Opinion on the proposal for a Council Directive on Monitoring and Controlling Large Exposures of Credit Institutions [1]

(91/C 339/10)

On 13 May 1991, the Council, in accordance with Article 57(2) of the Treaty establishing the European Economic Community, decided to ask the Economic and Social Committee for an Opinion on the abovementioned proposal.

The Section for Industry, Commerce, Crafts and Services, which was responsible for the preparatory work, adopted its Opinion on 10 July 1991. The Rapporteur was Mr R. Pelletier.

At its 289th plenary session (meeting of 25 September 1991) the Economic and Social Committee adopted the following Opinion with 2 votes against and 4 abstentions.

The international banking community has for several years been passing through a zone of turbulence whose origins include: the debt crisis of the less developed countries (LDC), the impact of the recommendations of the International Monetary Fund (IMF) on banks' balance sheets and the crises in the American banking and Japanese financial systems. The EEC, which has remained relatively sheltered from major disasters, is now suffering from the weaknesses of institutions which have extensive activities and commitments within its borders but which are controlled by non-EEC countries.

Under these circumstances it is understandable that the authorities responsible for supervising credit institutions should seek much more effective machinery for carrying out supervision and for giving advance warning of disasters.

The Committee understands and approves the Commission's desire to help strengthen existing prudential rules by submitting a directive designed to prevent credit institutions from becoming exposed to the risks which arise when they commit a major part of their own funds. It congratulates the Commission on the quality of its work in a complex regulatory area.

However, because of the complexity of this field and the difficulties of understanding all the economic and financial implications of an approach which perforce is more concerned with regulatory rather than economic criteria, the Committee is obliged to make certain comments which, while very often of a technical nature, are, in its view, essential.

These comments are intended to be constructive, but the Committee cannot forget that it must also reflect the concerns of the economic and social interest groups at the prospect of regulations which may have a major impact on the dynamism of the whole Community.

1. Presentation of the Directive

1.1. *Aim of the Directive*

The aim of the present proposal is to flesh out the Community prudential rules which have already been proposed or adopted; these concern: solvency ratios, own funds, capital adequacy and consolidation.

The proposal is designed to replace the Recommendation of 22 December 1986 on the same subject [2]; the need for harmonising the rules on risk spreading was specifically mentioned in the Commission's White Paper on completing the internal market in 1993.

So, the proposal's two aims are:

— to amplify the prudential rules on the freedom to provide services by monitoring and limiting large exposures in order to encourage the spreading of risks, for an over-concentration of risks on a single counterparty could, in the event of the counterparty's bankruptcy, affect the solvency of a credit institution and sometimes even lead to its failure, and

— to prevent distortions of competition between institutions arising from a competitive advantage being enjoyed by institutions subject to less stringent rules.

1.2. *The economic operators concerned*

The proposal concerns credit institutions.

[1] OJ No C 123, 9. 5. 1991, p. 18.

[2] OJ No L 33, 4. 2. 1987, p. 10.

1.3. *The standards proposed*

The proposal seeks to prevent the excessive exposure of a credit institution to a single client or 'group of connected clients', so that the failure of one party will not lead to the failure of the institution.

To do this the proposal lays down that all exposures of 10 % or more of the lending institution's own funds must be reported to the competent authorities and imposes a double limit on such large exposures:

— an individual limit: a credit institution may not incur an exposure to a client or group of connected clients with a value exceeding 25 % of its own funds, and

— an aggregate limit: a credit institution may not incur large exposures with an aggregate limit of more than 800 % of its own funds.

Provision is made for transitional measures allowing authorities to give credit institutions a maximum of 5 years to bring down existing exposures to the permitted limits. However, loans with a longer maturity with binding contractual terms for the credit institution may be held until maturity. An additional exemption until the year 2000 is granted to institutions with a capital of less than ECU 5 million.

2. General comments

In accordance with the aims of the proposal, the Committee considers the following points to be essential:

2.1. A text on this matter has been prepared by the Basle Committee. The text is a code of good practice, unlike that on the Cooke ratio. It therefore does not have to be applied by all the member countries of the Basle Committee; moreover, it does leave ample discretionary margins.

