EBA-Op-2020-09

Opinion of the European Banking Authority on measures in accordance with Article 458 of Regulation (EU) No 575/2013

Introduction and legal basis

1. On 23 April 2020, the European Banking Authority (EBA) received notification from the Haut Conseil de Stabilité Financière (HCSF, the French macroprudential authority) of its intention to apply Article 458(9) of Regulation (EU) No 575/2013 of the European Parliament and of the Council (Capital Requirements Regulation, CRR)[1]. This notification concerned the extension of a measure introduced by the HCSF in 2018 in application of Article 458(2)(d)(ii) of the CRR to tighten, for French global or other systemically important institutions only, the large-exposure limits applicable to large and highly indebted non-financial corporations (NFCs) resident in France or groups of connected NFCs assessed to be highly indebted and based in France.

2. The EBA's authority to deliver an opinion is based on the second subparagraph of Article 458(4) in conjunction with Article 458(9) of the CRR.

3. According to the second subparagraph of Article 458(4) of the CRR, within 1 month of receiving the notification from the designated or competent authority entrusted with the national application of Article 458 of the CRR, the EBA is required to provide its opinion on the points referred to in Article 458(2) of the CRR to the Council, the European Commission and the Member State concerned.

4. In accordance with Article 14(2) of the Rules of Procedure of the EBA[2], the Board of Supervisors has adopted this opinion.

[1] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

[2] Decision of the EBA concerning the Rules of Procedure of the Board of Supervisors of 22 January 2020 (EBA/DC/2020/307).

Background of the measure to be extended

5. The measure consists of a tightening of large exposure limits in relation to exposures to highly indebted large NFCs that are resident in France. In particular, French systemically important institutions are not to incur an exposure that exceeds 5% of their eligible capital for NFCs or groups of connected NFCs assessed to be highly indebted. For the application of the stricter limit, the exposures have to fulfil all of the following criteria:

   - They must be exposures as defined in Articles 389 and 390 of the CRR that are larger than or equal to EUR 300 million before taking into account the effect of credit risk mitigation (techniques and exemptions, in line with Article 9 of Commission Implementing Regulation (EU) No 680/2014.
   - They must be exposures of globally or domestically important institutions (currently six institutions[3]) at the highest level of consolidation of the banking prudential perimeter.
   - Exposures to NFCs[4]:
     - for NFCs resident in France, they are the sum of the net exposures towards the NFC and all its subsidiaries (resident in France or not);
     - for NFCs resident in France belonging to a foreign group, the large exposure limit applies to the sum of the exposure of NFCs resident in France at the highest level of consolidation.
   - The NFC's ultimate parent company fulfils both of the following criteria computed on a consolidated basis:
     - the net leverage ratio (defined as total financial debt less outstanding liquid assets on total equity) is higher than 100%;
     - the interest coverage ratio (defined as earnings before interest and taxes (EBIT)[5] divided by interest expenses) is lower than 3.

   The HCSF states that the calibration of its measure remains identical to when it was initially implemented. The measure has the same objectives of resilience (limiting concentration risks) and prevention (intensifying the vigilance about high leverage of NFCs). The extension will be applicable from 1 July 2020 until 30 June 2021.

[3] https://acpr.banque-france.fr/sites/default/files/media/2019/11/22/liste_aeis_2019_au_titre_2018.pdf.

[4] The HCSF states that its measure is fully aligned with Article 394 of the CRR with regard to the identification of groups of connected clients.

[5] The HCSF specifies that, given that the focus of the measure is on firms' medium-term vulnerability, the concept of EBIT – rather than earnings before interest, taxes, depreciation and amortisation – is preferred because it allows the assessment of whether a firm is economically viable.

6. The original measure was notified to the EBA on 13 February 2018 and the EBA provided its opinion[6] to the Council, the Commission and the Member State on 13 March 2018.

7. In its opinion, the EBA did not object to the adoption of this measure. The EBA stated that the objective of limiting indebtedness levels of large and already indebted French NFCs is appropriate with a view to promoting financial stability and preventing future systemic shocks to the French and EU economies.

