where there are other investors in the same tranches). This treatment is justified because the default of each underlying exposure can result in a total loss. Since the order of defaults of the underlying exposures is unknown to the investors, subordinated tranches may be deployed to cover the default of some underlying exposures, leaving other underlying exposures uncovered. The fact that tranches can disappear very abruptly (near-simultaneous defaults) leads the EBA to consider the most conservative assumption and treat all tranches as first losses from inception.

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

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?

Article 6

Procedure for determining the contribution of underlying exposures to overall exposures

1. An institution shall take all reasonable steps to identify the obligors of all credit risk exposures underlying a transaction with underlying assets.

2. For each credit risk exposure for which the obligor is identified, an institution shall include the exposure value of the institution's exposure to the relevant underlying asset when calculating the overall exposure to this obligor as an individual client or to the group of connected clients to which this obligor belongs.

3. If an institution is able to fully distinguish the amounts of each of the underlying exposures of a transaction, the institution shall assign an underlying exposure to the unknown client where:

   a) the underlying exposure is a credit risk exposure and the institution has not been able to identify the obligor;

   b) the institution does not know whether an underlying exposure is a credit risk exposure.

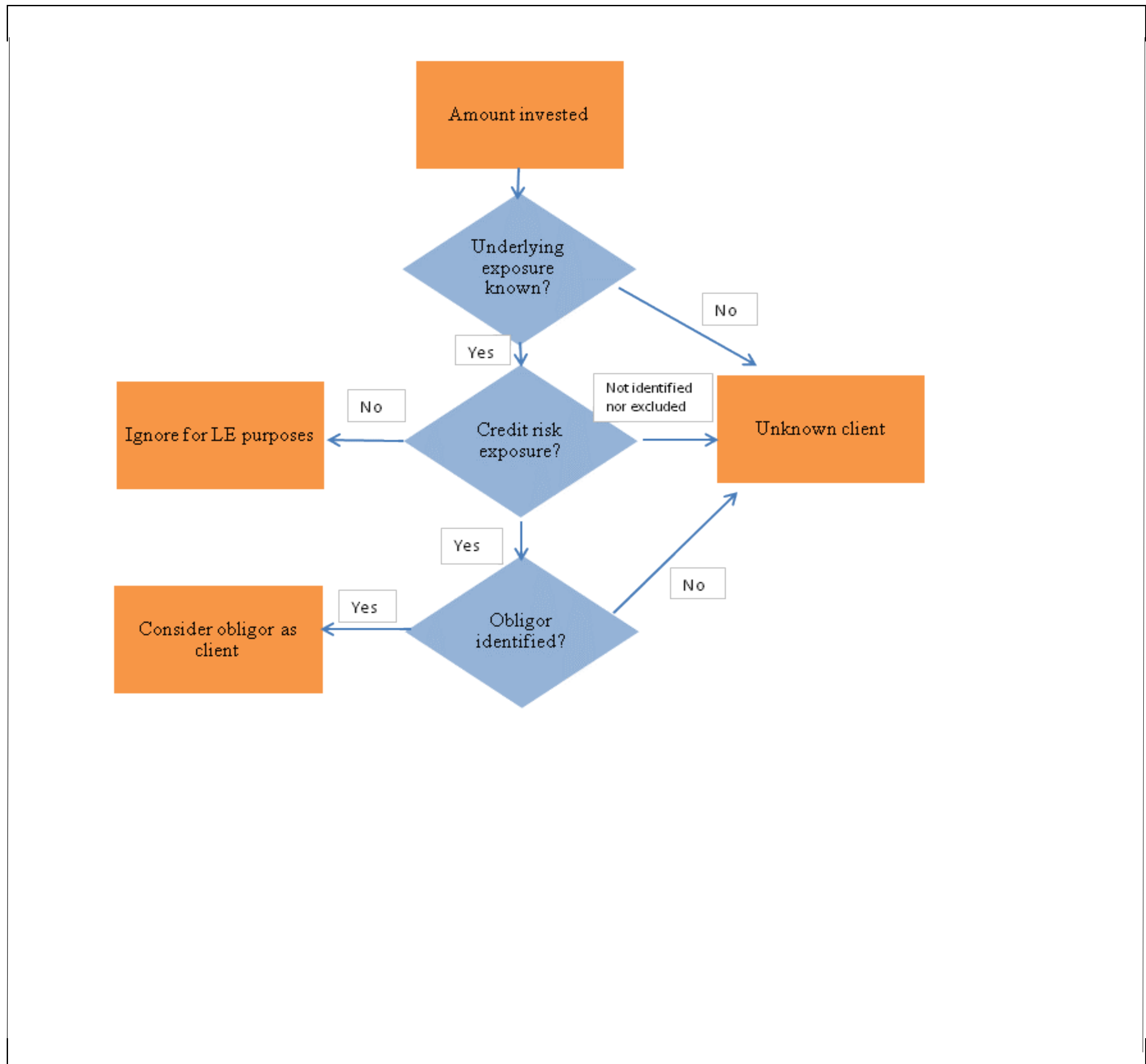
4. If an institution is not able to fully distinguish the amounts of each of the underlying exposures of a transaction, the institution shall assign the total exposure value to the unknown client.

