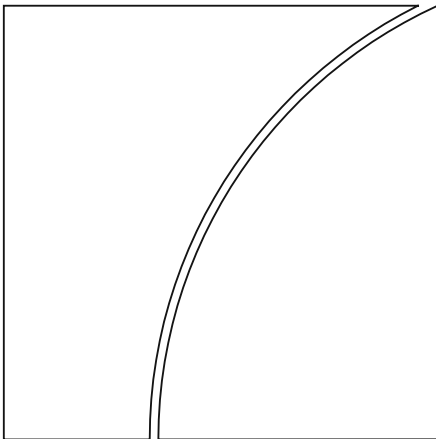


# Basel Committee on Banking Supervision

## Standards

### Supervisory framework for measuring and controlling large exposures

April 2014



**BANK FOR INTERNATIONAL SETTLEMENTS**

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## Abbreviations

ABS	Asset-backed securities
CDO	Collateralised debt obligation
CDS	Credit default swap
CCF	Credit conversion factor
CIU	Collective investment undertaking
CCP	Central counterparty
CRM	Credit risk mitigation
D-SIB	Domestic systemically important bank
ECAI	External credit assessment institution
G-SIB	Global systemically important bank
G-SIFI	Global systemically important financial institution
IRB	Internal ratings-based
LTA	Look-through approach
OTC	Over-the-counter
PD	Probability of default
Q-CCP	Qualifying central counterparty
SA-CCR	Standardised approach for counterparty credit risk
SIFI	Systemically important financial institution
SFT	Securities financing transaction

# Supervisory framework for measuring and controlling large exposures

## I. Introduction

### A. Rationale and objectives of a large exposures framework

1. One of the key lessons from the financial crisis was that banks did not always consistently measure, aggregate and control exposures to single counterparties or to groups of connected counterparties across their books and operations. Throughout history there have been instances of banks failing due to concentrated exposures to individual counterparties (eg Johnson Matthey Bankers in the United Kingdom in 1984, the Korean banking crisis in the late 1990s). Large exposures regulation has been developed as a tool for limiting the maximum loss a bank could face in the event of a sudden counterparty failure to a level that does not endanger the bank's solvency.

2. The need for banks to measure and limit the size of large exposures in relation to their capital has long been recognised by the Basel Committee on Banking Supervision (the Committee). In particular, in 1991, the Committee reviewed supervisory practices and issued supervisory guidance on large exposures.<sup>1</sup> In a similar vein, the *Core Principles for Effective Banking Supervision* (Core Principle 19) require that local laws and bank regulations set prudent limits on large exposures to a single borrower or a closely related group of borrowers.<sup>2</sup> But neither the 1991 guidance nor the Core Principles set out how banks should measure and aggregate their exposures to a single counterparty, nor do they explain which factors should be taken into account when considering whether separate legal entities form a group of connected counterparties. This has resulted in a considerable variation of practice across the globe. A stocktake of Committee member countries' regulations of large exposures showed considerable homogeneity in general (consistent with Core Principle 19) but revealed material differences in important aspects such as: scope of application; the value of large exposure limits; the definition of capital on which limits were based; methods for calculating exposure values; treatment of credit risk mitigation techniques; and whether certain types of exposures were subject to more lenient treatments.

3. A large exposures framework complements the Committee's risk-based capital standard because the latter is not designed specifically to protect banks from large losses resulting from the sudden default of a single counterparty. In particular, the minimum capital requirements (Pillar 1) of the Basel risk-based capital framework implicitly assume that a bank holds infinitely granular portfolios, ie no form of concentration risk is considered in calculating capital requirements. Contrary to this assumption, idiosyncratic risk due to large exposures to individual counterparties may be present in banks' portfolios. Although a supervisory review process (Pillar 2) concentration risk adjustment could be made to mitigate

<sup>1</sup> The first Basel Committee guidance on this topic, *Measuring and controlling large credit exposures*, was published in January 1991 in an attempt to increase convergence in the supervision of large exposures while recognising the scope for variation according to local conditions. This best practice for bank supervisors in the monitoring and controlling of large credit exposures was developed in the context of the standards in Basel I. It included numerical limits as a percentage of Basel I capital, the definition of which has been subsequently revised in later vintages of the Basel capital framework and more recently and substantively in Basel III.

<sup>2</sup> Principle 19 states "The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate concentrations of risk on a timely basis. Supervisors set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties." (The *Core Principles for Effective Banking Supervision*, published by the Committee in September 2012, are accessible at [www.bis.org/publ/bcbs230.pdf](http://www.bis.org/publ/bcbs230.pdf)).

this risk,<sup>3</sup> these adjustments are neither harmonised across jurisdictions, nor designed to protect a bank against very large losses from a single counterparty default. For this reason, the Committee has concluded that the existing risk-based capital framework is not sufficient to fully mitigate the microprudential risk from exposures that are large compared to a bank's capital resources. That framework needs to be supplemented with a simple large exposures framework that protects banks from traumatic losses caused by the sudden default of an individual counterparty or group of connected counterparties. To serve as a backstop to risk-based capital requirements, the large exposures framework should be designed so that the maximum possible loss a bank could incur if a single counterparty or group of connected counterparties were to suddenly fail would not endanger the bank's survival as a going concern.

4. The treatment of large exposures could also contribute to the stability of the financial system in a number of other ways, a consideration that the Committee believes should be reflected in the design of the large exposures framework.

