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EBA-Op-2021-05

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

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## Introduction and legal basis

1. On 5 May 2021, the European Banking Authority (EBA) received notification from the European Systemic Risk Board (ESRB) on the intention of the Haut Conseil de Stabilité Financière (HCSF, the French macroprudential authority) to apply Article 458(9) of Regulation (EU) No 575/2013 of the European Parliament and of the Council (Capital Requirements Regulation, CRR)<sup>1</sup>. This notification concerned the extension for a second time 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 one 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<sup>2</sup>, the Board of Supervisors has adopted this opinion.

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<sup>1</sup> 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).

<sup>2</sup> 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 tightens large exposure limits in relation to exposures larger than or equal to EUR 300 million, before taking into account the effect of credit risk mitigation<sup>3</sup>, of seven French globally or domestically important institutions<sup>4</sup> 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 Tier 1 capital for NFCs or groups of connected NFCs assessed to be highly indebted.<sup>5</sup> The notified measure considers resident large NFCs to be highly indebted when both their net leverage ratio (defined as total financial debt less outstanding liquid assets on total equity) is above 100% and their interest coverage ratio<sup>6</sup> (defined as earnings before interest and taxes, EBIT, divided by interest expenses) is lower than 3.
6. Due to amendments introduced to the CRR following the adoption of Regulation (EU) No 2019/876, in terms of the large exposure framework, the calibration of the limit is different compared to when the measure was initially implemented. According to the amendment of Article 392 of the CRR, the large exposure limit should be calculated based on Tier 1 capital instead of eligible capital, which was used during the period of initial application of the measure and during the period of its first extension. However, the HCSF proposes to maintain the same nominal threshold of 5%. Nevertheless, the HCSF clarifies that the measure has the same objectives of resilience (limiting concentration risks) and prevention (intensifying the vigilance about high leverage of NFCs) as the initial and extended measures.
7. The original measure was notified to the EBA on 13 February 2018 and the EBA provided its opinion<sup>7</sup> to the Council, the Commission and the Member State on 13 March 2018. On 23 April 2020, a first request for extension of the measure was notified to the EBA and the EBA submitted its opinion<sup>8</sup> to the Council, the Commission and the Member State on 20 May 2020. On 5 May 2021, the EBA received a request for a second extension of the measure, which will be applicable for two years from 1 July 2021 to 30 June 2023. The one institution which was added to the list of other systemically important institutions (O-SIIs) during 2020 is expected to conform to the requirements of this extension by the same date at which the new capital requirements as an O-SII will be fully phased in.

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<sup>3</sup> Exposures as defined in Articles 389 and 390 of Regulation (EU) No 575/2013 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.

<sup>4</sup> [https://acpr.banque-france.fr/sites/default/files/media/2020/11/12/liste\\_aeis\\_2020\\_au\\_titre\\_2019.pdf](https://acpr.banque-france.fr/sites/default/files/media/2020/11/12/liste_aeis_2020_au_titre_2019.pdf).

<sup>5</sup> The HCSF states that its measure is fully aligned with Article 394 of Regulation (EU) No 575/2013 with regard to the identification of groups of connected clients.

<sup>6</sup> 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.

<sup>7</sup> 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>.

<sup>8</sup> Opinion of the European Banking Authority on measures in accordance with Article 458 of Regulation (EU) No 575/2013 of 20 May 2020 (EBA/Op/2020/09), available at <https://www.eba.europa.eu/eba-issues-opinion-measures-address-macroprudential-risk-following-notification-french-high-council>.