So, by laying down specific and binding standards the Commission would be imposing additional constraints on EC credit institutions.

The Committee must therefore draw the Commission's attention to the risks of competition between EC and non-EC credit institutions being distorted if the proposed directive is adopted.

The Commission proposal is inspired by the Basle Committee. But the latter's text, without saying so explicitly, is addressed to large credit institutions operating on an international scale. The Commission's proposal concerns all credit institutions in the EC, irrespective of their size. It therefore takes no account of the specific nature of institutions which, although only limited in size or operating on a regional scale, play a vital role in financing their economic environment, especially small or medium-sized firms, by incurring exposures which are considerable in relation to their own funds. If the directive were applied, these institutions would be faced with such problems that their very existence could be jeopardised unless the supervisory authorities were allowed to grant exemptions and additional periods for adjustment.

2.2. The present proposal is a logical continuation of other directives (on solvency ratios, own funds, capital adequacy and consolidation).

But, for instance, it contains no mention of the solvency risk weightings.

There must be some consistency between the various texts:

— first, to ensure that the proposed prudential rules remain rational, and

— second, to enable institutions and the authorities to set up homogenous and consistent supervisory machinery.

2.3. The proposed directive only concerns credit institutions, even though some of the activities listed in the Second Banking Directive may also be carried out by investment firms. To us it seems essential that, in order to prevent any distortions of competition from occurring, there should be identical prudential standards and equivalent definitions of own funds applying to all establishments which may carry out the same activities. Such rules should be included in the capital adequacy directive for investment firms.

2.4. The proposal clearly stresses that the lowering of the ceiling from that of the Recommendation is fairly significant and may pose some not inconsiderable problems of adjustment for some credit institutions; certain banking systems, or parts thereof, may be faced with problems of a more structural nature.

In view of this the directive should retain the 40 % ceiling contained in the Recommendation of 22 December 1986, for both external and group exposure.

This maximum limit would provide the authorities with greater discretionary powers, enabling them to take account of the particular set-ups in each of the Member States.

2.5. As regards exposures incurred to a client or group of connected clients consisting of the parent undertaking of the credit institution and/or one or more subsidiaries of that parent undertaking [Art. 4(2) of the proposal], there is no reason to reduce the percentage laid down in Article 4(1); on the contrary, a single threshold should be adopted for the two types of exposure.

3. Specific comments

The Committee would like to draw the Commission's attention to a number of points which ought to be clarified, or even amended.

3.1. *Definitions (Art. 1)*

3.1.1. Firm commitment to underwrite an issue of securities (Art. 1, paragraph 4)

The major risk in any firm commitment to underwrite an issue of securities is a short-term market risk, rather than a counterparty risk.

Such operations should therefore be covered only in the capital adequacy directive, which specifically deals with market risk. Moreover, it should be noted that a firm commitment to underwrite an issue of securities is explicitly mentioned and dealt with in this same directive.

So, any firm commitment to underwrite an issue of securities should be exempted from the proposed directive until the date when it is recorded in whole or in part in the balance sheet. If such an exemption were not allowed, the market in firm commitments might be endangered. Such an exemption is all the more justified because firm commitments obviously only represent provisional risks.

3.1.2. Definition of the term 'connected clients'

a) The expression 'group of connected clients' refers both to a legal criterion, the existence of a power of control, and an economic criterion, *de facto* interdependence resulting from certain economic links. But the text makes it clear that the combined exposure presumptions in the definition are relative presumptions which can be reversed if there is proof to the contrary.

When the limit on large exposures was 40 % this definition, although very broad, was tolerable. The Commission is proposing that this limit be brought down to 25 %. The Committee proposes either to go back to the limit of 40 % or, if the threshold of 25 % is kept, to leave it up to the credit institution concerned to determine, in the light of the information in its possession, which parties should be considered as a 'group of connected clients', although this freedom of assessment should be subject to the monitoring of the competent authorities.

b) The concept of 'direct commercial interdependence which cannot be substituted in the short term' covers far too many categories of economic relations. If the Commission intends this definition to cover only the case of a supplier delivering a very specific product which cannot be used by any other producer, then this indent should be redrafted so as to avoid any abusive interpretation.

