EBA/GL/2019/01

17 January 2019

Final Report

Guidelines on specification of types of exposures to be associated with high risk under Article 128(3) of Regulation (EU) No 575/2013

Contents

Executive summary

The standardised approach (SA) for determining the minimum capital requirements for credit risk assigns risk weights to be applied to the exposure amount based on the exposure class of a considered exposure. The exposure classes relevant for the SA are laid down in Article 112 of Regulation (EU) No 575/2013 (Capital Requirements Regulation (CRR)). Among these exposure classes there are 'exposures associated with particularly high risk'.

This high risk exposure class represents the implementation of the discretion that national supervisors are granted in paragraph 80 of the current Basel II standard that states that national supervisors may decide to apply a 150% (or higher) risk weight to reflect 'the higher risks associated with some other assets, such as venture capital and private equity investments'.

Article 128 of the CRR sets out the requirements for classifying an exposure as an item associated with particularly high risk, which results in an assignment of a 150% risk weight for the considered exposure. Paragraph 2 of Article 128 provides a list of exposures which are assigned to this exposure class:

(a) investments in venture capital firms;

(b) investments in AIFs as defined in Article 4(1)(a) of Directive 2011/61/EU except where the mandate of the fund does not allow a leverage higher than that required under Article 51(3) of Directive 2009/65/EC;

(c) investments in private equity;

(d) speculative immovable property financing.

Article 128(3) CRR provides a mandate to the European Banking Authority (EBA) to draft guidelines that specify which types of exposures, other than those mentioned in Article 128(2) CRR, are to be associated with particularly high risk and the circumstances under which this should happen. As a result of an exposure being identified as an 'item of particularly high risk', such exposure receives a risk weight of 150%.

The guidelines consist of two sections. The first section aims to clarify the notions of investments in venture capital firms and private equity as referred to in Article 128(2) CRR; the second section specifies the types of exposures other than those listed in points (a) to (d) that should be considered as high risk (and under which circumstances) by way of application of Article 128(3) CRR.

Regarding the first section, it should be noted that the outlined clarification is not within the mandate for the guidelines that the CRR provides, but that the inclusion of this clarification, as an own initiative contribution, was considered helpful by the EBA.

The second section contains the actual policy related to the mandate as laid down in Article 128(3) CRR. This part has been drafted with the intention that institutions should specify those individual exposures as items of particularly high risk that carry a high risk of loss due to being structurally different from common exposures of the same original asset class.

The EBA recognises that the revised SA for credit risk agreed by the Basel Committee on Banking Supervision as part of its Basel III finalisation in December 2017 no longer includes provisions on 'higher risk exposures' as the Basel II standard currently does. Nevertheless, the EBA considers it beneficial to issue these guidelines in order to ensure detection of high risk within banks before the transposition of Basel III into the EU legislative framework, as well as a harmonised and consistent application of Article 128(2) and (3) of the CRR until any revision of these provisions has to be applied by institutions, noting that the Basel Committee only requires the framework to apply from 2022 onwards.

Background and rationale

Article 128(3) CRR gives a mandate to the EBA for drafting guidelines that specify which types of exposures, other than those mentioned in Article 128(2) CRR, are associated with particularly high risk and the circumstances under which this should happen, which would result in these exposures receiving a risk weight of 150%. The mandate represents the implementation of the discretion that national supervisors are granted in paragraph 80 of the Basel II agreement, which states that national supervisors may decide to apply a 150% (or higher) risk weight that reflects 'the higher risks associated with some other assets, such as venture capital and private equity investments'.

It should be noted that the Basel II agreement considers all credit exposures carrying a risk weight of 150% or higher to be high risk assets. However, in Article 128, the CRR sets out the notion of 'items associated with particular high risk', which serves as a possibility to assign a 150% risk weight where this is not provided by the respective original asset class of a considered exposure. As a result, an exposure that falls under Article 128 CRR is excluded from its original exposure class and is considered instead under 'items associated with particular high risk' of Article 128. A high risk exposure (according to the notion provided by the Basel standard) that already receives a 150% risk weight in its original exposure class (e.g. Credit Quality Step 5 or 6 for exposures to corporates) is therefore not affected by Article 128 CRR. The CRR specifies in Article 128(2) four types of exposures that shall be considered as items associated with particularly high risk, namely:

a) investments in venture capital firms;

b) investments in AIFs as defined in Article 4(1)(a) of Directive 2011/61/EU except where the mandate of the fund does not allow a leverage higher than that required under Article 51(3) of Directive 2009/65/EC;

c) investments in private equity;

d) speculative immovable property financing.

These guidelines consist of two sections. The first section aims to clarify the notion of investments in venture capital firms and private equity; the second section specifies which other types of exposures should be considered as high risk and under which circumstances.

Following the three-month public consultation period, which ran between 17 April 2018 and 17 July 2018, the second section on other types of exposures considered as high risk was re-organised in order to provide stakeholders with a clearer identification scheme for the exposures that are associated with high risk: (i) identification of the scope of application; (ii) generic criterion for identification; (iii) specific cases to be considered; and (iv) other specific cases that apply to equity exposures.

Investments in venture capital firms or private equity

The part of the guidelines that deals with investments in venture capital firms or private equity contains clarification regarding the types of exposures that should be considered as investments in private equity and venture capital firms. It was considered necessary for the EBA to provide, on its own initiative and in line with its prerogatives, a definition for these two concepts for the purposes of the present guidelines. This is because definitions are necessary to ensure harmonisation regarding the types of exposures that are considered as investments in both venture capital and private equity.

In agreement with the decision of the legislators to include investments in venture capital firms and investments in private equity separately in the CRR, through Article 128(2), points (a) and (c), respectively, the EBA provided separate definitions for the two notions (i.e. investments in private equity and investments in venture capital firms).

The section in the guidelines that details the definitions specifies that investments in private equity or venture capital firms should include at least non-debt exposures constituting subordinated, residual claims on the assets or income of an enterprise not listed on an exchange, or debt exposures of a comparable character.