5. A separate key lesson from the crisis is that material losses in one systemically important financial institution (SIFI) can trigger concerns about the solvency of other SIFIs, with potentially catastrophic consequences for global financial stability. There are at least two important channels for this contagion. First, investors may be concerned that other SIFIs might have exposures similar to those of the failing institution. For example, in 2008, in response to the announcement of material losses on exposures to some asset-backed securities (ABS) and collateralised debt obligations (CDOs) incurred by a number of large banks, investors withdrew funds from other banks believed to have similar exposures, threatening their liquidity and solvency. Second, and more directly, investors may be concerned that other SIFIs have direct large exposures to the failing SIFI, in the form of either loans or credit guarantees. For example, one of the key concerns regarding AIG in September 2008 was that a number of SIFIs were believed to have bought large amounts of credit protection from AIG. The Committee is of the view that the large exposures framework is a useful tool to mitigate the risk of contagion between global systemically important banks, thus supporting global financial stability. Consequently, a relatively tighter limit on exposures between G-SIBs is included in the framework.

6. This framework is also seen as a useful tool to contribute to strengthening the oversight and regulation of the shadow banking system in relation to large exposures.<sup>4</sup> In particular, this is the case for the proposals for the treatment of exposures to funds, securitisation structures and collective investment undertakings (CIU). The framework thus includes a requirement for banks to apply a look-through approach (LTA) when appropriate, and to assess possible additional risks that do not relate to the structure's underlying assets, but rather to the structure's specific features and to any third parties linked to the structure. Once these risks are identified, a new exposure must be recognised, where appropriate, which is subject to the large exposure limit.

7. As part of the Committee's broader efforts to avoid adding unnecessary complexity in the Basel standards, the framework follows, where practicable, existing standards in the Basel framework and departs from them only if this is necessary for the purpose of achieving the objectives of the large exposures framework. Accordingly, this document includes a number of references to the Basel risk-based capital framework.<sup>5</sup>

<sup>3</sup> The market risk framework also explicitly requires that trading book models for specific risk capture concentration risk.

<sup>4</sup> See FSB, *Shadow Banking: Strengthening Oversight and Regulation, Recommendations of the FSB*, October 2011, and in particular Recommendation 2, p 17.

<sup>5</sup> Unless stated otherwise, the corresponding document is *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version* (June 2006), which can be accessed at

## B. Other types of concentration risk

8. The Committee recognises that the risk from large exposures to single counterparties or groups of connected counterparties is not the only type of concentration risk that could undermine a bank's resilience. Other types include both sectoral and geographical concentrations of asset exposures; reliance on concentrated funding sources; and also a significant net short position in securities, because the bank may incur severe losses if the price of these securities increases. The Committee has decided to focus this framework on losses incurred due to default of a single counterparty or a group of connected counterparties and not to take into account any other type of concentration risk.

9. Similarly, intragroup exposures have not been included in the scope of this framework, although they could be considered as another source of concentration risk that might potentially endanger banks' survival.

## II. Overall design of a prudential framework for large exposures

### A. Scope and level of application

10. The large exposures framework is constructed to serve as a backstop and complement to the risk-based capital standards. As a consequence, it must apply at the same level as the risk-based capital requirements are required to be applied following paragraphs 21 and 22 of the Basel II text, ie at every tier within a banking group.

11. The large exposures framework is applicable to all internationally active banks. As with all other standards issued by the Committee, member jurisdictions have the option to set more stringent standards. They also have the option to extend the application to a wider range of banks, with the possibility – if they deem it necessary – to develop a different approach for banks that usually fall outside the scope of the Basel framework.<sup>6</sup>

12. The application of the large exposures framework at the consolidated level implies that a bank must consider all exposures to third parties across the relevant regulatory consolidation group and compare the aggregate of those exposures with the group's eligible capital base.

### B. Scope of counterparties and exemptions

13. A bank must consider exposures to any counterparty. The only counterparties that are exempted from the framework are sovereigns as defined in paragraph 61. Section IV sets out the types of counterparties that are exempted from the large exposure limit or for which another specific treatment is necessary.

[www.bis.org/publ/bcbs128.htm](http://www.bis.org/publ/bcbs128.htm), as subsequently modified by *Revisions to the Basel II market risk framework and Enhancements to the Basel II framework* both issued in July 2009 (accessible at <http://www.bis.org/publ/bcbs158.htm> and at <http://www.bis.org/publ/bcbs157.htm>) and by *Basel III: A global regulatory framework for more resilient banks and banking systems - revised version June 2011*, accessible at <http://www.bis.org/publ/bcbs189.htm>).

<sup>6</sup> For instance, the Committee notes that for these banks that fall outside the scope of application of the Basel framework, there may be a case for recognising physical collateral, which is not recognised in the large exposures framework set out in this document.

## C. Definition of a large exposure and regulatory reporting

14. The sum of all exposure values of a bank to a counterparty or to a group of connected counterparties, as defined in Section II part E below, must be defined as a large exposure if it is equal to or above 10% of the bank's eligible capital base. The exposure values must be measured as specified in Sections III and IV.