8. However, the EBA raised some issues in its opinion dated 13 March 2018 including the following:

- The HCSF considered the proposed measure to be a preventative backstop. The EBA believed that the proposed measure would be more effective as a backstop if it were applied to the entire group of connected clients, as defined in Article 4(1)(39) of the CRR. The EBA suggested that French authorities could have used Pillar 2 to address the risk in a specific segment or institution.

- The proposed measure aimed to reduce institutions' concentration risk, particularly to riskier and more indebted NFCs. The EBA believed that the measure could be somewhat effective, although it did not capture any institution with such an exposure.

- While acknowledging that the secondary objective of the measure was to raise investors' awareness of risk associated with large and highly indebted firms, the EBA was of the opinion that this objective is less likely to be achieved.

- The EBA took note that the measure would be applied and monitored by the HCSF – with delegated powers given to the Autorité de contrôle prudentiel et de résolution (ACPR, the French Prudential Supervision and Resolution Authority) – in close contact with the ECB SSM for these six banks in case of a breach. Indeed, in France, the HCSF, as the 'designated authority', was and is currently in charge of the application of Article 458 of the CRR according to French law.

- The EBA welcomed the intention of the HCSF to closely monitor from a macroprudential perspective the impact of the proposed measure and to develop additional monitoring tools to assess the evolution of the financial situation of the NFCs. Against this background, the EBA encouraged close interaction between macro- and microprudential competent authorities to ensure that all the stakeholders involved adequately monitored this measure.

[6] Opinion of the European Banking Authority on measures in accordance with Article 458 of Regulation (EU) No 575/2013 of 13 March 2018 (EBA/Op/2018/02), available at https://eba.europa.eu/eba-issues-opinion-on-measures-to-address-macroprudential-ri-4.

Opinion on the extension

Economic rationale for the measure

9. The HCSF states that the increase in corporate debt was unchanged and strong until 2019 and that its assessment, which warranted the activation of the measure back then, remains valid. The HCSF is proposing to extend the period of application of its earlier decision of 1 July 2018 for 1 year until 30 June 2021.

10. The HCSF elaborates that unsustainable debt levels of large companies could generate a substantial negative impact on credit institutions' solvency position, if the credit institutions' exposure towards them were to be highly concentrated. This could in turn have negative consequences on the real economy, through second-round effects induced by banks' reactions (restriction of credit), which may have systemic consequences. In the current context of market stress, depressed demand for corporate bonds on markets could lead to a higher share of bank borrowing relative to market-based finance. It is important to ensure that exposures remain adequately diversified between institutions. This is particularly true given the high concentration of the banking sector in France, with the top six banks representing a large share of corporate loan ownership, and foreign banks representing only 7% of total loans to French NFCs. This makes the French banking sector more likely to bear excessive concentration risk. Hence, the proposed measure would provide a structural backstop on concentration risk that can prove useful in the current context, while at the same time not triggering excessive deleveraging.

11. The HCSF explains that the NFC debt growth has continued at a fast pace following the announcement of the measure in December 2017, and its implementation in July 2018. The total NFC annualised growth rate stood at 5.7% from November 2017 to November 2019. Although loans to large firms have not been the least dynamic segment, with a 3% annualised growth rate, large firms' debt growth has been fast, since the bulk of large firms' debt is in the form of debt securities (75% as of Q2 2019).

12. The NFC debt growth rate is well above the GDP growth rate, so the NFC debt-to-GDP ratio rose by 3.6 pp over the period according to the HCSF. Moreover, the HCSF attributes the increase mainly to an increase in aggregate net leverage. The HCSF characterises two specific vulnerabilities of French corporate debt, which allow one to infer that part of the aggregate increase in the net leverage ratio is due to large firms:

    - Corporate debt is highly concentrated, with large firms representing around 43% of total resident corporate borrowing. The top 20 groups accounted for about EUR 560 billion as of 2018 (including their foreign subsidiaries), nearly a third of total corporate debt.

