

# ALLEN & OVERY



## Capital Requirements Directive IV Framework *Large Exposures*

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# CRD IV Framework: *Large Exposures*

This briefing paper is part of a series of briefings on the implementation of Basel III in Europe via the Capital Requirements Directive IV<sup>1</sup> (**CRD IV**) and the Capital Requirements Regulation<sup>2</sup> (**CRR**), replacing the Banking Consolidation Directive<sup>3</sup> and the Capital Adequacy Directive.<sup>4</sup> The legislation is highly complex: these briefings are intended to provide a high-level overview of the architecture of the regulatory capital and liquidity framework and to draw attention to the legal issues likely to be

<sup>1</sup> 2013/36/EU.

<sup>2</sup> Regulation 575/2013.

<sup>3</sup> 2006/48/EU.

<sup>4</sup> 2006/49/EU.

relevant to the in-house lawyer. This briefing is for general guidance only and does not constitute definitive advice.

**NOTE: In relation to the topics discussed in this briefing, the CRR contains a number of discretions for member states in relation to national implementation. The regime may therefore differ across member states in a number of respects.**

**This briefing paper is based on information available as of 17 January 2014.**

## Background and scope

The large exposures regime is a key plank of regulation of the financial sector. It is important to ensure that firms and other regulated entities diversify their exposures. The large exposures regime aims to protect against systemic risk and the risk of a firm failing as a result of the failure of a market participant, by requiring firms to avoid undue concentration of risks in any one counterparty or group of counterparties.

This briefing paper discusses the scope of the large exposures rules under the CRR in the context of a UK regulated firm under the supervision of the Prudential Regulation Authority (the **PRA**).

## Sources

CRR (*Regulation 575/2013*): Part 4 Articles 387-403.

[UK Financial Conduct Authority \(FCA\) Policy Statement \(PS13/10\) CRD IV for Investment Firms \(December 2013\)](#).

[PRA Policy Statement \(PS7/13\) Strengthening capital standards: implementing CRD IV, feedback and final rules \(December 2013\)](#).

[PRA Supervisory Statement \(SS16/13\) Large exposures \(December 2013\)](#).

# Introduction

The large exposures regime requires banks and investment firms to monitor and control their large exposures. This entails identifying and reporting on large exposures.

In addition, to ensure due diversification of firms' holdings and avoid systemic risk associated with

significant reliance by one firm on any given counterparty, the rules also place limits on the maximum size of banking book exposure which a firm may have.

The requirements apply on a differentiated basis as between the trading book and the banking book.

# Application

The large exposures requirements apply on a solo basis to a bank or an investment firm whose authorisation permits it to undertake proprietary dealing or underwriting and on a consolidated basis to groups including such entities.<sup>5</sup>

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<sup>5</sup> Article 388 CRR removes from the scope of the large exposures rules investment firms within the scope of Articles 95(1) or 96(1) CRR, or groups which comprise only such investment firms and ancillary companies. Article 96(1) CRR includes certain firms which deal on own account but which do not have external customers. Article 493 CRR

exempts investment firms whose main business relates to commodity derivatives, financial contracts for differences or exotic derivatives on a transitional basis until the end of 2017 (or, if earlier, the date of any amendment to the CRR following review by the European Commission).

# What is an exposure? Identification of exposures, valuation and counterparties

In order to be within the scope of the large exposures rules, an item must be:

- (i) an exposure;
- (ii) to a counterparty or group of counterparties;
- (iii) "large"; and

(iv) not exempt.

## Identification of exposures

For the purposes of the large exposures rules, an exposure is any asset or off-balance sheet item, with the exception of exposures which are entirely deducted from a firm's financial resources and

certain exposures incurred in the ordinary course of settlement of payment services, foreign currency and securities transactions.

## Identification of counterparties: counterparties and groups of connected clients

Large exposures rules seek to capture the risk associated with concentration of risk. Assessing exposures solely on an entity-by-entity basis does not give an accurate reflection of the risk to which the firm is subject, as multiple entities may form the same risk – for example because they are members of the same group, or are cross-guaranteed. To mitigate this concern, the large exposures rules require that exposures be measured not simply on an entity-by-entity basis, but also across groups of connected counterparties.