15. Banks must report to the supervisor the exposure values before and after application of the credit risk mitigation techniques. Banks must report to the supervisor:

- (i) all exposures with values measured as specified in Sections III and IV equal to or above 10% of the bank's eligible capital (ie meeting the definition of a large exposure);
- (ii) all other exposures with values measured as specified in Sections III and IV without the effect of credit risk mitigation being taken into account equal to or above 10% of the bank's eligible capital;
- (iii) all the exempted exposures with values equal to or above 10% of the bank's eligible capital;
- (iv) their largest 20 exposures to counterparties measured as specified in Sections III and IV and included in the scope of application, irrespective of the values of these exposures relative to the bank's eligible capital base.

## D. Minimum requirement – the large exposure limit

16. The sum of all the exposure values of a bank to a single counterparty or to a group of connected counterparties must not be higher than 25% of the bank's available eligible capital base at all times. However, as explained in Section V, this figure is set at 15% for a G-SIB's exposures to another G-SIB.

17. The exposures must be measured as specified in Sections III and IV. The eligible capital base is the effective amount of Tier 1 capital fulfilling the criteria defined in Part 1 of the Basel III framework.<sup>7</sup>

18. Breaches of the limit, which must remain the exception, must be communicated immediately to the supervisor and must be rapidly rectified.

## E. Definition of connected counterparties

19. In some cases, a bank may have exposures to a group of counterparties with specific relationships or dependencies such that, were one of the counterparties to fail, all of the counterparties would very likely fail. A group of this sort, referred to in this framework as a group of connected counterparties, must be treated as a single counterparty. In this case, the sum of the bank's exposures to all the individual entities included within a group of connected counterparties is subject to the large exposure limit and to the regulatory reporting requirements as specified above.

20. Two or more natural or legal persons shall be deemed a group of connected counterparties if at least one of the following criteria is satisfied.

- (a) Control relationship: one of the counterparties, directly or indirectly, has control over the other(s).

<sup>7</sup> *Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010 (rev June 2011)* is accessible at <http://www.bis.org/publ/bcbs189.pdf>.



(b) Economic interdependence: if one of the counterparties were to experience financial problems, in particular funding or repayment difficulties, the other(s), as a result, would also be likely to encounter funding or repayment difficulties.

21. Banks must assess the relationship amongst counterparties with reference to (a) and (b) above in order to establish the existence of a group of connected counterparties.

22. In assessing whether there is a control relationship between counterparties, banks must automatically consider that criterion (a) is satisfied if one entity owns more than 50% of the voting rights of the other entity.

23. In addition, banks must assess connectedness between counterparties based on control using the following criteria:

- Voting agreements (eg control of a majority of voting rights pursuant to an agreement with other shareholders);
- Significant influence on the appointment or dismissal of an entity's administrative, management or supervisory body, such as the right to appoint or remove a majority of members in those bodies, or the fact that a majority of members have been appointed solely as a result of the exercise of an individual entity's voting rights;
- Significant influence on senior management, eg an entity has the power, pursuant to a contract or otherwise, to exercise a controlling influence over the management or policies of another entity (eg through consent rights over key decisions).

24. Banks are also expected to refer to criteria specified in appropriate internationally recognised accounting standards for further qualitative guidance when determining control.

25. Where control has been established based on any of these criteria, a bank may still demonstrate to its supervisor in exceptional cases, eg due to the existence of specific circumstances and corporate governance safeguards, that such control does not necessarily result in the entities concerned constituting a group of connected counterparties.

26. In establishing connectedness based on economic interdependence, banks must consider, at a minimum, the following qualitative criteria:

- Where 50% or more of one counterparty's gross receipts or gross expenditures (on an annual basis) is derived from transactions with the other counterparty (eg the owner of a residential/commercial property and the tenant who pays a significant part of the rent);
- Where one counterparty has fully or partly guaranteed the exposure of the other counterparty, or is liable by other means, and the exposure is so significant that the guarantor is likely to default if a claim occurs;
- Where a significant part of one counterparty's production/output is sold to another counterparty, which cannot easily be replaced by other customers;
- When the expected source of funds to repay each loan one counterparty makes to another is the same and the counterparty does not have another source of income from which the loan may be fully repaid;
- Where it is likely that the financial problems of one counterparty would cause difficulties for the other counterparties in terms of full and timely repayment of liabilities;
- Where the insolvency or default of one counterparty is likely to be associated with the insolvency or default of the other(s);
- When two or more counterparties rely on the same source for the majority of their funding and, in the event of the common provider's default, an alternative provider cannot be found -in this

case, the funding problems of one counterparty are likely to spread to another due to a one-way or two-way dependence on the same main funding source.

27. There may, however, be circumstances where some of these criteria do not automatically imply an economic dependence that results in two or more counterparties being connected. Provided that the bank can demonstrate to its supervisor that a counterparty which is economically closely related to another counterparty may overcome financial difficulties, or even the second counterparty's default, by finding alternative business partners or funding sources within an appropriate time period, the bank does not need to combine these counterparties to form a group of connected counterparties.

28. There are cases where a thorough investigation of economic interdependencies will not be proportionate to the size of the exposures. Therefore, banks are expected to identify possible connected counterparties on the basis of economic interdependence in all cases where the sum of all exposures to one individual counterparty exceeds 5% of the eligible capital base.

### III. Values of exposures

29. This section refers to the values of exposures to counterparties, including to a group of connected counterparties identified according to Section II part E above that must be treated as a single counterparty.

#### A. General measurement principles

30. The exposure values a bank must consider in order to identify large exposures to a counterparty are all those exposures defined under the risk-based capital framework. It must consider both on- and off-balance sheet exposures included in either the banking or trading book and instruments with counterparty credit risk under the risk-based capital framework.