Investments in private equity are characterised by the intention to hold the exposure with the objective of generating a profit through, for example, a leveraged buyout, an initial public offering or any other way of selling the equity. Types of investments in which the institution has the intention to develop a strategic business relationship with the enterprise it has invested in are explicitly excluded. The latter may still be assigned to the high risk asset class for other reasons but should not be considered investments in private equity. The same holds true for investments in listed equity, which could be assigned to the high risk asset class, but should not be considered investment in private equity.

Regarding the notion of investments in venture capital firms, the guidelines clarify that this includes exposures to firms that provide funding to newly established enterprises (e.g. funding for the development of a new product and for the related research for the enterprise to bring this product to the market, and funding for the build-up of the production capacity of the enterprise or for the expansion of the business of the enterprise).

It is important to clarify that, in line with the answer provided by the European Commission to Q&A 2013_374[1], the definitions apply to direct investments and whenever the look-through approach is used for exposures in the form of shares or units in collective investment undertakings (CIUs).

Other types of exposures to be considered high risk exposures

[1] https://eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2013_374

This part of the guidelines builds on the criteria already set out in Article 128(3) CRR in which it is required that 'institutions shall take into account the following risk characteristics, when assessing whether an exposure should be considered of particularly high risk:

a. there is a high risk of loss as a result of a default of the obligor[2];

b. it is impossible to assess adequately whether the exposure falls under point (a).

To begin with, paragraph 3 presents the scope of application. As the mandate in Article 128(3) does not limit the application of the guidelines to a series of specific exposure classes, institutions need to assess all the exposures on their balance sheet with a view to identifying those that are associated with high risk. Consequently, the guidelines do not provide an exhaustive list of types of exposures to be classified as exposures of particularly high risk. However, empirically it is more likely that exposures that could be associated with high risk be more frequent in some asset classes, such as those in Article 112 CRR points (g), (p) and (q). The rationale for this guidance is to ensure more harmonisation in the application of Article 128(3) CRR under these guidelines.

Furthermore, section 4.2 of the guidelines relies on the fact that institutions should identify, as items associated with particularly high risk, those individual exposures that carry a high risk of loss due to being structurally different from other obligors or transactions of the same exposure class. Paragraph 4 of the guidelines lays out this ground principle for the identification of high risk exposures. This assessment is to be carried out regardless of the original exposure class of an individual exposure.

The rationale for relying on this principle is that the flat risk weights[3] of the SA provided by the current Basel standard and its CRR implementation (e.g. 100% for unrated corporates, 75% for retail exposures, 100% for equity exposures) are calibrated to cover items across the risk spectrum. The flat risk weights can be understood as representing a certain quantile of an underlying loss distribution, which includes exposures that carry a loss risk equivalent to a 150% risk weight (or even higher) as well as exposures that carry a loss risk lower than that expressed by the flat risk weights, thereby ensuring, on average, an appropriate capitalisation for a specific exposure class. In principle, the flat risk weights provided for each asset class in the CRR are set prior to Article 128(3) CRR. Institutions should therefore consider exposures as being of particularly high risk when they show structural differences that are not reflected in the existing flat risk weights associated with their original exposure class.

In addition, paragraph 5 provides banks with a series of criteria and examples to enable the identification of those exposures that, at a minimum, should be associated with high risk and thus risk-weighted at 150%. The types of exposures listed in paragraph 5(a) and (b) of these guidelines facilitate the assessment regarding what constitutes structurally different exposures as referred to in paragraph 4 of the guidelines. More specifically, paragraph 5(a) outlines that banks should consider any financing of speculative investments (other than immovable property, as these are

[2] In this regard, a high risk of loss should be understood as rather referring to the loss given default, which in the universe of the IRB would be defined at the level of a transaction.

[3] Flat risk weights should be considered risk weights that are not determined by an external credit assessment by ECAIs.

already high risk items under Article 128(2) CRR) as high risk exposures if there are indications that there is a risk of a high loss (e.g. because of insufficient market liquidity and/or high price volatility for the financed object that is not yet sufficiently mitigated by pre-sales contracts for example, and there is insufficient other income and assets of the obligor for mitigating the loss risk for the financing institution). As an example, an institution could decide to finance speculative investments in mobile property (e.g. ships, containers or cars), in agricultural products or even in intangible assets, such as licenses or patents.

Paragraph 5(b) provides that, in their assessment of high risk items, institutions should consider exposures that are similar to specialised lending exposures as being potentially high risk exposures. In particular, in cases in which such exposures relate to a single project in its pre-operational phase and where the cash flows serve as security and as source of repayment at the same time, institutions should assess whether or not these exposures exhibit a high risk of loss. However, it should be noted that such exposures are not high risk by definition, but that paragraph 5(b) also requires that the institution considers such a project of no high quality in order for it to be characterised as a high risk item.

Specifically, paragraph 5(b), point (i), lists some potential indicators for the existence of high risk exposures (for exposures similar to all types of specialised lending exposures). These pointers are based on the criteria that would be used by an internal ratings based (IRB) institution when applying the slotting approach for specialised lending exposures. However, as these guidelines are intended for institutions using the Standardised Approach, it is not expected that SA banks apply the regulatory technical standards (RTS) on slotting[4], but that they take the overall principles as listed in paragraph 5(b), point (i), into account for the purpose of assessing whether or not an exposure similar to a specialised lending exposure should be considered high risk. It should be noted that the guidelines do not generally hinder a potential preferential treatment of infrastructure projects.