## Counterparty

A counterparty is, in broad terms, the counterparty with respect to an exposure (for example, the borrower under a loan for a firm) or (where relevant) another person in respect of whom the firm is exposed to credit risk or the risk of loss if that person fails to meet its obligations (for example an issuer of a security which underlies a derivative held by the firm).

Where an exposure to a counterparty is protected by a guarantee or credit derivative<sup>6</sup> from a third party, the firm may treat the exposure as being to the third party and not to the counterparty, provided the guarantee or credit derivative complies with the requirements applicable to guarantees and credits derivatives (see Client Briefing 6 (*Unfunded Credit Risk Mitigation in the Banking Book: Guarantees and Credit Derivatives*)), and attracts a lower risk weight than the protected exposure. Where the guarantee or credit derivative has a currency mismatch with the relevant exposure, then a haircut

<sup>6</sup> Other than a credit-linked note (CLN) - self-issued CLNs are exempted under Article 400 CRR.

is required in relation to the recognition of the guarantee/credit derivative.

## Groups of connected clients

The rules provide for exposures to groups of connected clients to be treated effectively as a single exposure.

Exposures to a group of connected clients must be calculated by summing all the exposures to the individuals within the group definition. For this purpose the term ‘group of connected clients’ is defined in Article 4(39) of the CRR, and broadly captures counterparties under common control, or persons who are to be regarded as a single risk because they are so interconnected that, if one of them were to experience financial problems, the other or all of the others would also be likely to encounter funding or repayment difficulties.

## Problems with identifying counterparties – “look-through”

The identification of counterparties in the context, particularly, of structured finance transactions has given rise to some concerns. There was a lack of clarity historically (prior to amendments made to the CRD in 2010) as to whether, in the case of securitisations and other structures involving the repackaging of credit risk through an SPV or other vehicle, the counterparty should be the vehicle, the underlying credits or both.

Article 390 of the CRR provides that, in order to determine the overall exposure to a client or group of connected clients to which the institution has exposures through securitisations, collective investment undertakings or other transactions where there is an exposure to underlying assets, the institution must assess its underlying exposures taking into account the economic substance of the transaction. This parallels the existing requirement, which is subject of CEBS<sup>7</sup> Guidelines on the implementation of the revised large exposures regime (the **CEBS Guidelines**), but extends it to exposures which are not securitisations or collective

<sup>7</sup> The Committee of European Banking Supervisors.

investment undertakings. The article requires the European Banking Authority (**EBA**) to produce draft regulatory technical standards (**RTS**) by 1 January 2014 setting out how look-through should be used, and when the securitisation, collective investment scheme or other arrangement looked through can be disregarded for large exposure purposes. The EBA has produced draft legislation, which differs substantially from the CEBS Guidelines, particularly in respect of the treatment of unknown exposures and securitisation.

As pre-CRR, the starting point in setting out the calculation methodology is to require institutions to take all the reasonable steps to look through to the underlying assets and to identify the obligors of all credit risk exposures underlying the transaction. Where an institution is not able to identify the obligors of underlying exposures, the EBA draft proposes a requirement to add all these exposures to the same hypothetical ‘unknown client’ (subject to a *de minimis* exemption): the large exposures limit applies to the ‘unknown client’ in the same way it applies to any other single client. Therefore, all unknown exposures stemming from all transactions should be considered as a single risk and as one hypothetical ‘unknown client’.

## Definition of large exposure

A large exposure is defined as the total exposure of a firm to a counterparty or group of connected clients, whether in the banking book or trading book or both, which in aggregate equals or exceeds 10% of the firm’s eligible capital. Eligible capital for these purposes is the total of the firm’s Tier 1 capital and Tier 2 capital (see Client Briefing 2 (*Capital and Capital Adequacy*)), less deductions.