31. An exposure to a counterparty that is deducted from capital must not be added to other exposures to that counterparty for the purpose of the large exposure limit.<sup>8</sup>

#### B. Definition of exposure value

##### Banking book on-balance sheet non-derivative assets

32. The exposure value must be defined as the accounting value of the exposure.<sup>9</sup> As an alternative, a bank may consider the exposure value gross of specific provisions and value adjustments.

<sup>8</sup> This general approach does not apply where an exposure is 1,250% risk-weighted. When this is the case, this exposure must be added to any other exposures to the same counterparty and the sum is subject to the large exposure limit, except if this exposure is specifically exempted for other reasons.

<sup>9</sup> Net of specific provisions and value adjustments.

Banking book and trading book OTC derivatives (and any other instrument with counterparty credit risk)

33. The exposure value for instruments that give rise to counterparty credit risk and are not securities financing transactions must be the exposure at default according to the standardised approach for counterparty credit risk (SA-CCR).<sup>10</sup>

#### Securities financing transactions

34. The Committee is undertaking a review of the Standardised Approach for credit risk, which includes a review of the comprehensive approach used to the measurement of securities financing transaction (SFT) exposures. The Committee expects that the forthcoming revised comprehensive approach and supervisory haircuts<sup>11</sup> – or equivalent non-internal model method – will be appropriate for large exposures purposes. In this case, all banks must use the comprehensive approach with supervisory haircuts. The Committee's expectation is that the review of the standardised approaches will have been completed in advance of the implementation deadline for the large exposures framework, but in the event of a delay banks would be allowed to use the method they currently use for calculating their risk-based capital requirements against SFTs.

#### Banking book "traditional" off-balance sheet commitments

35. For the purpose of the large exposures framework, off-balance sheet items will be converted into credit exposure equivalents through the use of credit conversion factors (CCFs) by applying the CCFs set out for the standardised approach for credit risk for risk-based capital requirements, with a floor of 10%.

### C. Eligible credit risk mitigation (CRM) techniques

36. Eligible credit risk mitigation techniques for large exposures purposes are those that meet the minimum requirements and eligibility criteria for the recognition of unfunded credit protection<sup>12</sup> and financial collateral that qualify as eligible financial collateral under the standardised approach for risk-based capital requirement purposes.

37. Other forms of collateral that are only eligible under the Internal-ratings based (IRB) approach in accordance with paragraph 289 of the Basel II text (receivables, commercial and residential real estate and other collateral) are not eligible to reduce exposure values for large exposures purposes.

38. A bank must recognise an eligible CRM technique in the calculation of an exposure whenever it has used this technique to calculate the risk-based capital requirements, and provided it meets the conditions for recognition under the large exposures framework.

<sup>10</sup> See BCBS, March 2014, *The standardised approach for measuring counterparty credit risk exposures*, accessible at <http://www.bis.org/publ/bcbs279.htm>.

<sup>11</sup> The current comprehensive approach and standard supervisory haircuts are described in paragraphs 147 and followings and in paragraphs 151 to 153 respectively of the Basel II framework.

<sup>12</sup> Unfunded credit protection refers collectively to guarantees and credit derivatives the treatment of which is described in Part 2, Section D (The standardised approach – credit risk mitigation) of the Basel II framework.

## Treatment of maturity mismatches in CRM

39. In accordance with provisions set out in the risk-based capital framework,<sup>13</sup> hedges with maturity mismatches are recognised only when their original maturities are equal to or greater than one year and the residual maturity of a hedge is not less than three months.

40. If there is a maturity mismatch in respect of credit risk mitigants (collateral, on-balance sheet netting, guarantees and credit derivatives) recognised in the risk-based capital requirement, the adjustment of the credit protection for the purpose of calculating large exposures is determined using the same approach as in the risk-based capital requirement.<sup>14</sup>

## On-balance sheet netting

41. Where a bank has in place legally enforceable netting arrangements for loans and deposits, it may calculate the exposure values for large exposures purposes according to the calculation it uses for capital requirements purposes – ie on the basis of net credit exposures subject to the conditions set out in the approach to on-balance sheet netting in the risk-based capital requirement.<sup>15</sup>

## D. Recognition of CRM techniques in reduction of original exposure

42. A bank must reduce the value of the exposure to the original counterparty by the amount of the eligible CRM technique recognised for risk-based capital requirements purposes. This recognised amount is:

- the value of the protected portion in the case of unfunded credit protection;
- the value of the portion of claim collateralised by the market value of the recognised financial collateral when the bank uses the simple approach for risk-based capital requirements purposes;
- the value of the collateral adjusted after applying the required haircuts, in the case of financial collateral when the bank applies the comprehensive approach. The haircuts used to reduce the collateral amount are the supervisory haircuts under the comprehensive approach.<sup>16</sup> Internally modelled haircuts must not be used.

## E. Recognition of exposures to CRM providers

43. Whenever a bank is required to recognise a reduction of the exposure to the original counterparty due to an eligible CRM technique, it must also recognise an exposure to the CRM provider. The amount assigned to the CRM provider is the amount by which the exposure to the original counterparty is reduced (except in the cases defined in paragraph 57).

<sup>13</sup> See paragraphs 143 and 204 of the Basel II framework.