As pointed out above, Article 128(3) CRR is not limited to certain exposure classes and therefore the types of exposures specified in paragraph 5(a) and (b) should be assessed for exposures to central governments or central banks, exposures to regional governments and local authorities and exposures to public sector entities. However, in practice, it is unlikely that any exposure of these exposure classes will fall under the types mentioned in paragraph 5(a) or (b). Similarly, the same reasoning holds for exposures to multilateral development banks listed in Article 117(2) CRR. The assessment for high risk purposes may be perceived to be contradictory to the intrinsic nature of multilateral development banks that are created for economic and social development projects; yet, as these exposures are not excluded from Article 128 CRR, they cannot be excluded from the scope of these guidelines. As well as this, exposures towards small and medium-sized enterprises (SMEs) will generally not constitute financing of speculative investments or specialised lending and it is therefore improbable that exposures to these borrowers are considered high risk as a result of paragraph 5(a) and (b). It is therefore considered that the assessment of SME exposures for high risk purposes under paragraph 5 will not negatively affect the financing of SMEs that play a

[4] https://eba.europa.eu/documents/10180/1489608/EBA-2016-RTS-02+%28Final+RTS+on+specialised+lending+exposures%29.pdf/e915f563-acba-485d-a05a-0756ce8360dd

fundamental role in creating economic growth and providing employment in the Union market (see recital 44 of the CRR).

Paragraph 6 sets out specific criteria in which equity exposures should be considered as potentially constituting exposures that have a high risk of loss. In particular, equity exposures should be considered whether to be classified as high risk if (i) the institution holds any other debt exposure to the same issuer and this other exposure is risk-weighted at 150%, or (ii) the debt of any such issuer would receive a 150% risk weight if these debt obligations were exposures of the institution.

Finally, within their relevant governance structures, institutions should ensure that all types of exposure outlined in the guidelines are assigned to the applicable high risk exposure class, regardless of the state of the considered exposure within its credit life cycle. What is more, Article 128(3) CRR is limited neither to specific exposure classes nor to the principle set out in paragraph 4 of the guidelines. Therefore, institutions could and should identify exposures that carry particularly high risk as a result of Article 128(3) CRR and that are not covered by these guidelines.

Nonetheless, it is expected that only in exceptional cases would an exposure need to be assigned to a high risk exposure class outside the scope of these guidelines or of Article 128(2) of the CRR. Therefore, a notification mechanism is proposed in section 4.3 in which it is required that banks notify their national competent authority (NCA) of any type of exposure that they identify as carrying particularly high risk by application of Article 128(3) CRR, but is not covered by the present guidelines. The rationale for this notification mechanism is twofold: first, to allow the monitoring of the characteristics of exposures that should receive a 150% risk weight as a result of the application of Article 128(3), and, second, to ensure a harmonised application of Article 128(3) CRR in cases of exposure not covered by these guidelines. In this regard, it should be pointed out that through the regulatory reporting scheme (Common Reporting – COREP) regulators can monitor the amount of exposure in the high risk exposure class, but not the nature of these exposures.

EBA/GL/2019/01

17 January 2019

Guidelines

on specification of types of exposures to be associated with high risk

1. Compliance and reporting obligations

Status of these guidelines

1. This document contains guidelines issued pursuant to Article 16 of Regulation (EU) No 1093/2010[5]. In accordance with Article 16(3) of Regulation (EU) No 1093/2010, competent authorities and financial institutions must make every effort to comply with the guidelines.

2. Guidelines set out the EBA's view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area. Competent authorities, as defined in Article 4(2) of Regulation (EU) No 1093/2010, to which guidelines apply should comply by incorporating them into their practices as appropriate (e.g. by amending their legal framework or their supervisory processes), including where guidelines are directed primarily at institutions.

Reporting requirements

3. In accordance with Article 16(3) of Regulation (EU) No 1093/2010, competent authorities must notify the EBA that they comply or intend to comply with these guidelines, or otherwise give reasons for non-compliance, by 01.07.2019. In the absence of any notification by this deadline, competent authorities will be considered by the EBA to be non-compliant. Notifications should be sent by submitting the form available on the EBA website to compliance@eba.europa.eu with the reference 'EBA/GL/2018/xx'. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities. Any change in the status of compliance must also be reported to the EBA.

4. Notifications will be published on the EBA website, in line with Article 16(3) of Regulation (EU) No 1093/2010.

[5] 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 (OJ L 331, 15.12.2010, p.12).

2. Subject matter, scope and definitions

Subject matter

5. These guidelines specify which types of exposures other than those mentioned in Article 128(2) of Regulation (EU) No 575/2013 are to be associated with particularly high risk and under which circumstances, as mandated by Article 128(3) of Regulation (EU) No 575/2013.

6. In addition, on the EBA's own initiative, these guidelines specify, for the purposes of the present guidelines only, definitions for the notions of 'venture capital' and 'private equity', as referenced in points (a) and (c) of Article 128(2) of Regulation (EU) No 575/2013.

Scope of application

7. These guidelines clarify the notions of investments in venture capital firms and investments in private equity as mentioned in Article 128(2), points (a) and (c), CRR. The guidelines also specify which types of exposures, other than those mentioned in Article 128(2) CRR, are to be associated with particularly high risk and under which circumstances, in line with the mandate in Article 128(3) CRR.

Addressees

8. These guidelines are addressed to competent authorities as defined in point (i) of Article 4(2) of Regulation (EU) No 1093/2010 and to institutions as defined in Article 4(1) of Regulation No 1093/2010.

Definitions

9. Unless otherwise specified, terms used and defined in Regulation (EU) No 575/2013 have the same meaning in the guidelines.

3. Implementation

Date of application

10. These guidelines apply from 01.07.2019.

4. EBA Guidelines on specification of types of exposures to be associated with high risk

4.1. Investments in venture capital firms and/or private equity

1. Institutions should consider that investments in venture capital firms referred to in point (a) of Article 128(2) of Regulation (EU) No 575/2013 include, at a minimum, any investment that meets both of the following conditions:

   (a) the investment is either of the following types of investment:

      (i) non-debt exposures not listed on an exchange conveying a subordinated, residual claim on the assets or income of an enterprise not listed on an exchange;

      (ii) debt exposures and other securities, partnerships, derivatives or other vehicles, the economic substance of which is similar to the exposures specified in point (i) and not listed on an exchange;

   (b) the investment is held with the objective of providing funding to newly established enterprises, including to the development of a new product and related research for the enterprise in order to bring this product to the market, to the build-up of the production capacity of the enterprise or to the expansion of the business of the enterprise.