    - Large firms have been particularly increasing their leverage ratio in response to the recent environment. The median leverage increased from 0.5 to around 0.6 from 2016 to 2018.

13. Despite the current low interest rate environment, the net leverage ratio of French firms has deteriorated over the past few years, as the HCSF outlines. For large firms, even the distribution

of the ratio of interest coverage by EBIT, which excludes principal repayment, has deteriorated in recent years. According to the HCSF, the amount of debt owed by firms breaching both set thresholds, however, remained stable. The HCSF also states that the highly indebted firms tend to deleverage and therefore the bulk of the debt increase over the past few years could therefore be attributed to an increase in indebtedness of firms with lower debt ratios.

14. The HCSF is of the opinion that the proposed measure would address indirectly the source of systemic risk coming from highly indebted NFC sector and is in line with the measure's objectives:

- Resilience: The measure mitigates the impact of idiosyncratic corporate defaults on the most systemic institutions by limiting concentration risk. The measure ensures that NFCs have a properly diversified lender base.

- Signalling: With regard to the sectors not covered by the measure, but which hold substantial amounts of corporate debt (insurance sector, asset management), the signalling function of Article 458 of the CRR should raise awareness of the associated risks.

Rationale for not using alternative measures

15. The CRR and Directive 2013/36/EU (the Capital Requirements Directive – CRD)[7] offer various options for addressing macroprudential risks. Article 458(2)(c) and (e) of the CRR requires the designated authority to justify why the stricter national measure is necessary and why other possible measures (i.e. under Articles 124 and 164 of the CRR and Articles 101, 103, 104, 105, 133 and 136 of the CRD) cannot adequately address the macroprudential or systemic risk identified, taking into account the relative effectiveness of those measures. The HCSF explains that these measures cannot adequately address the identified macroprudential or systemic risk of a highly indebted NFC sector:

- Articles 124 and 164 of the CRR deal with risk weights on exposures secured by mortgages on immovable property.

- Articles 101 to 105 of the CRD are microprudential in nature or address liquidity risk. Pillar 2 measures would not help to raise public awareness of the growing debt of French corporates.

- Article 133 and 136 of the CRD do not cover the nature of the macroprudential risks identified. The systemic risk buffer (SyRB) addresses long-term non-cyclical risk, whereas the identified risks are of a cyclical nature. The countercyclical buffer (CCyB) is also not suited to address the identified risk targeted with this measure.

16. Moreover, the HCSF also explains in its notification that a measure directly targeting the corporate debt markets to address the potential issues of highly indebted large non-financial

[7] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

corporations is not feasible and its effectiveness would not be ensured, for the following reasons:

- A significant proportion of large French NFCs issue bonds on foreign markets.

- The French Financial Markets Authority (AMF) does not have the power to limit the issuances of highly indebted NFCs. Similarly, the HCSF does not have restricting powers over bond issuances by NFCs.

- The AMF could alternatively reinforce the information requirements on issuing NFCs, in order to underline the risk associated with the targeted segment of firms. Nevertheless, the effectiveness of such a measure would probably be low, since these firms may choose to shift their issuance to foreign markets, in particular in Europe, with the same market depth and the same investor base.

Assessment and conclusions

17. Based on the evidence provided and the additional information received by the HCSF, and on the recommendation of the European Systemic Risk Board[8], the EBA acknowledges that the objectives of this measure are to ensure risk diversification across the biggest lenders for highly indebted corporate clients and to send a signal towards financial institutions and investors regarding the high leverage of large French NFCs. The measure helps to promote financial stability and prevent future systemic shocks to the French and EU economies. The proposed 1-year extension of the period of application of the measure comes in the middle of an unprecedented crisis, the impact of which is expected to significantly damage the real economy in the EU. As a response to it, fiscal and monetary policy measures have been implemented to ensure solvency and liquidity in all sectors of the economy. In the banking sector, microprudential and macroprudential authorities are encouraged to use in addition the flexibility embedded in the existing regulatory framework, where applicable, to support the viability, business continuity and credit supply of European banks. In this regard, the HCSF released the countercyclical buffer for France on 1 April 2020[9].