<sup>14</sup> See paragraphs 202 to 204 of the Basel II framework.

<sup>15</sup> See paragraphs 139 and 188 of the Basel II framework.

<sup>16</sup> The supervisory haircuts currently in use are described in paragraphs 151 to 153 of the Basel II framework.

## F. Calculation of exposure value for trading book positions

44. A bank must add any exposures to a single counterparty arising in the trading book to any other exposures to that counterparty that lie in the banking book to calculate its total exposure to that counterparty.

### Scope of large exposure limits in the trading book

45. The exposures considered in this section correspond to concentration risk associated with the default of a single counterparty for exposures included in the trading book (see paragraph 8). Therefore, positions in financial instruments such as bonds and equities must be constrained by the large exposure limit, but concentrations in a particular commodity or currency need not be.

### Calculation of exposure value for trading book positions

46. The exposure value of straight debt instruments and equities must be defined as the accounting value of the exposure (ie the market value of the respective instruments).

47. Instruments such as swaps, futures, forwards and credit derivatives must be converted into positions following the risk-based capital requirements.<sup>17</sup> These instruments are decomposed into their individual legs. Only transaction legs representing exposures in the scope of the large exposures framework need be considered.<sup>18</sup>

48. In the case of credit derivatives that represent sold protection, the exposure to the referenced name must be the amount due in the case that the respective referenced name triggers the instrument, minus the absolute value of the credit protection.<sup>19</sup> For credit-linked notes, the protection seller needs to consider positions both in the bond of the note issuer and in the underlying referenced by the note. For positions hedged by credit derivatives, see paragraphs 53 to 56.

49. The measures of exposure values of options under this framework differ from the exposure value used for risk-based capital requirements. The exposure value must be based on the change(s) in option prices that would result from a default of the respective underlying instrument. The exposure value for a simple long call option would therefore be its market value and for a short put option would be equal to the strike price of the option minus its market value. In the case of short call or long put options, a default of the underlying would lead to a profit (ie a negative exposure) instead of a loss, resulting in an exposure of the option's market value in the former case and equal the strike price of the option minus its market value in the latter case. The resulting positions will in all cases be aggregated with those from other exposures. After aggregation, negative net exposures must be set to zero.

50. Exposure values of banks' investments in transactions (ie index positions, securitisations, hedge funds or investment funds) must be calculated applying the same rules as for similar instruments in the banking book (see Section IV part D). Hence, the amount invested in a particular structure may be

<sup>17</sup> See paragraph 718 (x – xii).

<sup>18</sup> A future on stock X, for example, is decomposed into a long position in stock X and a short position in a risk-free interest rate exposure in the respective funding currency, or a typical interest rate swap is represented by a long position in a fixed and a short position in a floating interest rate exposure or vice versa.

<sup>19</sup> In the case that the market value of the credit derivative is positive from the perspective of the protection seller, such a positive market value would also have to be added to the exposure of the protection seller to the protection buyer (counterparty credit risk; see paragraph 33 of this framework). Such a situation could typically occur if the present value of already agreed but not yet paid periodic premiums exceeds the absolute market value of the credit protection.

assigned to the structure itself, defined as a distinct counterparty, to the counterparties corresponding to the underlying assets, or to the unknown client, following the rules described in paragraphs 72 to 76).

## G. Offsetting long and short positions in the trading book

### Offsetting between long and short positions in the same issue

51. Banks may offset long and short positions in the same issue (two issues are defined as the same if the issuer, coupon, currency and maturity are identical). Consequently, banks may consider a net position in a specific issue for the purpose of calculating a bank's exposure to a particular counterparty.

### Offsetting between long and short positions in different issues

52. Positions in different issues from the same counterparty may be offset only when the short position is junior to the long position, or if the positions are of the same seniority.

53. Similarly, for positions hedged by credit derivatives, the hedge may be recognised provided the underlying of the hedge and the position hedged fulfil the provision of paragraph 52 above (the short position is junior or of equivalent security to the long position).

54. In order to determine the relative seniority of positions, securities may be allocated into broad buckets of degrees of seniority (for example, "Equity", "Subordinated Debt" and "Senior Debt").

55. For those banks that find it excessively burdensome to allocate securities to different buckets based on relative seniority, they may recognise no offsetting of long and short positions in different issues relating to the same counterparty in calculating exposures.

56. In addition, in the case of positions hedged by credit derivatives, any reduction in exposure to the original counterparty will correspond to a new exposure to the credit protection provider, following the principles underlying the substitution approach stated in paragraph 43, except in the case described in paragraph 57.

57. When the credit protection takes the form of a CDS and either the CDS provider or the referenced entity is not a financial entity, the amount to be assigned to the credit protection provider is not the amount by which the exposure to the original counterparty is reduced but, instead, the counterparty credit risk exposure value calculated according to the SA-CCR.<sup>20</sup> For the purposes of this paragraph, financial entities comprise:

- (i) regulated financial institutions, defined as a parent and its subsidiaries where any substantial legal entity in the consolidated group is supervised by a regulator that imposes prudential requirements consistent with international norms. These include, but are not limited to, prudentially regulated insurance companies, broker/dealers, banks, thrifts and futures commission merchants; and
- (ii) unregulated financial institutions, defined as legal entities whose main business includes: the management of financial assets, lending, factoring, leasing, provision of credit enhancements, securitisation, investments, financial custody, central counterparty services, proprietary trading and other financial services activities identified by supervisors.