### Limits on large exposure in the banking book

In relation to the banking book, a firm must ensure that the total amount of its exposure to any counterparty, group of connected clients or

A further significant difference compared to the CEBS Guidelines is the proposal for a more punitive treatment for securitisation positions whereby all tranches in a securitisation would be treated equally as if they were a first loss tranche and therefore fully exposed to the underlying assets.

## Measurement of exposures

Exposures are measured in a manner broadly consistent with the assessment of exposures for the purposes of risk-weighting exposures in the trading and banking books.

Counterparty exposures are calculated in line with the measurement of exposures for the purposes of risk-weighting.

Issuer exposures in each of the trading and banking books are measured on a net basis as the excess of the book value of long positions over short positions in each financial instrument issued by the relevant issuer (subject to limited netting across non-identical financial instruments issued by the same issuer). Netting between the banking and trading book is not allowed for this purpose. Additional detailed requirements apply in respect of swaps, options and securities financing transactions.

connected counterparties, does not exceed 25% of eligible capital. Small institutions may have exposures to other institutions in excess of 25% subject to a cap of €150 million or 100% of eligible capital, whichever is lower.

### Capital charges on large exposures in the trading book

In relation to the trading book, the rules give greater latitude for incurring large exposures. The exposures in a firm’s trading book are exempt from the 25% limit but are subject to an additional capital

requirement in relation to the relevant trading exposures. This is a capital charge levied against the regulatory capital requirements associated with the trading book exposures exceeding the 25% limit times a multiplier. The multiplier is a percentage (varying from 200% to 900%) applied by reference to the excess that has persisted, and the amount of the excess exposure as a percentage of the firm's eligible capital.

## Lower limits (1): Ring-fencing

Article 395 of the CRR seeks to accommodate ring-fencing measures by allowing lower large exposure limits to apply to intra-group exposures on a sub-consolidated basis as between a ring-fenced subgroup and its wider group. The discretion to impose a lower limit is constrained by a floor on the limit of 15% until 30 June 2015, and 10% thereafter. Any ring-fencing measures are required to be notified to the European Commission, Council of the

European Union and competent authorities at least two months in advance of any decision to use the discretion, and the European Commission has the right to reject the measure under certain circumstances.

## Lower limits (2): Shadow banking

Shadow banking is a source of concern to the European authorities, but remains an embryonic area of study. Reflecting that concern, Article 395 of the CRR requires the EBA to conduct a study on exposures to shadow banking entities (which term is undefined) to assess whether there should be aggregate limits on exposures to shadow banks and/or lower individual large exposure limits, with a European Commission report and (if appropriate) legislative proposal to follow by the end of 2015.

# Exemptions

There are a number of exemptions from the large exposures rules. Exempt exposures are not taken into account for the purposes of the rules (although they are still taken into account for the purposes of risk weighting). The following are exempt exposures:

- exposures to central governments, central banks, public sector entities, international organisations or multilateral development banks (MDBs) which would receive a 0% risk weighting under the Standardised Approach, and exposures guaranteed by or attributable to such persons;
- exposures to central governments or central banks (other than those above) which are denominated and (where applicable) funded in the national currency of the borrower;
- exposures to or guaranteed by EEA states' regional governments and local authorities, where they would receive a 0% risk weighting under the Standardised Approach;

- cash collateralised claims (including claims secured by the institution's certificates of deposits or those of its group);
- exposures under undrawn credit facilities classified as low-risk off-balance sheet items, provided that the client has agreed that the facility may not be drawn if it will breach the large exposures limit;
- exposures to EEA deposit guarantee schemes; and
- trade exposures and default fund contributions to central counterparties.

Certain other classes of exposures may be fully or partially exempt at the discretion of the competent authorities. These include:

- covered bonds;

- exposures to or guaranteed by EEA states’ regional governments and local authorities, where they would receive a 20% risk weighting under the Standardised Approach;
- reserves at central banks;
- statutory liquidity requirements held in government securities;<sup>8</sup>
- exposures to recognised exchanges; and
- 50% of certain medium/low risk documentary credits and undrawn credit facilities.