3.2. *Reporting of large exposures (Art. 3)*

The Committee considers that the two possibilities proposed by the draft directive will involve financial costs for credit institutions.

As regards the first possibility, it seems essential to specify that only increases—and, indeed, increases of some size—must be reported.

However, the Committee does feel that the best solution would be to leave the frequency of reporting to the discretion of the Member States.

3.3. *Limits on large exposures (Art. 4)*

Several questions of interpretation have to be made clear in the proposed directive:

— In practice it is desirable if risks can be assessed at their book value, which is not necessarily their nominal value. This is particularly true in the case of securities which are taken up by the institutions at their net value (purchase price less provisions).

— Risks should be assessed on the basis of their residual term.

3.3.1. For off balance sheet items the lines of credit or standby lines negotiated between credit institutions should be assessed on the basis of that part which could be used immediately, and not by their total amount, which means taking account of their use ceiling. So, if a line of credit has a six-monthly ceiling it will be considered as interbank at less than one year.

As for lines of credit for more than one year, the present proposal should take over the 50 % weighting from the solvency ratio directive, so as to ensure consistency of treatment for the same risk in the two directives.

3.3.2. For interest and/or exchange rate swaps, caps [1] and floors [2], one should simply take account of the net difference resulting from transactions concluded under a bilateral outline contract between a credit institution and its counterparty and recognised by the national supervisory authorities. It is this figure which really reflects the potential risk involved in such operations.

3.3.3. Repurchase agreements and back-to-back loans of securities must be calculated in relation to the risks of the underlying party, using the weightings in the capital adequacy directive.

3.3.4. Mortgage guarantees must be given the treatment provided for in the solvency ratio directive; this took into account the particularly high level of security of mortgage credit in Europe. According to this directive, loans which are fully guaranteed to the satisfaction of the competent authorities concerned by mortgages on a dwelling which is or will be occupied or let by the borrower are given a weighting of 50 %. This 50 % weighting should also be applied to property leasing for the same reasons as those set out above for mortgage credits.

The Committee wishes to draw attention to the potential effect of the directive on borrowers. For example, figures supplied by the German Mortgage Banks Federation show that for the financing of a complex made up of several typical family dwellings worth, on average, DM 420 000 and requiring a credit of DM 300 000, and representing a large exposure for the lending institution, the direct effect of the directive on the borrower would be to increase his repayments from DM 500 to DM 750 a year, or from around DM 40 to DM 60 a month.

3.4. *Taking account of the interbank factor*

The Commission authorises partial or total exemption from the limits for interbank claims of less than one year. Claims of more than one year are weighted at 100 %.

The Commission has thus considered that the risks taken by credit institutions on the interbank market are of a specific nature:

— the market is made up exclusively of professionals and is subject to particular supervision by the monitoring authorities,

— categories of claims are treated differently depending on their duration.

These two criteria should be amplified with respect to large exposures in two ways:

— prudential treatment of interbank claims, and

— definition of interbank claims.

3.4.1. Prudential treatment of interbank claims

One should apply the claims weighting adopted by the proposal (0 %) for claims defined below and leave it up to the authorities to implement a beefed-up supervisory system, with other claims being subject to the solvency ratio (20 %).

3.4.2. Definition of interbank claims

For applying the 0 % weighting the present proposal should consider interbank claims as:

— claims at less than one year on credit institutions, and

— claims at more than one year on credit institutions represented by securities issued by a credit institution and actually negotiable on a market regulated by a national authority.

[1] Contract whereby a bank, in return for payment of a premium, guarantees a maximum agreed interest rate for a specified loan and for a specified period in the future. This guarantee is obtained by the payment of any interest differential if the rate observed at the start of the reference period is higher than that guaranteed.

[2] Contract whereby a bank, in return for payment of a premium, guarantees a minimum agreed interest rate for a specified deposit and for a specified period in the future. This guarantee is obtained by the payment of any interest differential if the rate observed at the start of the reference period is lower than that guaranteed.

3.5. *Application of the transitional provisions to off balance sheet instruments (Article 6)*

The present proposal authorises a credit institution to continue until their maturity long-term loans contracted before the date of publication of the directive.

This transitional provision does not therefore concern off balance sheet instruments with maturity dates fixed by contract.