<sup>20</sup> See BCBS, March 2014, *The standardised approach for measuring counterparty credit risk exposures*, accessible at <http://www.bis.org/publ/bcbs279.htm>.

Offsetting short positions in the trading book against long positions in the banking book

58. Netting across the banking and trading books is not permitted.

Net short positions after offsetting

59. When the result of the offsetting is a net short position with a single counterparty, this net exposure need not be considered as an exposure for large exposure purposes (see paragraph 45).

## IV. Treatment of specific exposure types

60. This section covers exposures for which a specific treatment is deemed necessary. Any exposure type not included in this part is subject in all respects to the large exposure limit.

### A. Sovereign exposures and entities connected with sovereigns

61. As set out in paragraph 13, banks' exposures to sovereigns and their central banks are exempted. This exemption also applies to public sector entities treated as sovereigns according to the risk-based capital requirement. Any portion of an exposure guaranteed by, or secured by financial instruments issued by, sovereigns would be similarly excluded from the scope of this framework to the extent that the eligibility criteria for recognition of the credit risk mitigation are met.

62. Where two (or more) entities that are outside the scope of the sovereign exemption are controlled by or economically dependent on an entity that falls within the scope of the sovereign exemption defined in paragraph 61, and are otherwise not connected, those entities need not be deemed to constitute a group of connected counterparties [pursuant to Section II Part E above].

63. However, as specified in paragraph 15 (iii) above, a bank must report exposures subject to the sovereign exemption if these exposures meet the criteria for definition as a large exposure (see paragraph 14).

64. In addition, if a bank has an exposure to an exempted entity which is hedged by a credit derivative, the bank will have to recognise an exposure to the counterparty providing the credit protection as prescribed in paragraph 43 and 57, notwithstanding the fact that the original exposure is exempted.

### B. Interbank exposures

65. To avoid disturbing the payment and settlement processes, intraday interbank exposures are not subject to the large exposures framework, either for reporting purposes or for application of the large exposure limit.

66. In stressed circumstances, supervisors may have to accept a breach of an interbank limit ex post, in order to help ensure stability in the interbank market.

67. For other interbank exposures, the Committee will undertake further observation and consider whether, for the purposes of ensuring there are no unavoidable adverse consequences for the implementation of monetary policy, a specific treatment for a limited range of interbank exposures may be necessary. This observation period, and any subsequent adjustments to this framework, will be concluded by 2016.

## C. Covered bonds

68. Covered bonds are bonds issued by a bank or mortgage institution and are subject by law to special public supervision designed to protect bond holders. Proceeds deriving from the issue of these bonds must be invested in conformity with the law in assets which, during the whole period of the validity of the bonds, are capable of covering claims attached to the bonds and which, in the event of the failure of the issuer, would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest.

69. A covered bond satisfying the conditions set out in paragraph 70 may be assigned an exposure value of no less than 20% of the nominal value of the bank's covered bond holding. Other covered bonds must be assigned an exposure value equal to 100% of the nominal value of the bank's covered bond holding. The counterparty to which the exposure value is assigned is the issuing bank.

70. To be eligible to be assigned an exposure value of less than 100%, a covered bond must satisfy all the following conditions:

- it must meet the general definition set out in paragraph 68;
- the pool of underlying assets must exclusively consist of:
  - claims on, or guaranteed by, sovereigns, their central banks, public sector entities or multilateral development banks;
  - claims secured by mortgages on residential real estate that would qualify for a 35% or lower risk weight under the Basel II Standardised Approach for credit risk and have a loan-to-value ratio of 80% or lower; and/or
  - claims secured by commercial real estate that would qualify for the 100% or lower risk-weight under the Basel II Standardised Approach for credit risk and with a loan-to-value of 60% or lower;
- The nominal value of the pool of assets assigned to the covered bond instrument(s) by its issuer should exceed its nominal outstanding value by at least 10%. The value of the pool of assets for this purpose does not need to be that required by the legislative framework. However, if the legislative framework does not stipulate a requirement of at least 10%, the issuing bank needs to publicly disclose on a regular basis that their cover pool meets the 10% requirement in practice. In addition to the primary assets listed in para 70, the additional collateral may include substitution assets (cash or short term liquid and secure assets held in substitution of the primary assets to top up the cover pool for management purposes) and derivatives entered into for the purposes of hedging the risks arising in the covered bond programme.

71. In order to calculate the required maximum loan-to-value for residential real estate and commercial real estate referred to in paragraph 70 above, the operational requirements included in paragraph 509 of the Basel II framework regarding the objective market value of collateral and the frequent revaluation must be used. The conditions set out in paragraph 70 must be satisfied at the inception of the covered bond and throughout its remaining maturity.



## D. Collective investment undertakings, securitisation vehicles and other structures

72. Banks must consider exposures even when a structure lies between the bank and the exposures, that is, even when the bank invests in structures through an entity which itself has exposures to assets (hereafter referred to as the "underlying assets"). Banks must assign the exposure amount, ie the amount invested in a particular structure, to specific counterparties following the approach described below. Such structures include funds, securitisations and other structures with underlying assets.

### Determination of the relevant counterparties to be considered

73. A bank may assign the exposure amount to the structure itself, defined as a distinct counterparty, if it can demonstrate that the bank's exposure amount to each underlying asset of the structure is smaller than 0.25% of its eligible capital base, considering only those exposures to underlying assets that result from the investment in the structure itself and using the exposure value calculated according to paragraphs 78 and 79.<sup>21</sup> In this case, a bank is not required to look through the structure to identify the underlying assets.

