

MODEL METHODOLOGY

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Supervisory Framework for Measuring and Controlling Large Exposures

Summary

The Basel Committee on Banking Supervision (BCBS) released the final policy framework for the measurement and control of large exposures¹ in April 2014. The final framework takes into account the industry comments on the March 2013 proposal² and would replace the Committee's 1991 guidance. The revised framework will complement the risk-based capital standard by protecting banks from large losses resulting from the sudden default of a single counterparty or a group of connected counterparties. It will also protect banks from possible contagions in case of systemically important financial institutions (SIFIs). This framework represents a common minimum standard for measuring, aggregating and controlling single name concentration risk across jurisdictions, from both on- and off-balance sheet exposures, included in either the banking or trading book.

The framework will apply a general limit of 25% of a bank's Tier 1 capital to all of the bank's exposures to a single counterparty or groups of connected counterparties. A stricter limit of 15% of Tier 1 capital will apply to exposures between banks designated as global systemically important banks (G-SIBs). The framework will require exposures to OTC derivatives transactions to be determined using the recently finalized "standardized approach for measuring exposure at default for counterparty credit risk" (SA-CCR), even for the banks that have approval to use internal model (IMM) for estimating counterparty credit exposures for assessing risk weighted assets (RWA). The framework will also strengthen the oversight and regulation of the shadow banking system in relation to large exposures from funds, securitization structures and collective investment undertakings (CIUs). A summary of the revisions in the final framework over the March 2013 proposal is available in the appendix.

When compared to the large exposure rules proposed in US under Single Counterparty Credit Limit (SCCL) and in EU under Capital Requirements Directive IV (CRD IV), BCBS large exposure framework combines the stricter clauses from both rules. The BCBS framework considers only Tier 1 capital as opposed to including Tier 2 capital or total eligible capital, under US and EU rules respectively. The BCBS framework requires banks to capture exposures to both protection provider and collateral issuer, disallows use of internal models and prescribes use of the look-through approach for calculating exposures to investment and securitization vehicles.

Exposures to qualified central counterparties (QCCPs) related to clearing activities, which are currently exempted from the framework, would be under observation until 2016. The final framework will be applicable as of January 1, 2019.

¹ BCBS final standard on 'measurement and control of large exposures' ([link](#))

² BCBS consultative document on 'measurement and control of large exposures' ([link](#))

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1 Scope and Timeline

Large exposure is applicable to all internationally active banks. The framework will be applicable at the same level as risk-based capital standards are required. It will cover exposures to all counterparties, except for sovereigns. This framework considers only losses incurred due to the default of a single counterparty or a group of connected counterparties, and does not take into account any other type of concentration risk, including sector and geographic concentrations of asset exposures, reliance on concentrated funding sources, significant net short position in securities, and intragroup exposures.

The Basel Committee expects national supervisors to implement the large exposures framework by January 1, 2019. Supervisors may also require banks to begin reporting large exposures before 2019 to facilitate bank preparations and to identify any difficulties in transition.

2 Large Exposure Definition, Limits and Regulatory Reporting

The Basel Committee definition of large exposures is when the sum of all exposures of a bank to a counterparty, or to a group of connected counterparties, is equal to or above 10% of the bank's eligible capital base (i.e. Tier 1 capital). The 10% threshold is in contrast to the 5% limit proposed earlier, and includes exposures which are both on- and off-balance sheet, and in either the banking or trading book.

Connected counterparties are defined as counterparties with a control relationship or economic interdependence such that one's default can lead to default of the other. They will be treated as a single counterparty when applying the large exposure framework. All counterparties for which the sum of the exposures exceeds 5% of the eligible capital base will be assessed for economic interdependence to identify possible connected counterparties.

The framework requires that the banks must report:

- » All exposures with values equal to or above 10% of the bank's eligible capital
- » All other exposures with values measured without the effect of credit risk mitigation being taken into account if they are equal to or above 10% of the bank's eligible capital
- » All the exempted exposures with values equal to or above 10% of the bank's eligible capital
- » Largest 20 exposures to counterparties included in the scope of application, irrespective of the values of these exposures relative to the bank's eligible capital base

The sum of all the exposure values of a bank to a single counterparty or to a group of connected counterparties must never be higher than 25% of the bank's available eligible capital base (i.e. Tier 1 capital). For a G-SIB's exposures to another G-SIB, the cap will be 15%. The Committee also encourages jurisdictions to consider applying stricter limits to exposures between domestic systemically important banks (D-SIBs) and that of small banks to G-SIBs and D-SIBs.