But there is no reason to draw a distinction between balance sheet and off balance sheet items, and the present proposal offers no justification for such a distinction.

3.6. *Date of application*

3.6.1. The present proposal for a directive is due to come into force on 1 January 1993. But as soon as the directive is published credit institutions will have five years after that date to bring excessive exposures into line with the provisions of the directive, except in the case of longer-term loans, where the lending institution has to abide by the terms of the loan. In addition, after the publication date of the directive, the credit institution involved will lose the benefit of the grace period allowed for bringing any increase in exposure within the limits laid down.

3.6.2. These rules, especially the linkage to the publication date of the directive, which the credit institutions do not know in advance:

— will seriously affect business relations with customers because the penalty laid down (i.e. the loss of the period of grace) will discourage institutions from negotiating new transactions that may increase their exposure beyond the 25 % limit after the publication date,

— will therefore lead to the standards being applied in advance to the vast majority of individual risks,

— will particularly penalise institutions granting large volumes of short-term credit renewable annually to clients whose needs are of a cyclical nature (e.g. financing of stocks in the agrofood industry), for the following two reasons:

  (i) either exposures to some major customers will be at a low point in the economic cycle on the date when the directive is published,

  (ii) or, from 1 January 1993, their renewable credits cannot, whatever happens, exceed the yardstick of 25 %. One imagines the problems that such a tight deadline might involve for the credit institutions concerned, which have to redeploy their activities, and their customers, who have to diversify their financing,

— the same would apply to institutions offering long-term loans; they would have to freeze their dealings with customers with whom their risk exposure would exceed 25 % on the date the directive was published.

3.6.3. For these reasons, if the 25 % figure is retained, despite the proposal contained in point 2.4 of this Opinion, there should no longer be any reference to the date of the directive's publication; a general deadline for compliance of five years from 1 January 1993 should be laid down, with the possibility of exemptions for loans maturing after this date.

3.6.4. Institutions would have to reduce their excess exposures gradually under the authorities' supervision, without the application of the intended 'ratchet' (i.e. the publication date), in order to maintain the flexibility necessary to their business relations.

4. Conclusion

4.1. The experiences of the last few years have shown that the western world's credit institutions could turn out to be more vulnerable than one imagines. The serious difficulties of entire networks in the USA have led the banking supervisory authorities to formulate a harmonised framework of new prudential rules.

The Committee does not wish to criticise a step which has been inspired by a concern to safeguard the solidity and stability of the EC banking system and, hence, savers' assets.

4.2. However, it is difficult to underestimate, from a purely economic point of view, the dampening effect on the initiative, indeed the dynamism, of a profession whose vocation is, by definition, to finance economic development and business investment by taking risks.

It is feared that the banking sector will be subject to such constraints that its dynamism at European level will be seriously affected. The sectors which play a decisive role in the progress of our society often involve

risks. But it is these vital sectors which might be deprived of the financing which they need.

If all credit institutions are made subject to rigid standards this may lead to them shouldering less responsibility and to less competition. The cumulative effect of all the new prudential rules may in fact be a creeping cartelization of the banking industry.

One may also wonder about the question of 'large exposures', for experience has shown—especially in the USA—that the really large exposures are those involving a whole sector suffering from recession—such as the building industry—rather than a massive commitment to one or a few borrowers.

Instead of regulatory constraints there could be strict obligations concerning information; these would have the same effect of protecting savers but would leave credit institutions greater management freedom.

In any event, the above considerations fully justify our call for the 40 % ceiling to be retained.

4.3. The Committee would like to see consultations with the Commission directorates responsible for economic and financial affairs, particularly DG II, which assesses the economic impact of Community policies. The purpose of these consultations would be to use simulations based on a sample of EC credit institutions to measure the impact on banking activities of all the prudential directives submitted to the Economic and Social Committee, including, of course, those which are the subject of this Opinion.

If the Commission did not think it could carry out this study with the means at its disposal, the Committee suggests that this mission be entrusted to an independent bureau, which would be given the means to conduct the investigations necessary.

Done at Brussels, 25 September 1991.

The Chairman

of the Economic and Social Committee

François STAEDELIN