74. A bank must look through the structure to identify those underlying assets for which the underlying exposure value is equal to or above 0.25% of its eligible capital base. In this case, the counterparty corresponding to each of the underlying assets must be identified so that these underlying exposures can be added to any other direct or indirect exposure to the same counterparty. The bank's exposure amount to the underlying assets that are below 0.25% of the bank's eligible capital base may be assigned to the structure itself (ie partial look-through is permitted).

75. If a bank is unable to identify the underlying assets of a structure:

- where the total amount of its exposure does not exceed 0.25% of its eligible capital base, the bank must assign the total exposure amount of its investment to the structure;
- otherwise, it must assign this total exposure amount to the unknown client.

The bank must aggregate all unknown exposures as if they related to a single counterparty (the unknown client), to which the large exposure limit would apply.

76. When the look-through approach (LTA) is not required according to paragraph 73, a bank must nevertheless be able to demonstrate that regulatory arbitrage considerations have not influenced the decision whether to look through or not – eg that the bank has not circumvented the large exposure limit by investing in several individually immaterial transactions with identical underlying assets.

### Calculation of underlying exposures - bank's exposure amount to underlying assets

77. If the LTA need not be applied, a bank's exposure to the structure must be the nominal amount it invests in the structure.

### *Any structure where all investors rank pari passu (eg CIU)*

78. When the LTA is required according to the paragraphs above, the exposure value assigned to a counterparty is equal to the pro rata share that the bank holds in the structure multiplied by the value of the underlying asset in the structure. Thus, a bank holding a 1% share of a structure that invests in 20 assets each with a value of 5 must assign an exposure of 0.05 to each of the counterparties. An exposure

<sup>21</sup> By definition, this required test will be passed if the bank's whole investment in a structure is below 0.25% of its eligible capital base.

to a counterparty must be added to any other direct or indirect exposures the bank has to that counterparty.

*Any structure with different seniority levels among investors (eg securitisation vehicles)*

79. When the LTA is required according to the paragraphs above, the exposure value to a counterparty is measured for each tranche within the structure, assuming a pro rata distribution of losses amongst investors in a single tranche. To compute the exposure value to the underlying asset, a bank must:

- first, consider the lower of the value of the tranche in which the bank invests and the nominal value of each underlying asset included in the underlying portfolio of assets
- second, apply the pro rata share of the bank's investment in the tranche to the value determined in the first step above.

Identification of additional risks

80. Banks must identify third parties that may constitute an additional risk factor inherent in a structure itself rather than in the underlying assets. Such a third party could be a risk factor for more than one structure that a bank invests in. Examples of roles played by third parties include originator, fund manager, liquidity provider and credit protection provider.

81. The identification of an additional risk factor has two implications.

- The first implication is that banks must connect their investments in those structures with a common risk factor to form a group of connected counterparties. In such cases, the manager would be regarded as a distinct counterparty so that the sum of a bank's investments in all of the funds managed by this manager would be subject to the large exposure limit, with the exposure value being the total value of the different investments. But in other cases, the identity of the manager may not comprise an additional risk factor – for example, if the legal framework governing the regulation of particular funds requires separation between the legal entity that manages the fund and the legal entity that has custody of the fund's assets. In the case of structured finance products, the liquidity provider or sponsor of short-term programmes (asset-backed commercial paper – ABCP – conduits and structured investment vehicles – SIVs) may warrant consideration as an additional risk factor (with the exposure value being the amount invested). Similarly, in synthetic deals, the protection providers (sellers of protection by means of CDS/guarantees) may be an additional source of risk and a common factor for interconnecting different structures (in this case, the exposure value would correspond to the percentage value of the underlying portfolio).
- The second implication is that banks may add their investments in a set of structures associated with a third party that constitutes a common risk factor to other exposures (such as a loan) it has to that third party. Whether the exposures to such structures must be added to any other exposures to the third party would again depend on a case-by-case consideration of the specific features of the structure and on the role of the third party. In the example of the fund manager, adding together the exposures may not be necessary because potentially fraudulent behaviour may not necessarily affect the repayment of a loan. The assessment may be different where the risk to the value of investments underlying the structures arises in the event of a third-party default. For example, in the case of a credit protection provider, the source of the additional risk for the bank investing in a structure is the default of the credit protection provider. The bank must add the investment in the structure to the direct exposures to the credit protection provider since both exposures might crystallise into losses in the event that the protection provider defaults (ignoring the covered part of the exposures may lead to the undesirable situation of a high concentration risk exposure to issuers of collateral or providers of credit protection).

82. It is conceivable that a bank may consider multiple third parties to be potential drivers of additional risk. In this case, the bank must assign the exposure resulting from the investment in the relevant structures to each of the third parties.

83. The requirement set out in paragraph 77 to recognise a structural risk inherent in the structure instead of the risk stemming from the underlying exposures is independent of whatever the general assessment of additional risks concludes.

## E. Exposures to central counterparties

84. The Committee will consider the appropriateness of setting out a large exposure limit for banks' exposures to qualifying central counterparties (QCCPs)<sup>22</sup> after an observation period that will be concluded in 2016. In the meantime, the assumption is that banks' exposures to QCCPs related to clearing activities are exempted from the large exposures framework.