8. In its opinions dating 13 March 2018 and 20 May 2020, the EBA did not object to the adoption and the first extension of this measure. The EBA stated that the objective of limiting indebtedness of large and already indebted French NFCs is appropriate to promote financial stability and prevent future systemic shocks to the French and EU economies.
9. However, the EBA raised some issues in its opinion dated 20 May 2020 including the following:
- The extension of the measure was notified amidst the unfolding of an unprecedented crisis, the impact of which was expected to significantly damage the real economy in the EU. The EBA strongly encouraged the French authorities to closely monitor the situation during the COVID-19 pandemic and stand ready to deactivate the notified measure.
  - Against this backdrop, the EBA raised concerns that the notified extension of the measure could constrain credit supply to targeted firms after a sharp deterioration of their financial health. Nevertheless, the EBA acknowledged that some of these effects could be mitigated by the supply of government-guaranteed loans, which will not affect the large exposure amount. The EBA noted that the extension of the measure occurred at a time when corporate debt issuance was impaired and thus credit demand for bank credit may increase. Furthermore, a possible deterioration of banks' own capital ratios could make the 5% large exposure limit more binding. Additionally, the measure could provoke market uncertainty and have unintended consequences on credit supply by discouraging markets or non-targeted financial institutions to lend to large and highly indebted NFCs.
  - To alleviate concerns regarding the impact on credit supply, the HCSF intended to pursue a flexible case-by-case approach in the event of a bank breaching this preventive measure. However, the EBA in its opinion considered this measure to be macroprudential in nature and thus its deactivation should also follow macroprudential considerations, rather than a case-by-case approach.
  - Further, the EBA observed that the measure may not necessarily reduce the high levels of debt and enhance the resilience of large and highly indebted NFCs. 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.

## Opinion on the extension

### Economic rationale for the measure

10. The HCSF states that corporate debt increased further in 2020 and that the assessment which warranted the activation of the measure in 2018 and its subsequent extension in 2020 remains valid. NFC debt growth accelerated further in 2020, standing at 13.1% between January 2020 and December 2020. Although loans to large firms have not been the most dynamic segment, large firms' debt growth has been fast, since the bulk of large firms' debt is in the form of debt securities. Thus, the HCSF is proposing to extend, for a second time, the period of application of its measure for two years until 30 June 2023.

11. The HCSF elaborates that the unsustainable debt levels of large companies could generate a substantial negative impact on credit institutions' solvency position and could lead through second-round effects to systemic consequences affecting the real economy. In the current COVID-19 pandemic, the surge in credit demand, accommodated through credit supply stimulus, could put further pressure on banks' balance sheets. In this context, it is important to ensure that exposures remain adequately diversified across institutions. This is particularly true given the high concentration of the banking sector in France, with the top seven banks representing a dominant share of corporate loan ownership,<sup>9</sup> and foreign banks representing only 6% of total loans to French NFCs.
12. According to HCSF figures, aggregate non-financial corporate sector leverage increased between 2016 and 2019, and in particular for large corporates. Despite the low interest rate environment, the interest coverage ratio of large French firms deteriorated over the past few years. However, the amount of debt owed by firms breaching the thresholds for both indicators of corporate vulnerability 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 be attributed to an increase in indebtedness of firms with lower debt ratios.
13. Against this backdrop of high concentration and increasing non-financial sector leverage, the HCSF is of the opinion that the proposed measure would address indirectly the source of systemic risk coming from the highly indebted NFC sector and is in line with the measure's objectives to increase resilience of systemic institutions and signal associated risks related to corporate debt to sectors not in the scope of the measure.
14. The HCSF does not expect the measure to have an adverse impact on the functioning of the internal market. The measure only targets large NFCs resident in France and their foreign subsidiaries. The latter are within the scope of the measure in order to limit opportunities for French NFCs to increase their lending from French systemically important institutions via their foreign subsidiaries. An additional consequence of the measure could be a shift of borrowing by affected NFCs to foreign banks. However, the HCSF highlights that the share of foreign banks to NFC lending in France has remained stable and low at around 6% over the period since the initial application of the measure in 2018.

### Rationale for not using alternative measures

15. The CRR and Directive 2013/36/EU (the Capital Requirements Directive – CRD)<sup>10</sup> 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 suitable, effective and proportionate to addressing the situation and why other possible measures (i.e. under

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<sup>9</sup> Based on figures provided by the HCSF, 84.6% of total assets and 96% of total loans to the non-financial private sector, residents and non-residents, distributed by the 27 French banks included in the Consolidated Banking Data (CBD – ECB Statistical Data Warehouse).

<sup>10</sup> 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).