18. The EBA does not object to the 1-year extension of the period of application of the current measure but the EBA strongly encourages the French authorities to monitor closely the developments during the COVID-19 pandemic and to be ready to de-activate the measure promptly if its application leads to unintended consequences for the continued credit supply during the downturn. In particular, the EBA wonders whether such a flexible case-by-case approach that the HCSF intends to pursue in the event of a bank breaching this preventative measure is the most appropriate. The rationale of this measure was that a macroprudential measure would be better suited than a microprudential measure. Therefore, de-activation should also follow a macroprudential justification rather than a case-by-case approach.

[8] https://www.esrb.europa.eu/pub/pdf/recommendations/2019/esrb.amendment190211_2015_2.en.pdf.

[9] https://www.economie.gouv.fr/files/files/directions_services/hcsf/Decision_D-HCSF-2020-2_CCyB_vHCSF_signee.pdf.

19. In the light of the current circumstances and the COVID-19 pandemic, the EBA would like to provide some additional observations:

- Currently, no large and highly indebted NFC in France has reached the 5% limit for a single institution. In a context of higher demand for credit, this limit may be reached but it may also incentivise NFCs to broaden their lender basis to avoid exposures exceeding the tighter large exposures limit. During the COVID-19 pandemic crisis, NFCs may need to borrow more to overcome the weakening of the economy. In doing so, the leverage ratio of the NFCs will increase and in turn the interest coverage ratio will deteriorate, which will result in more NFCs falling under the scope of this measure. In relation to the ongoing COVID-19 pandemic, corporates in France may ask banks for loans – often government guaranteed – to offset temporary difficulties. The EBA understands that the part of the loan guaranteed by the government will not affect the large exposure limit and this may mitigate that effect[10].

- In addition, French NFCs are highly dependent on market funding. The debt issuance of NFCs is quite substantial and the shift towards market funding has been a secondary intended consequence of this initial measure. However, in the current environment, corporate debt issuance has been impaired and other forms of external financing have dried up[11]. This is especially the case for lower rated companies. If this risk materialises, lower rated NFCs may also turn to banks to get additional funding. This could trigger the result that the relevant exposures exceed the tighter large exposures limit set out in the measure as soon as the lender base is not diversified enough.

- On the other hand, institutions' capital ratios may deteriorate because losses resulting from COVD-19 reduce the denominator used to calculate the 5% limit. With potentially the numerator increasing and the denominator decreasing, the probability that the relevant exposures would exceed the tighter limit set out in the measure increases.

- The current economically challenging times may also discourage systemically important institutions in France from lending to large and highly indebted NFCs. Any restraints on lending during this current pandemic may cause some uncertainty in the market or even unintended effects such as contraction of credit supply.

20. In addition to these specific concerns, the EBA has other general observations.

- While acknowledging that the measure intends to spread the risk over a larger investor basis, the measure may not necessarily reduce the high levels of debt and enhance the resilience of large and highly indebted NFCs which itself can be a source of risk. The targeted NFCs might search for alternative funding sources (unregulated entities) and/or spread their bank borrowing across different institutions, namely other, smaller, institutions in France that

[10] The part of the loan guaranteed by the government qualifies as an eligible credit risk mitigation technique. As per Article 395 of the CRR, the large exposures ratio will not deteriorate with regard to the guaranteed part because these exposures are taken after credit risk mitigation techniques when computing the limit.

[11] https://www.bis.org/publ/bisbull11.pdf.

might be able to offer advantageous conditions on account of not being directly affected by the proposed measure.

- In addition, the EBA would welcome the HCSF's considering in further assessments the suitability and effectiveness of the measure in the light of the forthcoming changes in the applicable regulatory framework (in particular, the sectoral SyRB).

This opinion will be published on the EBA's website.

Done at Paris, 20 May 2020

[signed]

Jose Manuel Campa

Chairperson
For the Board of Supervisors