The following are subject to the discretionary power of the competent authority to reduce the value for large exposures purposes, subject to certain conditions:

- loans secured by mortgages on residential property and certain leases on residential property, in relation to up to 50% of the market value of the residential property concerned or 60% of the mortgage lending value of the residential

<sup>8</sup> At the discretion of the competent authority this exemption may be limited to investment grade governments only.

property concerned where the relevant member state has rigorous criteria for the assessment of that class of exposures; and

- exposures secured by mortgages relating to offices or other commercial premises and certain leases relating to such property where the exposure would receive a 50% risk weighting under the Standardised Approach, and only in respect of up to 50% of the market value of the property concerned or 60% of the mortgage lending value of the property concerned where the relevant member state has rigorous criteria for the assessment of that class of exposures.

Further exemptions exist in relation to certain parental guarantees and exposures within the so-called “core groups” regime.

Financial collateral is also recognised as exempting exposures to the extent that the financial collateral is eligible under the relevant approach (financial collateral simple method, financial collateral comprehensive method, or IRB method), subject to certain conditions (including, in relation to institutions using the financial collateral comprehensive method or IRB method, periodic stress testing).

## EBA technical standards and guidelines

The CRR mandates that various technical standards and reports shall be produced. In connection with large exposures, the following standards and guidelines have been produced:

CRR SOURCE	TECHNICAL STANDARDS/GUIDELINES REQUIRED	DEADLINE FOR SUBMISSION TO THE EUROPEAN COMMISSION	EBA AND OTHER PUBLICATIONS
Article 390 ( <i>Calculation of the exposure value</i> )	Draft regulatory technical standards (RTS) in relation to the ‘look-through’ provisions.	1 January 2014.	Consultation on the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets (May 2013) ( <a href="#">EBA/CP/2013/07</a> ).  Final draft regulatory technical standards on the determination of the overall

CRR SOURCE	TECHNICAL STANDARDS/GUIDELINES REQUIRED	DEADLINE FOR SUBMISSION TO THE EUROPEAN COMMISSION	EBA AND OTHER PUBLICATIONS
			exposure to a client or a group of connected clients in respect of transactions with underlying assets (December 2013) ( <a href="#">EBA/RTS/2013/07</a> ).
Article 394 ( <i>Reporting requirements</i> )	Draft implementing technical standards (ITS) to ensure uniform formats for reporting on large exposures.	1 January 2014.	Consultation on the supervisory reporting requirements for large exposures (February 2012) ( <a href="#">CP51</a> ). Final draft implementing technical standards on supervisory reporting (July 2013) ( <a href="#">EBA/ITS/2013/02</a> ). <a href="#">European Commission: draft implementing technical standards with regard to supervisory reporting of institutions according to regulation (EU) No 575/2013 (January 2014)</a> .
Article 395 ( <i>Limits to large exposures</i> )	EBA shall, taking into account the effect of the credit risk mitigation in accordance with Articles 399 to 403 as well as the outcomes of developments in the area of shadow banking and large exposures at the Union and international levels, issue guidelines by 31 December 2014 to set appropriate aggregate limits to such exposures or tighter individual limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework.	31 December 2014.	None to date.

## National discretions and UK implementation

The CRR provides competent authorities with certain discretions:

CRR SOURCE	NATURE OF DISCRETION	FCA/PRA APPROACH
Article 395(1) ( <i>Limits to</i>	Competent authorities may set a lower limit	In respect of FCA authorised firms, the FCA