3 Exposure Value

Both on- and off-balance sheet exposures included in either the banking or the trading book and instruments with counterparty credit risk will be constrained by the large exposure limit to manage the concentration risk associated with the default of a single counterparty. The exposure value varies by asset type and book, as follows:

- » Banking book, on-balance sheet, non-derivative assets: calculated as the accounting value of the exposure
- » Banking book and trading book OTC derivatives:
 - » All instruments, except security financing transactions (SFTs): calculated using SA-CCR
 - » SFTs: calculated as in case of risk-based capital requirements, until the Basel committee completes review of the comprehensive approach for measuring SFT exposures
- » Banking book "traditional" off-balance sheet commitments: equal to the credit exposure equivalents calculated using credit conversion factors (CCFs) used for the standardized approach for credit risk with a floor of 10%
- » Trading book exposures in financial instruments (except for commodity or currency exposures):
 - » Straight debt instruments and equities: calculated as the accounting value (i.e. the market value) of the exposure
 - » Instruments such as swaps, futures, forwards and credit derivatives: calculated by decomposing the instruments into individual legs and considering only the exposures from transaction legs in scope of the large exposure framework
 - » Options: based on the change in option prices that would result from a default of the respective underlying instrument
 - » Investments in transactions (i.e. index positions, securitizations, hedge funds or investment funds): calculated as per the banking book rules

3.1 Eligible Credit Risk Mitigation (CRM) Techniques and Netting Conditions

Value of the exposure to the counterparty will be reduced by the amount of eligible CRM technique. Only the unfunded credit protection and financial collateral that meets the minimum requirements and eligibility criteria as under the standardized approach for risk-based capital requirements would qualify for CRM. Other forms of collateral that are only eligible under the IRB approach in accordance with the Basel II text³ (receivables, commercial and residential real estate and other collateral) are not eligible to reduce exposure values for large exposures purposes.

Reduction amount will be recognized as an exposure to the CRM provider. Eligible CRM amount will be:

- » The value of the protected portion in the case of unfunded credit protection
- » The value of the portion of claim collateralized by the market value of the recognized 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 supervisory haircuts, in the case of financial collateral when the bank applies the comprehensive approach

With legally enforceable netting arrangements in place for loans and deposits, a bank will be allowed to consider netted credit exposures for calculating the exposure value. The netted credit exposure must be calculated in accordance with the on-balance sheet netting rules as under the risk-based capital requirement.

³ Paragraph 289 of the Basel II framework ([link](#))

3.2 Offsetting in Trading Book

- » Long and short positions in the same issue may be offset. Two issues are defined as the same if the issuer, coupon, currency and maturity are identical.
- » 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 using broad buckets of degrees of seniority, for example equity, subordinated debt and senior debt.
- » For hedges to be recognized in case of credit derivatives, the underlying hedge and the position hedged should fulfill the condition that the short position is junior or of equivalent seniority to the long position. Any reduction in original exposure will be recognized as an exposure to the credit protection provider. For CDS, it should be calculated as per SA-CCR, when either the CDS provider or the referenced entity is not a financial entity.
- » Netting across the banking and trading books is not permitted.
- » Net short positions with a single counterparty will not be considered as an exposure for large exposure purposes.

4 Treatment of specific exposures

4.1 Sovereign Exposures

Exposures to sovereigns and their central banks are exempted. The exemption also applies to public-sector entities treated as sovereigns. However, such exposures must be reported if they meet the large exposure criterion. Any portion of an exposure guaranteed/secured by eligible financial instruments issued by sovereigns would also be excluded.

4.2 Interbank Exposures

In contrast to the initial proposal to treat interbank exposures similar to any other third-party exposures, the final framework excludes intraday interbank exposures from being subjected to the large exposures framework. The BCBS Committee will undertake further observation until 2016 and consider whether a specific treatment for a limited range of interbank exposures may be necessary.

4.3 Covered Bonds

Covered bonds meeting specific conditions may be assigned an exposure value of no less than 20% and other covered bonds an exposure value of 100% of the nominal value of the bank's covered bond holding.

4.4 CIUs, Securitization Vehicles and Other Structures

- » Instead of the granularity test proposed earlier, the final framework will require banks to look through the structure and compare the underlying assets' underlying exposure value with 0.25% of its eligible capital base.
 - » If a bank's exposure amount to each underlying asset of the structure is smaller than 0.25% of its eligible capital base, the bank may assign the exposure amount to the structure itself, defined as a distinct counterparty.
 - » Otherwise, the underlying assets for which the underlying exposure values are equal to or above 0.25% of the eligible capital base, those underlying exposures will be grouped with any other direct or indirect exposure to the same counterparty. The exposure amounts to the underlying assets that are below 0.25% of the eligible capital base may still be assigned to the structure itself (partial look-through approach).

- » If a bank is unable to identify the underlying assets of a structure where the total amount of its exposure exceeds 0.25% of its eligible capital base, total exposure amount will be assigned to the unknown client.
- » Exposure calculation:
 - » If the look through approach (LTA) need not be applied, a bank's exposure to the structure will be the nominal amount it invests in the structure
 - » If the LTA is required:
 - » In structures like CIU, where all investors rank equally, the exposure value to a counterparty will be equal to the pro rata share that the bank holds in the structure multiplied by the value of the underlying asset in the structure
 - » In structures like securitization vehicles, where there are different seniority levels among investors, the exposure value to counterparty will be measured for each tranche within the structure, assuming a pro rata distribution of losses among investors in a single tranche. Exposure value will be calculated as 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, multiplied with the pro rata share of the bank's investment in the tranche
- » In addition, banks will also have to identify third parties that may add risk to 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 would include originator, fund manager, liquidity provider and credit-protection provider.