5. An institution shall monitor the composition of the transaction on an ongoing basis. The monitoring frequency shall be appropriate to the frequency and materiality of the changes in the underlying assets of the transactions, and shall, as a minimum, be monthly.

Text for consultation purposes:

As further explained in the background section of this document, the EBA is aware that its proposals deviate from the CEBS Guidelines and from the proposals of the Basel Committee, currently under consultation, as it does not include a materiality threshold and requires institutions to assign all unknown exposures to the unknown client regardless of their size. The EBA will closely monitor the developments of the Basel Committee's proposals.

The following decision tree illustrates the procedure for determining the contribution of underlying exposures to overall exposures as set out in Article 6.



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.

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.

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.

Article 7

Additional exposure constituted by the structure of a transaction

1. The structure of a transaction with underlying assets does not constitute an additional exposure if the transaction meets both of the following conditions:

   a) the legal and operational structure of the transaction is designed to prevent the manager of the transaction or a third party from redirecting any cash flows which result from the transaction to persons who are not otherwise entitled under the terms of the transaction to receive these cash flows;

   b) neither the issuer nor any other person can be required, under the transaction, to make a payment to the institution in addition to, or as an advance payment of, the cash flows from the underlying assets.

2. The condition in paragraph (1)(a) shall be considered to be met where the transaction with underlying assets is one of the following:

   a) an undertaking for collective investment in transferable securities (UCITS) as defined in Article 1 of Directive 2009/65/EU;

   b) an undertaking established in a third country, that carries out activities similar to those carried out by a UCITS and which is subject to supervision pursuant to a Union legislative act or pursuant to legislation of a third country which applies supervisory and regulatory requirements which are at least equivalent to those applied in the Union to UCITS.

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?

Article 8

Final provisions

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Commission
The President

[For the Commission
On behalf of the President

[Position]

5. Accompanying documents

5.1 Draft Cost- Benefit Analysis / Impact Assessment

Background

An Impact Assessment is required to be conducted alongside the development of a draft RTS, in order to:

- Demonstrate that a relevant range of implementation options have been identified, to support the specific legal provisions relating to the treatment of large exposures with respect to transactions with underlying assets, as contained in the draft CRR.
- Justify the choice of a preferred option(s), by reference to the cost-benefit impacts identified within the process of option appraisal.

A distinction should be made between the Impact Assessment conducted at the level of a draft RTS, in contrast to the previous Impact Assessment conducted in respect of the draft CRR (SEC(2011)949 final). The purpose of the Regulation-level impact assessment is to establish the high-level issues that the proposed regulation is seeking to address, scope the range of potential options for intervention that might deliver these desired policy objectives and then establish a preferred option(s) on the basis of cost-benefit appraisal. At the level of the draft RTS, the purpose of the assessment is to identify the optimal specification for the preferred regulatory option, within the legal parameters that are established through the Level 1 legislative text.