CRR SOURCE	NATURE OF DISCRETION	FCA/PRA APPROACH
<i>large exposures</i> )	than €150 million or 25% of an institution's eligible capital.	<p>indicated it does not intend to exercise this discretion. See FCA Policy Statement (Q16 at paragraph 2.33). The FCA has set out whether it intends to exercise these discretions in Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013).</p> <p>In respect of PRA authorised firms, the PRA does not intend to exercise this discretion (see PRA CP5/13 Strengthening capital standards: implementing CRD IV (August 2013) at paragraph 11.18).</p>
Article 396(1) ( <i>Compliance with large exposures requirements</i> )	Competent authorities may waive on a case-by-case basis compliance with the large exposures limits. A waiver would be permitted under certain circumstances and for a limited period of time for the firm to bring itself into compliance with the large exposures limit.	<p>In respect of FCA authorised firms, the FCA indicated it intends to exercise this discretion. See FCA Policy Statement (Q16 at paragraph 2.33). The FCA has set out whether it intends to exercise these discretions in Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013).</p> <p>In respect of PRA authorised firms, the PRA will consider whether to exercise this discretion on a case-by-case basis where the specific circumstances of the firm are judged exceptional (see PRA CP5/13 Strengthening capital standards: implementing CRD IV (August 2013) at paragraphs 11.19 and 11.21 and the PRA Rulebook at Annex K (Waivers and Transitional Provisions)).</p>
Article 400(1)(f) ( <i>Exemptions</i> )	In respect of firms with a Core UK Group Waiver, firms with permission can assign an exposure defined within the Core UK Group Waiver a 0% risk weight for the purposes of the large exposure requirements in Article 395(1).	<p>In respect of FCA authorised firms, the FCA indicated it intends to exercise this discretion. See IFPRU (at 8.1.14-8.1.21). The FCA has set out whether it intends to exercise these discretions in Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013).</p> <p>In respect of PRA authorised firms, see PRA CP5/13 Strengthening capital standards: implementing CRD IV (August 2013) at paragraphs 11 (Groups and large exposures), paragraph 2 (CRR Article 113(6): core UK group applications) of the PRA Supervisory Statement. See also paragraph 12 (Large Exposures) of the PRA Policy Statement and the PRA Rulebook at Annex K (Waivers and Transitional Provisions).</p>
Article 400(2) ( <i>Exemptions</i> )	Competent authorities may fully or partially exempt the exposures listed in this article from the large exposures limits provided certain conditions are met.	<p>In respect of FCA authorised firms, the FCA indicated it intends to exercise this discretion in part. IFPRU (at 8.2) sets out the rules in respect of this discretion. See also FCA Policy Statement (Q14 and Q15 at paragraphs 2.31 and 2.32 respectively). The FCA has set out whether it intends to exercise these discretions in Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013).</p> <p>In respect of PRA authorised firms, see PRA CP5/13 Strengthening capital standards:</p>

CRR SOURCE	NATURE OF DISCRETION	FCA/PRA APPROACH
		implementing CRD IV (August 2013) at paragraphs 11 (Groups and large exposures) and paragraph 3 (CRR Article 400(2)(c): non-core large exposures group exemptions (trading book and non-trading book)) and paragraph 4 (CRR Article 400(2)(g) and (h) – sovereign large exposures exemption) of the PRA Supervisory Statement. See also paragraph 12 (Large Exposures) of the PRA Policy Statement. The relevant rules are set out in the PRA Rulebook.
Article 401(2) ( <i>Calculating the effect of the use of credit risk mitigation techniques</i> )	Competent authorities may authorise an advanced IRB firm on a case-by-case basis to estimate the effects of financial collateral in its calculation of large exposures limits by using its own LGD estimates.	<p>In respect of FCA authorised firms, the FCA indicated it intends to exercise this discretion. The FCA has set out whether it intends to exercise these discretions in Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013).</p> <p>In respect of PRA authorised firms, the PRA will consult in respect of whether this discretion should be exercised (see PRA CP5/13 Strengthening capital standards: implementing CRD IV (August 2013) at paragraph 11.17).</p>

## Further reading

Client Briefing 1 (*Introduction to Regulatory Capital and Liquidity*)

Client Briefing 2 (*Capital and Capital Adequacy*)

Client Briefing 3 (*Standardised Approach to Credit Risk in the Banking Book*)

Client Briefing 5 (*Collateral: Funded Credit Risk Mitigation in the Banking Book*)

Client Briefing 6 (*Unfunded Credit Risk Mitigation in the Banking Book: Guarantees and Credit Derivatives*)

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