2. Institutions should consider that investments in private equity referred to in point (c) of Article 128(2) of Regulation (EU) No 575/2013 include, at a minimum, any investment that meets both of the following conditions:

   (a) the investment is either of the following types of investment:

      (i) all non-debt exposures not listed on an exchange conveying a subordinated, residual claim on the assets or income of an enterprise;

      (ii) debt exposures and other securities, partnerships, derivatives or other vehicles, the economic substance of which is similar to the exposures specified in point (i) and not listed on an exchange;

   (b) the investment is held with the intention of generating a profit through a leveraged buyout, an initial public offering, sale of the equity stake by other means or any transaction with a similar economic substance.

Any investments in which the institution has the intention to develop a strategic business relationship with the enterprise it has invested in should not be considered as private equity for the purposes of these guidelines. However, such investments may still constitute high risk exposures according to section 4.2 of these guidelines.

4.2. Other types of exposures to be considered high risk exposures

3. The scope of the exercise of identifying items associated with particularly high risk that are not already covered by Article 128(2) of Regulation (EU) No 575/2013 should cover all exposure classes, with a particular emphasis on the exposure classes referred to in points (g), (p) and (q) of Article 112 of Regulation (EU) No 575/2013.

4. Institutions should consider as items associated with particularly high risk, from among those referred to in paragraph 3, at a minimum, those exposures that exhibit levels and ranges of risk drivers that are not common to other obligors or transactions of the same exposure class.

5. For the purposes of paragraph 4, institutions should consider, at a minimum, all of the following exposures as exhibiting levels and ranges of risk drivers that are not common to other obligors or transactions of the same exposure class:

   (a) any financing of speculative investments in both financial and non-financial assets other than immovable property, in which the obligor has the intention to resell the assets for profit, including the financing of speculative investments in mobile property, agricultural products or intangible assets (such as licenses or patents) where both of the following conditions are met:

      (i) there is a particularly high risk of loss in cases of the default of the obligor, in particular in the case of insufficient market liquidity or high price volatility for the financed object that has not yet been sufficiently mitigated by contractual arrangements, including irrevocable pre-sale contracts;

      (ii) there are insufficient other incomes and assets of the obligor available for mitigating the loss risk for the financing institution, in particular in cases where the loss risk is high in relation to the financial resources of the obligor;

   (b) any exposure for which an issue-specific external credit assessment is not available, which is to an entity created specifically to finance or operate physical assets other than immovable property, or is an economically comparable exposure, with contractual arrangements that give the lender a substantial degree of control over the assets and the income that they generate and for which the primary source of repayment of the obligation is the income generated by the assets being financed, rather than the independent capacity of a broader commercial enterprise, in which any of the following conditions is met:

(i) the institution has identified in its analysis a high risk of loss resulting from any of the following:

- significant deficiencies in the financial strength of the corresponding special purpose vehicle;
- significant uncertainty related to the political and legal environment of the location of the project, if relevant;
- transaction or asset characteristics;
- diminished strength of the sponsor or developer;

(ii) the institution has identified a high risk of loss for an exposure related to project finance in the form of a single project in its pre-operational phase when it does not yet have a positive cash flow that is sufficient to cover any remaining contractual obligations and declining long-term debt, and where its cash flows serve both as security and as source of repayment that the institution considers to be of no high quality, as it renders it unable to fulfil its financial commitments in a timely manner.

6. All equity exposures to a given issuer should be considered whether to be classified as items associated with particularly high risk where either of the following conditions is met:

(a) the risk weight for any debt exposure of the institution to the same issuer is 150%;

(b) any debt of such an issuer would receive a 150% risk weight if these debt obligations were exposures of the institution due to either of the following reasons:

(i) the associated credit assessment of an external credit assessment institution (ECAI) nominated by the institution for the corresponding debt obligation warrants a 150% risk weight;

(ii) the issuer is in default in accordance with Article 178 of Regulation (EU) No 575/2013.

4.3. Notification requirements

7. Where institutions identify any types of exposures carrying a particularly high risk of loss in accordance with the conditions set out in Article 128(3) of Regulation (EU) No 575/2013, other than those identified in accordance with paragraph 5 or 6, institutions should notify the competent authorities in their jurisdiction, together with a brief description of the main characteristics of these exposures. The competent authorities should, in turn, notify the EBA.

Accompanying documents

Cost-benefit analysis/impact assessment

This impact assessment provides an analysis of the potential related costs and benefits of the policy provided in the present guidelines. This analysis provides the reader with an overview of the findings as regards the identification of the problem, the options identified to deal with the problem and the potential impacts of these options.

The following analysis consists of three parts. The first part provides an analysis of the baseline scenario in terms of institutions' current practices, supervisory rules and practices, and the regulatory environment. The second part contains the options considered with respect to the major policy decisions included in the Consultation Paper. Finally, the cost-benefit analysis is based on the main policy changes in comparison with the current supervisory rules and practices, institutions' current practices and the regulatory environment.

A. Problem identification

The issue addressed by the guidelines is the lack of common institutional and supervisory practices regarding the types of exposures that are associated with particularly high risk and under which circumstances. As a result of identifying an exposure that carries a particularly high risk by the application of Article 128(3) of the CRR, such an exposure receives a risk weight of 150%. All issues that have been considered during the development of these guidelines aim to harmonise the rules for the identification of exposures to be associated with particularly high risk.

B. Policy objectives

The objective of the guidelines is to establish the convergence of institutions' assessment of whether an exposure constitutes a particularly high risk in the sense of Article 128(3) CRR. Divergent practices of institutions and supervisors regarding the specification of types of exposures that should be considered as particularly high risk may lead to a non-level playing field among institutions, as well as to unjustified variability of risk-weighted assets (RWAs) in the SA. Member States and institutions are expected to enhance the comparability of own funds requirements.