Although the high-level prudential issues and regulatory policy objectives have already been identified in the Impact Assessment conducted in relation to the draft CRR (SEC (2011)949 final), it should be noted that this assessment does not include a specific focus on the provisions relating to the wider large exposures regime (in terms of monitoring and limitation of such exposures). Therefore, for the purposes of the specific Impact Assessment being conducted in relation to the development of the draft RTS mandated through Article 379(8), this will refer to the broader prudential principles identified in the wider Impact Assessment of the draft CRR, and where possible, identify the specific prudential benefits that are generated through the proposed options.

Rationale

The development of the Impact Assessment requires the identification of a baseline scenario, which is technically defined as the situation that would transpire if the provisions contained in the draft RTS were not proposed. This scenario therefore serves as a counterfactual to the proposed interventions, to enable a comparative assessment of whether the net benefits of further intervention are justified in light of the drivers underlying current situation. Two main options for establishing a baseline scenario in the context of this draft RTS were assessed:

A) The baseline scenario could be structured around the current regulatory treatment of exposures to transactions with underlying assets, as provided for in Article 106(3) of the CRD and the 2009 CEBS Guidelines in relation to the treatment for large exposure purposes of schemes with exposures to underlying assets – this option would enable a comparative assessment between the impact of the current proposals relating to treatment of exposures to underlying assets with the previous regime.

- The CEBS guidelines required institutions to check for connections in relation to investments in schemes which themselves invested in underlying assets (on the basis of control and/ or economic interconnectedness), in order to determine the existence of groups of connected clients.

- The granularity threshold for determining whether a look-through approach (LTA) would need to be applied was set at 5% (i.e. the ratio between the value of the individual underlying exposure and the overall value of the total scheme).

- In respect of the treatment of tranched products (e.g. securitisations), credit risk mitigation was recognised in relation to the subordination of tranches within a structure.

B) The baseline scenario could centre on the implementation of the wider CRD/CRR legislative package, including the wider provisions relating to the large exposures regime, but minus the specific provisions relating to the treatment of transactions with exposures to underlying assets – this option would enable an assessment of the incremental impact of the proposals contained in the current draft RTS, against the wider legislative provisions relating to large exposures as contained in the CRR.

This draft Impact Assessment uses option A) as the baseline scenario.

Large Exposures rules – main benefits and costs

Given that the Impact Assessment conducted in respect of the draft CRR did not specifically focus on the large exposures rules, it is sensible to briefly summarise the high-level costs and benefits of implementing a large exposures regime in order to establish the context for the Impact Assessment conducted in respect of the draft RTS. Respondents to this consultation should take into account the following drivers of costs and benefits when providing comments and input to the consultation questions.

The rationale for rules limiting institutions' large exposures is constructed around the forecast micro and macro-prudential benefits:

- The main micro-prudential benefit of limiting the absolute size of institutions' exposures to a single counterparty is the consequent reduction in the individual institution's probability of default in relation to counterparty default.

- The main macro-prudential benefits centre on the improvement in financial stability through the reduced risk of contagion between individual counterparties.

These prudential benefits are anticipated alongside the prudential benefits generated through the risk-based capital requirements regime (hence the rationale for a large exposures regime as a non-risk sensitive backstop to the risk-based capital regime). In theory, the incremental prudential benefits generated by a strengthening of the large exposures regime might be captured by reference to a reduced probability of default on the part of the individual institution and reduced contagion risk between institutions.

The main potential costs that could be forecast as a result of strengthening a large exposures regime would centre on:

- Increased administrative costs - for example, generated through a requirement to monitor exposures to underlying assets on a more granular and/or frequent basis.
- Increased funding costs– for example, by limiting the level of exposures that an institution could maintain in relation to single counterparties, this might inhibit the level of economies which the institution might secure in relation to its funding needs and therefore increase the institution's cost of capital.
- Reduced profitability – for example, by limiting an institution's level of exposure to a single counterparty, this may reduce the opportunity to fully exploit revenue-generating opportunities and therefore reduce the institution's overall profitability.

Regulatory Technical Standard

This section summarises the main elements within the draft RTS which have been subjected to an initial Impact Assessment. The intention at this stage is not to provide an exhaustive analysis but rather to highlight the principal areas on which this initial analysis around option appraisal and assessment against the baseline scenario has focused.