85. In the case of non-QCCPs, banks must measure their exposure as a sum of both the clearing exposures described in paragraph 87 and the non-clearing exposures described in paragraph 89, and must respect the general large exposure limit of 25% of the eligible capital base.

86. The concept of connected counterparties described in paragraphs 19 to 28 does not apply in the context of exposures to CCPs that are specifically related to clearing activities.

### Calculation of exposures related to clearing activities

87. Banks must identify exposures to a CCP related to clearing activities and sum together these exposures. Exposures related to clearing activities are listed in the table below together with the exposure value to be used:

<sup>22</sup> The definition of QCCP for large exposures purposes is the same as that used for risk-based capital requirement purposes. A qualifying central counterparty (QCCP) is an entity that is licensed to operate as a CCP (including a license granted by way of confirming an exemption), and is permitted by the appropriate regulator/overseer to operate as such with respect to the products offered. This is subject to the provision that the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the CPSS-IOSCO Principles for Financial Market Infrastructures.

Trade exposures	The exposure value of trade exposures must be calculated using the exposure measures prescribed in other parts of this framework for the respective type of exposures (eg using the SA-CCR for derivative exposures).
Segregated initial margin	The exposure value is 0. <sup>23</sup>
Non-segregated initial margin	The exposure value is the nominal amount of initial margin posted.
Pre-funded default fund contributions	Nominal amount of the funded contribution. <sup>24</sup>
Unfunded default fund contributions	The exposure value is 0.
Equity stakes	The exposure value is the nominal amount. <sup>25</sup>

88. Regarding exposures subject to clearing services (the bank acting as a clearing member or being a client of a clearing member), the bank must determine the counterparty to which exposures must be assigned by applying the provisions of the risk-based capital requirements.<sup>26</sup>

### Other exposures

89. Other types of exposures that are not directly related to clearing services provided by the CCP, such as funding facilities, credit facilities, guarantees etc, must be measured according to the rules set out in Sections III and IV of this framework, as for any other type of counterparty. These exposures will be added together and be subjected to the large exposure limit.

## V. Large exposures rules for global systemically important banks

90. The large exposure limit applied to a G-SIB's exposure to another G-SIB is set at 15% of the eligible capital base (Tier 1). The limit applies to G-SIBs as identified by the Basel Committee and published annually by the FSB.<sup>27</sup> When a bank becomes a G-SIB, it and other G-SIBs must apply the 15% limit within 12 months of this event, which is the same time frame within which a bank that has become a G-SIB would need to satisfy its higher loss absorbency requirement.<sup>28</sup>

91. Member countries are at liberty to set more stringent standards, as with any other standards approved by the Committee. In particular, the concern about contagion that has led the Committee to propose a relatively tighter limit on exposures between G-SIBs applies, in principle, at the jurisdictional

<sup>23</sup> When the initial margin (IM) posted is bankruptcy-remote from the CCP – in the sense that it is segregated from the CCP's own accounts, eg when the IM is held by a third-party custodian – this amount cannot be lost by the bank if the CCP defaults; therefore, the IM posted by the bank can be exempted from the large exposure limit.

<sup>24</sup> The exposure value for pre-funded default fund contributions may need to be revised if applied to QCCPs and not only to non QCCPs.

<sup>25</sup> If equity stakes are deducted from the level of capital on which the large exposure limit is based, such exposures must be excluded from the definition of an exposure to a CCP.

<sup>26</sup> See BCBS, April 2014, *Capital requirements for bank exposures to central counterparties - final standard*, accessible at <http://www.bis.org/publ/bcbs282.pdf>.

<sup>27</sup> See BCBS, *Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement*, July 2013, available at <https://www.bis.org/publ/bcbs255.pdf>.

<sup>28</sup> See paragraph 58 of BCBS, *Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement: rules text*, July 2013.

level to D-SIBs. The Committee therefore encourages jurisdictions to consider applying stricter limits to exposures between D-SIBs and to exposures of smaller banks to G-SIBs. The same logic would also be valid for the application of tighter limits to exposures to non-bank G-SIFIs, and such a limit might be considered by the Committee in the future.

92. The assessment of the systemic importance of G-SIBs is made using data that relate to the consolidated group and, consistent with this, the additional loss absorbency requirement will apply to the consolidated group.<sup>29</sup> But, consistent with the additional loss absorbency requirement for G-SIBs, the application of the relatively tighter limit on exposures between G-SIBs at the consolidated level does not rule out the option for host jurisdictions of subsidiaries of a group that is identified as a G-SIB to also apply the limit at the individual legal entity or consolidated level within their jurisdiction, ie to impose the 15% limit on the subsidiaries' exposures to other G-SIBs (defined at the individual legal entity or consolidated level within their jurisdiction).

## VI. Implementation date and transitional arrangements

93. All aspects of the large exposures framework must be implemented in full by 1 January 2019. Banks must adjust their exposures to abide by the large exposure limit by that date since no grandfathering will be arranged for existing exposures.

94. Supervisors might nonetheless consider requesting that banks begin reporting large exposures to them on the basis of the Committee's proposals during a period up to 2019 to facilitate bank preparation and to identify any instances in which banks might have difficulties in transitioning to the new large exposures regulation.

<sup>29</sup> See paragraph 55 of BCBS, *Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement: rules text*, July 2013.