Articles 124 and 164 of the CRR and Articles 133 and 136 of the CRD) would be less suitable and effective in addressing the macroprudential or systemic risk identified. 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 focus on risk weights on exposures secured by mortgages on immovable property, while the HCSF aims at addressing risks arising from increasing indebtedness of large French corporations. Therefore, the HCSF considers those provisions not relevant.
- The sectoral systemic risk buffer (SSyRB) could not target the macroprudential risk of concentration of banking exposures towards highly indebted large non-financial corporations, which is the primary motivation of the notified measure, because the interest coverage ratio and net leverage ratio metrics are not risk drivers in the EBA guidelines.<sup>11</sup> Furthermore, the HCSF deems the application of Article 133 of CRD in the current context as not appropriate, due to the encouragements towards banks to use their buffers.
- The countercyclical capital buffer (CCyB, Article 136 of the CRD) is also not deemed by the HCSF to be suited to addressing the identified risk due to the specific nature and structural component of the outlined risk.

### Assessment and conclusions

16. Based on the evidence provided, on additional information received by the HCSF, and on the recommendation of the European Systemic Risk Board<sup>12</sup>, the EBA acknowledges that the objectives of the notified extension of the measure are to ensure risk diversification across the biggest lenders for highly indebted corporate clients and to prevent build-up of debt. The measure helps to promote financial stability and prevent future systemic shocks to the French and EU economies by shielding individual systemically important lenders from idiosyncratic corporate defaults.
17. The proposed two-year extension of the period of application of the measure comes after an unprecedented shock following the COVID-19 pandemic while uncertainty still surrounds the economic outlook. Fiscal and monetary policy measures adopted as a response to the crisis remain accommodative, while banks continue to benefit from flexibility provided by microprudential and macroprudential authorities. Total credit to the NFC sector increased substantially while leverage in the NFC sector remained elevated. Large NFCs face a further deterioration of their relative equity position and interest coverage ratio as a continuation of

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[https://www.eba.europa.eu/sites/default/documents/files/document\\_library/Publications/Guidelines/2020/Guidelines%20on%20the%20appropriate%20subsets%20of%20exposures%20in%20the%20application%20of%20the%20systemic%20risk%20buffer/932759/Final%20Report%20on%20EBA%20draft%20GL%20on%20the%20appropriate%20subsets%20of%20exposures%20in%20the%20application%20of%20SSyRB.pdf](https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Guidelines/2020/Guidelines%20on%20the%20appropriate%20subsets%20of%20exposures%20in%20the%20application%20of%20the%20systemic%20risk%20buffer/932759/Final%20Report%20on%20EBA%20draft%20GL%20on%20the%20appropriate%20subsets%20of%20exposures%20in%20the%20application%20of%20SSyRB.pdf) .

<sup>12</sup> [https://www.esrb.europa.eu/pub/pdf/recommendations/2019/esrb.amendment190211\\_2015\\_2.en.pdf](https://www.esrb.europa.eu/pub/pdf/recommendations/2019/esrb.amendment190211_2015_2.en.pdf) .

the trend observed before the pandemic.<sup>13</sup> Against this backdrop, the considerations regarding corporate indebtedness, which led the HCSF to enact the measure in 2018 and extend it in 2020, remain relevant.

18. The EBA does not object to the two-year extension of the period of application of the current measure. However, according to figures provided by the HCSF, the number of large firms breaching both net leverage and interest coverage ratio thresholds increased over 2019. These indicators of firms' health, but also the number of firms breaching the thresholds for indebtedness, are expected to deteriorate further, as confirmed by an additional simulation provided by the HCSF. In light of the above, the EBA encourages the French authorities to monitor closely the developments during the application horizon of the measure and to be vigilant about any unintended consequences on credit supply.
19. The amended CRR large exposure framework, which will be in force at the time the measure is extended, leads to an implicit tightening of the proposed measure calibration when the same 5% nominal threshold is considered. The change in the limit calibration implies that the lending capacity of French systemically important institutions available for financing the targeted NFC sector decreases by approximately EUR 3 billion, according to data as of end-2020, compared to what would be available had the definition of the large exposure limit remained unchanged.
20. Considering the impact that the COVID-19 pandemic is having on the NFC sector, the EBA would like to provide some additional observations regarding the suitability, effectiveness and proportionality of the measure:
  - Due to the change in the list of systemically important institutions, a few large and highly indebted NFCs in France may breach the 5% limit when the extension of the measure comes into force. Therefore, the extension of the measure may entail an immediate impact on these firms and involved banks due to the need to undertake corrective actions.
  - Going forward and given the deterioration of financial positions of NFCs over 2020, it is likely that the number of large firms classified as highly indebted based on 2019 financial ratios is underestimated and this number could increase over the two-year horizon of the measure. Furthermore, a slower-than-expected recovery could hurt debt service ratios, thus increasing the number of firms in scope of the measure after the impact of the pandemic has receded.
  - While the EBA acknowledges that the measure intends to spread the risk over a larger investor base, the EBA notes that the measure may not necessarily reduce the high levels of NFC debt, a main source of vulnerability in the Member State<sup>14</sup>, and improve the resilience of large and highly indebted NFCs. According to figures provided by the HCSF, leverage of large NFCs continued to increase during the period 2018-2019, a period in which the measure was active and before the pandemic struck.