4.5 Exposure to central counterparties

- » Exposures to QCCPs will be exempted from the large exposures framework for now. The BCBS Committee will consider these exposures further during the observation period that will be concluded in 2016.
- » Exposures to non-QCCPs will be sum of both the clearing exposures and the non-clearing exposures, and the general large exposure limit of 25% of the eligible capital base will be applicable.
- » Concept of connected counterparties will not apply in the context of exposures to CCPs that are specifically related to clearing activities.
- » Exposure calculation:
 - » Exposures to a CCP related to clearing activities will have to be identified and summed up as in this table:

Exposure	Calculation
Trade exposures	The exposure value calculated using the exposure measures prescribed in this framework
Segregated initial margin	The exposure value is 0
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
Unfunded default fund contributions	The exposure value is 0
Equity stakes	The exposure value is the nominal amount

- » Other exposures not directly related to the clearing services provided by the CCP will be calculated as per the general rules of the large exposure framework and added together
- » For exposures subject to clearing services, with the bank acting as a clearing member or being a client of a clearing member, the bank will have to determine the counterparty to which exposures must be assigned by applying the provisions of the risk-based capital requirements

Appendix A: Summary of Primary Changes From the Proposed to the Final Framework

	FINAL FRAMEWORK	PROPOSED FRAMEWORK
Scope	<ul style="list-style-type: none"> » Framework applicable at every level for which risk-based capital requirements were applicable 	<ul style="list-style-type: none"> » Framework applicable at every level for which risk-based capital requirements were applicable. Exposures at solo level had to be monitored, even if large exposures framework was not applicable at the solo level.
Large Exposure Definition	<ul style="list-style-type: none"> » Exposures to a counterparty equal to or greater than 10% of bank's eligible capital base (Tier 1 capital) 	<ul style="list-style-type: none"> » Exposures to a counterparty equal to or greater than 5% of bank's eligible capital base
Exposure Limit	<ul style="list-style-type: none"> » Cap of 25% of eligible capital base for exposure to a single counterparty or to a group of connected counterparties » Cap of 15% of eligible capital base for a G-SIB's exposures to another G-SIB 	<ul style="list-style-type: none"> » Cap of 25% of eligible capital base for an exposure to a single counterparty or to a group of connected counterparties » No exposure cap limit specified for exposures of a G-SIB to another G-SIB
Exposure Value	<ul style="list-style-type: none"> » For banking book on-balance sheet non-derivative assets, accounting value of the exposure will be taken » For banking book and trading book OTC derivatives: <ul style="list-style-type: none"> » For all instruments except SFTs, exposure value will be calculated using SA-CCR » For SFT, exposure value will be calculated as in case of risk-based capital requirements, until the Basel committee completes the review of the comprehensive approach for measuring SFT exposures » For banking book "traditional" off-balance sheet commitments, credit exposure equivalents will be calculated using CCFs used for the standardized approach for credit risk for risk-based capital requirements with a floor of 10%. 	<ul style="list-style-type: none"> » For banking book on-balance sheet non-derivative assets, exposure value to be determined by accounting standards » For banking book and trading book OTC derivatives: <ul style="list-style-type: none"> » For all instruments except SFTs, exposure value to be calculated using CEM » For SFT, exposure value to be calculated using the comprehensive approach for SFTs with supervisory haircuts » For banking book "traditional" off-balance sheet commitments, credit exposure equivalents to be calculated using CCFs used for the standardized approach for credit risk for risk-based capital requirements.
Offsetting in Trading Book	<ul style="list-style-type: none"> » In case of CDS where either the CDS provider or the referenced entity is not a financial entity, any reduction in original exposure will be recognized as an exposure to the credit-protection provider and the exposure value will be calculated using SA-CCR. 	<ul style="list-style-type: none"> » No special treatment for CDS. Reduction amount itself will be recognized as an exposure to the credit protection provider.
Interbank Exposures	<ul style="list-style-type: none"> » Intraday interbank exposures will be out of scope 	<ul style="list-style-type: none"> » Intraday interbank exposures treated similar to any other third-party exposures
Covered bond exposures	<ul style="list-style-type: none"> » Covered bonds meeting specific conditions may be assigned an exposure value of no less than 20% and other covered bonds an exposure value of 100% of the nominal value of the bank's covered bond holding 	<ul style="list-style-type: none"> » No guidelines for covered bond exposures
Exposures From Investment in Structures	<ul style="list-style-type: none"> » Banks will look through the structure and compare the underlying assets' underlying exposure value with 0.25% of its eligible capital base to determine if they are material 	<ul style="list-style-type: none"> » Banks had to undergo a granularity test to identify if they need to apply the LTA and recognize the underlying names

References

1. Basel Committee on Banking Supervision, April 2014, "Supervisory Framework for Measuring and Controlling Large Exposures" – Final Standard ([link](#))
2. Basel Committee on Banking Supervision, March 2013, "Supervisory Framework for Measuring and Controlling Large Exposures" – Consultative Document ([link](#))

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