The guidelines aim to specify the types of exposures to be associated with particularly high risk, by way of:

- providing a clarification on the notions of investments in venture capital and investments in private equity as referred to in Article 128(2)(a) and (c) of the CRR;

- providing a general approach for identifying exposures to be associated with particularly high risk;
- specifying examples of types of exposures that should be considered as exposures to be associated with particularly high risk;
- introducing a notification scheme for any other high risk exposure assigned a 150% risk weight by application of Article 128(3) CRR not covered by any other requirement in these guidelines.

C. Baseline scenario

The baseline scenario can be defined in terms of supervisory rules and practices, institutions' current practices and the regulatory environment.

The baseline scenario in terms of the supervisory expectations is specified on the basis of information exchanged among the competent authorities that participated in the relevant working groups. Based on this exchange, it can be considered that speculative investments, as well as low-quality specialised lending, are already considered in some EU jurisdictions for the purpose of identifying exposures associated with particularly high risk.

The baseline scenario in terms of institutions' current practices is assumed to be comparable to the supervisory baseline scenario.

The baseline scenario in terms of the regulatory environment is set by the current CRR and therefore does not provide any starting point for the impact assessment, as currently no specific types of exposures are set out under Article 128(3) of the CRR.

D. Options considered

The scope of the guidelines on the identification of exposures associated with high risk

The exclusion of several exposure classes from the scope of these guidelines was discussed. In particular, it was proposed that exposures to central governments or central banks, exposures to regional governments and local authorities and exposures to public sector entities be excluded from the scope of the guidelines with the rationale that such exposures are not expected to be exposed to a high risk of loss. In this regard, it should be noted that Article 128(3) CRR cannot be limited to certain exposure classes and that therefore this article applies to the above outlined exposure classes as well. Moreover, it should be noted that in practice it is very improbable that any exposure stemming from these exposure classes will fall under the types of exposures described in paragraph 3, 4, 5 or 6 of these guidelines.

In addition, it was proposed that 'exposures to multilateral development banks', pursuant to Article 117(2) of the CRR, be exempt from the guidelines, as they are risk-weighted at 0%. For these

exposures, the assessment for high risk purposes contradicts the intrinsic nature of multilateral development banks, which are created for economic and social development projects and have large sovereign membership. However, as pointed out in the previous paragraph, the guidelines cannot limit the general scope of Article 128(3) CRR.

Finally, excluding SMEs from the scope of the guidelines was considered. In this regard, it was deemed that their assessment for high risk purposes might negatively affect the financing of SMEs, which play a fundamental role in creating economic growth and providing employment in the Union market (see recital 44 of CRR). This argument has been developed in the 'Background and rationale' section of the Consultation Paper. However, Article 128(3) of the CRR applies to SMEs through the CRR and the guidelines cannot reduce the general scope of that article as pointed out above. It should be noted, however, that it is very improbable that SME exposures will fall under the types of exposures captured by paragraphs 4 and 5 and therefore it was considered preferential to keep SMEs within the scope of the assessment, as otherwise their assessment for the purpose of Article 128(3) might be insufficiently harmonised.

Governance aspects

Including governance aspects in the guidelines was considered, which would have required institutions to lay down in internal policies, e.g. their risk appetite with respect to high risk exposures, how they assess high risk exposures for newly acquired businesses as well as for exposures already in the stock, and some other governance aspects. However, for the sake of keeping the guidelines in line with the mandate set out in Article 128(3) CRR, these considerations were not pursued.

List of criteria

In addition, introducing a list of more detailed and objective criteria for the assessment of whether or not single exposures/transactions are subject to a high risk of loss was considered. This would have required institutions to identify additional relevant types of exposure, which are not already covered by Article 128(2) CRR or any part of the guidelines. More detailed and objective criteria such as these would have required institutions to identify exposures that inhibit levels and ranges of risk drivers that are not common to other obligors or transactions in a considered exposure class by taking into account:

(a) triggers based on the institution's own credit assessment indicating insufficient financial resources of an obligor to repay debt;

(b) the significance of the amount of exposure, the portion of the unsecured part or level of loan-to-value (LTV) that would lead to high risk of loss;

(c) internal or external credit rating/quality expressing high level of risk or other aspects, which would lead to high risk of loss.

However, these considerations were discarded for the following reasons:

- If such a list were to be provided it would be deemed necessary to define thresholds for the individual triggers, otherwise the assignment of an exposure to the high risk exposure class would be bank specific, which would be in contradiction to the concept of the SA. The calibration of such thresholds was envisaged to be extremely difficult.

- It was considered that SA institutions might not have the required information at hand. Moreover, the proposed triggers would have to be defined with a high level of detail, which would be difficult, in practice, for SA banks to assess (e.g. LTV with respect to current or original market value, how to define market value).

Views of the Banking Stakeholder Group (BSG)

The Banking Stakeholder Group (BSG) welcomes the opportunity to contribute to the consultation on 'EBA Guidelines regarding the exposures to be associated with high risk'.

It is important to note that the high risk exposure class is currently being analysed in the context of the CRR2 trilogue negotiations, which could significantly alter the scope of Article 128. It will also be the case with the implementation of the new Basel III (finalisation) framework.

These guidelines therefore represent very transitional measures for modifying RWAs. The introduction of a notification process under paragraph 6 would only add a regulatory burden of low added value over a short period, at the time when banks implement CRR2 and then finalise Basel III.

Furthermore, it seems useful to align the definitions with those of the Basel III SA for credit risk, and in particular with those speculative exposures not listed and other subordinated debt, capital and equity.

In addition, we recommend that all investments for which a bank intends to develop a strategic business relationship with the company in question not be considered private capital for the purposes of these guidelines.

Furthermore, the high exposure criterion should not apply to real estate development cases in which future promises of sale are based on irrevocable commitments.