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<sup>13</sup> [https://publications.banque-france.fr/sites/default/files/medias/documents/2020\\_s2\\_ers\\_en.pdf](https://publications.banque-france.fr/sites/default/files/medias/documents/2020_s2_ers_en.pdf).

<sup>14</sup> [https://publications.banque-france.fr/sites/default/files/medias/documents/2020\\_s2\\_ers\\_en.pdf](https://publications.banque-france.fr/sites/default/files/medias/documents/2020_s2_ers_en.pdf).

- Even though the HCSF provides a flexible approach for meeting the large exposure limit, the affected NFCs might not be able to substitute limited credit supply by systemically important banks with lending from non-systemically important banks, which are not within the scope of the measure, or via market debt issuance. The intended signaling function of the measure could make other lenders and investors unwilling to undertake the lending obligations towards the affected firms. This could put at risk the supply of credit to NFCs at the time at which the recovery takes hold.
- In relation to the ongoing COVID-19 pandemic, corporations in France may have taken out loans – often government guaranteed – to offset temporary difficulties. The EBA understands that the part of the loan guaranteed by the government does not currently affect the large exposures limit due to its eligibility for credit risk mitigation<sup>15</sup>. However, the perimeter of the measure includes exposures larger than or equal to EUR 300 million to large NFCs or groups of connected NFCs before the effect of credit risk mitigation. If net borrowing needs to continue to increase in order to support the recovery, additional large NFCs could come within the scope of the measure. On the other hand, institutions might make undue use of credit mitigation techniques as a way to avoid breaching the imposed limit.
- Even though the measure could force highly indebted large NFCs to diversify their lender base, the measure could increase the interconnectedness of credit institutions via common exposures to large and highly indebted NFCs or groups of connected NFCs, making the financial system as a whole more vulnerable to idiosyncratic large corporate defaults.<sup>16</sup> Nevertheless, the share of systemically important institutions in NFC financing remained stable over 2020, according to the figures provided by the HCSF.

21. In addition to these specific considerations, the EBA has other general observations:

- In the case of banks breaching the large exposure limits, the HCSF maintains its intention to pursue a flexible case-by-case approach. The EBA reiterates its concerns on whether this approach is the most appropriate. The rationale of the action is that a macroprudential measure would be better suited to enhancing resilience of the banking sector to concentration risk than a microprudential measure. Therefore, deactivation and application of the measure should also follow a macroprudential justification rather than a case-by-case approach.
- In light of the structural nature and increasing trend in NFC indebtedness, the EBA welcomes the recent notice<sup>17</sup> of the HCSF on the availability of the SyRB. The EBA encourages the HCSF to consider in subsequent assessments the suitability and effectiveness of introducing a sectoral SyRB as a replacement to the Article 458 measure when the latter expires.

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<sup>15</sup> 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.

<sup>16</sup> [https://www.economie.gouv.fr/files/files/directions\\_services/hcsf/Traduction\\_RA2020HCSF.pdf](https://www.economie.gouv.fr/files/files/directions_services/hcsf/Traduction_RA2020HCSF.pdf) .

<sup>17</sup> [https://www.economie.gouv.fr/files/files/directions\\_services/hcsf/HCSF\\_20210318\\_Note\\_SyRB\\_0.pdf](https://www.economie.gouv.fr/files/files/directions_services/hcsf/HCSF_20210318_Note_SyRB_0.pdf) .

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

Done at Paris, 25 May 2021

[signed]

Jose Manuel Campa

Chairperson

For the Board of Supervisors