Article 5 – Calculation of the relevant exposure value

In relation to the consideration of alternative options, the principal focus in this section is on the method for calculating the value of an exposure that an institution holds in respect to underlyings of a transaction with underlying assets (within the scope of the definition of exposure value as stated in the provisions determining the approach to standardised credit risk within the CRR).

To enable the separate identification of the exposure value for each exposure, Article 5(1) proposes an initial assessment of the exposure value arising from the underlying asset and compares this to the total exposure value of the institution's exposures to the same underlying asset, in this case resulting from all exposures of the institution to the transaction. The lower value is then adopted as representing the exposure value of the institution to the underlying asset.

Article 5(2) proposes that the calculation of the total exposure to an obligor is structured around an assessment of whether the exposures of other investors rank pari passu with the institution's exposure, or whether the exposures are ranked differently. In the former situation, losses are distributed pro-rata across exposures (as with investments in CIUs), while in the latter case losses are distributed to specific tranches and in the event of multiple investors in the tranche on a pro-rata basis.

In the case of tranched exposures, the outlined treatment represents the most prudent approach to the losses potentially incurred in respect of single-name counterparty default associated with the underlying assets, given that no credit risk mitigation is recognised in respect of pro-rata distribution of losses across senior and subordinated tranches. For the purposes of option appraisal, it would be possible therefore to consider the impact of the alternative option of allowing a certain degree of credit risk mitigation in respect of senior tranches. Therefore instead of assuming a pro-rata distribution of losses across multiple investors, the calculation of the actual exposure to the underlying names would depend on the seniority of the position held in the securitisation. Therefore the impact of this alternative approach would be to

reduce the exposure levels of investors in senior tranches, while potentially increasing exposure levels for investors in junior tranches. In other words, at a micro level, different investors would incur different levels of exposures, while at the macro level the overall level of exposure would not alter in relation to the aggregate of underlying names although the distribution of exposures across investors would change.

Article 6 – Procedure for determining the contribution of underlying exposures to overall exposures

The main issue to consider in relation to Impact Assessment are the potential options for determining whether a materiality threshold should be set, and at which level, in order to establish the treatment of exposures to underlying assets where a specific name cannot be identified (which would therefore be considered under the 'unknown client' bucket).

- While the draft RTS does not propose the application of a granularity threshold, the EBA has reviewed the option of strengthening the granularity threshold as defined in the 2009 CEBS guidelines, which was set at 5% of the transaction value. In particular, the draft RTS cites the experience gathered by national supervisory authorities and also the Basel Committee's proposals, which were published on 26 March 2013, in which the proposed granularity threshold was set at 1% of the transaction value. The principal benefits of moving to a granularity threshold with a tighter limit would be to reduce the potential for understating the impact of underlying exposures in reference to the institution's eligible capital (i.e. that there is a prudent distinction between the definition of a large exposure at 10% and the setting of the granularity threshold). Moreover, the benefits include increased transparency and accuracy in calculating large exposures. In terms of principal costs, a more granular threshold would presumably incur more administrative effort on the part of institutions to regularly identify and monitor exposure to underlying assets (e.g. in order to avoid excessive concentration to specific clients or groups of connected clients).

- The EBA has also considered another option, namely to apply a 0.25% threshold in relation to the value of individual exposures for which the obligor has not been identified (in this option, the threshold would be defined as a ratio between the value of the underlying exposure and the institution's eligible capital). The principal benefit of this approach is that this avoids a potentially over-punitive treatment of exposures in respect of the unknown client bucket (which might otherwise incur a formal breach of the large exposure limit irrespective of the level of material risk). The principal cost of this approach is that it might ignore a situation where such small-sized exposures may nevertheless in fact be highly connected or correlated in a default scenario, therefore increasing the level of material risk.

The draft RTS currently proposes not to apply a granularity threshold, which would prevent exposures that would be considered immaterial from a large exposures' perspective from being assigned to the unknown client. The lack of a specific threshold therefore implies that all unidentified exposures are allocated to the 'unknown client' bucket, which presents prudential benefits by assuming the most conservative approach, but which also potentially imply costs to particular institutions which might incur a breach of exposure limits to the 'unknown client' bucket, even where the underlying names were in fact unconnected in terms of default risk.

5.2 Overview of questions for Consultation

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

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?

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.

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.

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.

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?