Last but not least, the BSG recognises the EBA's effort to undertake a thorough review of RWAs and especially of the IR method. Having said that, the current CRR definition of speculative immovable property needs further analysis. The European approach is very broad, as it requires almost all real estate financing to be considered high risk. Some more guidance is needed to distinguish speculative projects from non-speculative ones.

Feedback on the public consultation and on the opinion of the BSG

The EBA publicly consulted on the draft proposal contained in Consultation Paper CP/EBA/2018/03.

The consultation period lasted for three months and ended on 17 July 2018. A total of 13 responses were received, of which 11 were published on the EBA website.

A summary of the key points and other comments arising from the consultation, analysis and discussion triggered by these comments, and the actions taken to address them if deemed necessary is provided in the tables below.

In many cases, several industry bodies made similar comments, or the same body repeated its comments in its responses to different questions. In such cases, the comments and the EBA analysis are included in the section of this paper where the EBA considers them to be most appropriate.

Changes to the draft guidelines have been incorporated as a result of the responses received during the public consultation.

Summary of key issues and the EBA's response

Comments received during the consultation period questioned the timing of the guidelines. They considered either that the guidelines come too late after the issuing (in 2013) of the mandate in Article 128(3) CRR or that the guidelines will pre-empt (i) the upcoming EU implementation of the revised Basel III framework, which does not include the regulatory exposure class 'Items associated with particular high risk', and (ii) the possible amendments to Article 128 in the context of CRR2. The EBA considers that the interaction with the timeline of the forthcoming regulatory revisions to the current framework is unavoidable, but difficult to predict in terms of timing, and thus guidance on the treatment of current exposures associated with high risk is needed. These guidelines will not only enable a higher degree of comparability in terms of current practices in identifying exposures associated with high risk, but also facilitate the transition to the upcoming regulatory revisions, by allowing banks and supervisors to use the guidelines to identify risk factors that align with the future Basel framework.

Several respondents raised issues regarding the definition and the prudential treatment of speculative immovable property financing, despite the fact that the Consultation Paper underlines the fact that this type of exposure is outside the scope of the guidelines, as this type of exposure is already included in Article 128(2) CRR. The EBA's decision to exclude speculative immovable property financing from the guidelines was based on the consideration that the CRR already provides a definition of this. Furthermore, this is an area in which substantial changes are foreseen in the Basel III framework and may therefore lead to either pre-empting the implementation of the Basel III agreement or risking an inconsistent implementation with the future Basel III agreement. Notwithstanding this, the observations provided by the industry will be carefully assessed during the current debate within the EBA on this topic.

During the consultation period, comments were received from respondents who disagreed with the inclusion of the notion of private equity and venture capital in the guidelines. Respondents made the point that, as a second best solution, the definition of private equity and venture capital should apply only to banks' direct investments and should exclude all investments in the form of shares or units in a CIU. Moreover, it was stated that the definitions should be aligned with the

ones provided by the Basel III framework and, in particular, with the speculative unlisted exposures and other subordinated debt, capital and equity exposures (paragraphs 50-53). In line with its prerogatives, the EBA has taken the initiative to provide, for the purposes of the present guidelines only, a definition of the notions of private equity and venture capital. This step has been taken precisely because of the lack of guidance available to the public on these notions and because the definitions are deemed necessary for providing guidance and ensuring harmonisation regarding the types of exposures that are considered as investments in venture capital and private equity. Furthermore, the EBA clarifies that the definitions apply to direct investments and whenever the look-through approach is used for exposures in the form of shares or units in CIUs, in line with the answer provided by the Commission to Q&A 2013_374.

Many of the comments made regarding the Consultation Paper have tackled the issue of the scope of the guidelines, with respondents presenting heterogeneous opinions on whether the guidelines should take a broader or a narrower view with regard to the exposure classes that should be scoped out during the identification of exposures associated with high risk. In light of these comments, the EBA has amended section 4.2 of the guidelines to provide institutions with a clearer, holistic identification scheme for exposures associated with high risk. This is in line with the mandate granted to the EBA through Article 128(3) CRR. It also takes into account empirical evidence regarding the functioning of financial institutions. As a result, the underlying logic of section 4.2 is the following: (i) paragraph 3 presents the scope of what this exercise covers (all exposure classes) with some emphasis on some specific areas; (ii) paragraph 4 presents the generic criterion of when an exposure is considered to be associated with high risk; (iii) paragraph 5 illustrates specific cases in which the generic criterion will be considered to have been met; and (iv) paragraph 6 presents other specific cases in which the generic criterion will be considered to have been met, which are specific to the equity exposure class.

The introduction of the notification mechanism has been questioned by respondents to the Consultation Paper, but the EBA has decided to maintain it. This mechanism would be useful from the perspective of understanding what residual exposures could be associated with high risk but have not been identified using the previous steps provided in the guidelines. However, the addressees of the notifications should be the NCAs and not the EBA directly. The legal text has been amended accordingly. Any such notification should subsequently be forwarded to the EBA, once the technical solution for this has been implemented.

Summary of responses to the consultation and the EBA's analysis

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
General comments			
Timing of the guidelines and the interaction with the upcoming review of the regulatory framework	• Three respondents disagreed with the publication of the draft GLs. They pointed out that the draft GLs would be a transitory measure given the upcoming EU implementation of the revised Basel III framework, which removes the regulatory exposure class 'Items associated with particular high risk', and the possible amendments to Article 128 in the context of CRR2. The implementation of the draft GLs will therefore impose regulatory costs without any evident long-term benefits. • There was general support from three respondents for the initiative to provide guidelines to ensure a common understanding of the exposures associated with particularly high risk.	The interaction with the timeline of the forthcoming regulatory revisions to the current framework is unavoidable, but difficult to predict in terms of timing. A treatment for the current exposures associated with high risk is therefore needed. These guidelines will not only enable a higher degree of comparability in terms of current practices in identifying exposures associates with high risk, but also facilitate the transition to the upcoming regulatory revisions by allowing banks and supervisors to use the guidelines to identify risk factors that align with the future Basel framework.	The EBA did not make any amendments to the GLs on this point.
Inclusion of speculative immovable property financing exposures in the scope of the guidelines	• Several respondents raised issues regarding the definition and the prudential treatment of speculative immovable property financing. In particular, three	The definition of 'speculative immovable property financing' is out of the scope of the draft GLs. Notwithstanding this, the observations provided by	The EBA did not make any amendments to the GLs on this point.

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	respondents asked for more guidance on the definition of 'speculative immovable property financing' provided by the CRR. • Four respondents suggested using the criteria identified in paragraph 5(a)(i) and (ii) to assess speculative immovable property financing and, as a consequence, excluding some exposures from the high risk exposure class. The EBA was also asked to confirm that exposures for which repayment depends primarily on the income and financial capacities of the borrower, irrespective of the performance of the immovable property project underlying the credit transaction, should not be classified in said exposure class.	the industry will be assessed carefully during the current debate within the EBA on this topic.	
Interaction with the international financial reporting standards 9 (IFRS 9)	One respondent considered that the draft GLs should explicitly exclude the fact that exposures that are in IFRS 9 stage 2 are automatically considered high risk.	Pursuant to Article 128 CRR, IFRS 9 stage 2 assessment and high risk assessment have different purposes and are different concepts: while the IFRS 9 stage 2 could be considered a circumstantial description of the status of an exposure, the classification as high risk is related to the original features of the initial exposure.	The EBA did not make any amendments to the GLs on this point.
Proposed treatment for equity exposures (paragraph 7 on page 15 of EBA/CP/2018/03)	• Two respondents disagreed with the inclusion of paragraph 7 in the draft GLs because they believed that the treatment proposed is very prejudicial for equity exposures; they considered the assessment unreasonably burdensome for banks, requiring a high level of effort to achieve implementation. In addition,	The EBA clarified that the identification of the risk weight for cases in which there is no actual exposure to an institution should be carried out as follows: when a credit rating, issued by a nominated ECAI, is mapped to a 150% risk weight, or in cases in which the issuer meets the definition of default in line with the provisions of Article 178 CRR, the associated risk	The EBA has amended the text that refers to the treatment of equity exposures for the cases in which there is no actual exposure to an institution.

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	according to the industry, the EBA should also consider the forthcoming Basel III framework that provides a new treatment for equity exposures. • For three respondents, the second part of paragraph 7 was not clear and they asked the EBA to specify how institutions should evaluate the hypothetical debt exposures.	weight would be 150% and the exposures would be classified as being associated with high risk.	
Responses to questions in Consultation Paper EBA/CP/2018/03			
Question 1. Do you agree with the proposed clarifications in paragraphs 2 and 3? Would you like to bring forward arguments which potentially mitigate the caveats of the alternative approach for defining what constitutes an investment in private equity?			
Inclusion of the definitions for private equity (PE) and venture capital (VC)	Five respondents disagreed with the inclusion of the notion of PE and VC for several reasons: • the EBA has gone beyond its mandate, as set out in Article 128(3) CRR; • it is a temporary measure, considering the upcoming Basel III framework and the possible amendments of Article 128 in the context of CRR2; • it is not clear why the EBA has concluded that such clarification is needed now; • banks, as professional investors, are already well aware of what constitutes investments in PE and VC, and the definition could create confusion.	In line with its prerogatives, the EBA has taken the initiative to provide, for the purposes of the present GLs only, a definition of the notions of PE and VC. This step has been taken precisely because of the lack of guidance available to the public on these notions and because the definitions are deemed necessary for providing guidance and ensuring harmonisation regarding the types of exposures that are considered as investments in VC and PE.	Clarifications have been provided in the Background and rationale section of the present final report.
Types of investments included in the PE and VC definitions	Two of the respondents proposed, as a second best solution, that the definition of PE and VC should apply only to banks' direct investments and should exclude all investments in the form of shares or units in a CIU. In their opinion, this is in line with	The EBA would like to clarify that the definitions apply to direct investments and whenever the look-through approach is used for exposures in the form of shares or units in CIUs, in line with the answer provided by the Commission to Q&A 2013_374.	Clarifications were provided in the Background and rationale section of

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	both the EBA Q&A 2013_374 and the political intention of the co-legislator in the context of CRR2. On the other hand, one respondent commented that indirect exposures should be included.		the present final report.
Content of the definitions for PE and VC	Five respondents commented that the definitions of PE and VC are not clear and could subsequently create confusion. Some suggestions for amending the definitions were therefore provided. One respondent deemed that the definition should be aligned with the one provided by the Basel III framework and, in particular, with the speculative unlisted exposures and other subordinated debt, capital and equity exposures (paragraphs 50-53).	The text of the definitions is already aligned with the revised Basel III concepts, so no amendments to the text will be proposed.	The EBA did not make any amendments to the GLs on this point.
Question 2. Do you agree that the identification of high risk items is particularly relevant for some of the existing exposure classes?			
	Four respondents were specifically in agreement with the EBA's expectations that some exposure classes are more likely to contain items that would be considered high risk.	Empirically, the most prominent classes among these exposures are 'Corporates', 'Equity' and 'Other items', as specified in Article 112, points (g), (p) and (q), of the CRR. Moreover, as the criteria set out in paragraph 5(a) and (b) are very specific, it is expected that the GLs will have limited application to all other exposure classes under the SA, which include 'exposures to central governments', 'retail exposures' and 'exposures secured by mortgages on immovable property'.	The EBA did not make any amendments to the GLs on this point.
Question 3. Do you have any comments or concerns regarding the proposed scope of the exposures at least to be analysed according to paragraph 5? Should more guidance be provided as regards other types of exposures? If yes, please provide specifications.			

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
Criteria for the identification of exposures associated with high risk	• According to one respondent, the criteria defined by paragraph 5(a) and (b) are not sufficient to clarify which exposures must be considered as associated with high risk pursuant to Article 128(3) of the CRR. As such, further details are needed in order to minimise the room for interpretation. • Two respondents noted that the criteria defined in paragraph 5(a) and (b) overlap in some parts and they asked for some examples to clarify the distinction between the scopes of paragraph 5(a) and (b).	The points made were taken on board and examples provided in the background section of the Consultation Paper on the GLs on high risk have been added to paragraph 5(a) to shed light on the type of exposures expected to be identified.	Clarifications were made to the paragraphs that relate to the identification criteria for exposures associated with high risk.
Criteria for the identification of exposures associated with high risk	• One respondent noted that, in relation to paragraph 5(a), 'the assessment of high risk is not needed when, in line with the statements reported under 5(b), a specific external rating is available'.	The existence of an issue-specific external rating does not make an assessment on whether an exposure could still be classified as being associated with particularly high risk pursuant to paragraph 5(a) of the draft GLs unnecessary. This is because, despite the existence of an external rating, the criteria in paragraph 5(a) of the draft GLs could still be met. Moreover, paragraph 5(b) of the draft GLs is limited to exposures that can be considered similar to specialised lending, which is not the case for paragraph 5(a).	The EBA did not make any amendments to the GLs on this point.
References to IRB risk parameters in the Background and rationale section in EBA/CP/2018/03	One respondent underlined that the reference to IRB risk parameters (provided in the background of the draft GLs) is 'problematic and unsystematic' because this notion belongs to the IRB approach and not to the SA.	The reference to the IRB concept of loss given default (LGD) in the background section of the Consultation Paper does not imply that the SA banks have to estimate the LGD parameter for their exposures. The reference to LGD was included in order to explain the philosophy behind the criterion provided by	The EBA did not make any amendments to the GLs on this point.

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
		Article 128(3)(a) of the CRR: it should be applied with the transaction, not the obligor, in mind.	
Exposures similar to specialised lending exposures	• Two respondents proposed deleting paragraph 5b because specialised lending exposures do not belong to the current SA framework and because they deem specialised lending transactions as important for supporting investment and economic development and are low risk exposures. • According to the industry, the criteria proposed in paragraph 5(b) rely on the banks' level of information, which goes against the SA philosophy, as the internal assessment provided by banks should not have an impact on the risk weight of the exposures. One respondent requested additional clarifications on the requirement of 'significant uncertainty related to the political and legal environment of location of the project' included in paragraph 5(b) and proposed not to apply this requirement when the project financed by specialised lending is located in EU countries. Another respondent underlined the necessity to specify that the specialised lending exposures have to be considered high risk once a due diligence process has been	Paragraph 5(b) has been amended to more clearly illustrate that its scope covers exposures that are similar in nature to specialised lending exposures, but that the concept of specialised lending remains an IRB notion pursuant to the current regulatory framework. The paragraph intends neither to anticipate the forthcoming Basel III framework nor to require the SA banks to apply the RTS on slotting; its purpose is to provide some guidance – using the existing information on specialised lending transactions as a baseline – for identifying only those exposures that are associated with high risk.	Amendments were made both to the Background and rationale section in this final report, and to the text of the GLs in order to clarify the EBA's intent.

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
	performed and the project has been considered of not high quality. One other respondent commented that the requirements provided by paragraph 5(b)(i) and (ii) should be cumulative and not alternative.		
Question 4. Do you agree to the proposed scope of exposures to be assessed in paragraph 6(a) in order to identify additional types of exposures which should be subject to a potential assignment to the high risk exposure class due to being structurally different?			
Scope of exposures to be associated with high risk	• Four respondents disagreed with the inclusion of paragraph 6(a) in the draft GLs, as the exposures listed in Article 128(2) of the CRR and in paragraph 5(a) and (b) of the draft GLs already identify the type of exposures that present a high risk of loss. These respondents considered that an additional assessment in accordance with paragraph 6(a) would be burdensome for banks and would impose an additional assessment for those exposure classes that are very unlikely to contain high risk elements. • Four respondents agreed on the identification of some exposure classes that are less likely to include exposures associated with particularly high risk.	Paragraph 6 provides guidance on the assessment for the purpose of identifying exposures associated with particularly high risk that are not covered by paragraph 5. This first sub-paragraph, paragraph 6(a), clarifies that, under the scope of the GLs, institutions should identify additional types of exposures as constituting exposures of particularly high risk in line with the principles set out in paragraph 4 (i.e. exposures that exhibit levels and ranges of risk drivers that are not common to other obligors or transactions of the same exposure class) only for exposures to corporates, equity exposures and other items. The rationale for this limitation is to ensure greater harmonisation in the application of Article 128(3) CRR under these GLs. In light of the comments received, the EBA decided to maintain the proposed section 4.2 of the GLs, but amended the phrasing for the purposes of coherence and clarity.	Section 4.2. of the GLs has been reorganised. As a result, the underlying logic of section 4.2 is the following: (i) paragraph 3 presents the scope of what this exercise covers (all exposure classes) with some emphasis on some specific areas; (ii) paragraph 4 presents the generic criterion of when an exposure is considered to be associated with high risk; (iii) paragraph 5 illustrates specific

Comments	Summary of responses received	EBA analysis	Amendments to the proposals
			cases in which the generic criterion will be considered to have been met; and (iv) paragraph 6 presents other specific cases in which the generic criterion will be considered to have been met, which are specific to the equity exposure class.

Question 5. Should there be a notification mechanism as proposed in paragraph 6(b)? Based on the current portfolio of exposures, would you expect that your institution (the institutions represented by you) would need to provide a notification?

Notification mechanism	Five respondents disagreed with the notification mechanism provided for in paragraph 6(b) – and more generally with the content of paragraph 6 – because it represents a burden for banks.	Paragraph 6(b) has been maintained in order to provide a clearer identification scheme for exposures that are associated with high risk. From the perspective of understanding what residual exposures could be associated with high risk but have not been identified using the previous steps provided in the GLs, the proposed notification mechanism is useful; however, in order to reduce the burden, the NCAs will be the addressees of the notifications.	The EBA amended the content to reflect the change in the notification mechanism.