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## Basel III Framework: Large Exposures

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**Even banks with strong capital ratios may fail as a result of the sudden failure of a counterparty or group of connected counterparties. To address this risk and to complement the now near-final Basel III framework, the Basel Committee on Banking Supervision has published its final standard on “large exposures” which aims to ensure that exposures to counterparties are appropriately monitored and limited. The final standard will provide a degree of relief and flexibility to US and EU banks given the stricter standards proposed last year. However, requirements to conduct onerous assessments remain, particularly as regards the due diligence of exposures when investing in structures with underlying assets.**

Rules limiting the size of a bank’s concentration of exposures to a counterparty have historically been among the most important prudential rules, in particular for smaller institutions or local subsidiaries of larger banking organisations. Under the Basel II standard, a bank was required to have capital of at least four times its largest single exposure.<sup>1</sup> In other words, its largest exposure could not exceed 25% of its regulatory capital. For certain institutions this could be quite restrictive as for larger loans the risk-based capital requirements might amount to 5-10% of the loan amount but the large exposure restriction could in effect require the bank to have more capital supporting that loan. In many circumstances the final standards will be even more restrictive as a result of the tightening of the calibration to Tier 1 capital only.

<sup>1</sup> Basel Committee, “Measuring and Controlling Large Credit Exposures” (January 1991) (<http://www.bis.org/publ/bcbsc121.htm>). The Basel Committee has stated that the Final Standard supersedes the 1991 publication on large exposures.

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The Basel Committee submitted for consultation on 26 April 2013 a revised large exposures framework (the “**Proposal**”).<sup>2</sup> The revised framework (the “**Final Standard**”) was published on 15 April 2014<sup>3</sup>. The Final Standard is recommended for national implementation to the exclusion of conflicting rules by 1 January 2019.

In summary, the new regime centers on: (i) compulsory reporting by banks to national supervisors of all large exposures to single counterparties or groups of connected counterparties; and (ii) a prohibition on a large exposure exceeding 25% of Tier 1 capital. The Basel Committee has stated that it will aim, where possible, for “simplicity” in its recommendations.<sup>4</sup> A significant amount of detail relating to calibration of reportable exposures has been removed from the Final Standard with various technical requirements being left to national implementing rules.

### US and EU Large Exposures Framework

In the US, large exposure rules have been proposed which bear similarity to and which, once implemented, are expected to become even more closely aligned with the Final Standard. The US proposed single counterparty credit limit (the “**Proposed SCCL**”) under section 165(e) of the Dodd-Frank Act requires the Board of Governors of the US Federal Reserve System to adopt rules imposing a limit on exposures to a single counterparty by banking organisations holding \$50 billion or more in consolidated assets and non-bank financial institutions designated by the US Financial Stability Oversight Council.<sup>5</sup> Implementation of proposals in December 2011<sup>6</sup> and December 2012<sup>7</sup> was deferred pending publication of the Final Standard. Section 165(e) of the Dodd-Frank Act envisages implementation of final large exposure rules nearly four years ahead of the Basel III implementation date of 1 January 2019, by 21 July 2015.<sup>8</sup>

<sup>2</sup> Basel Committee, Consultative Document: “Supervisory Framework for Measuring and Controlling Large Exposures” (March 2013) (<http://www.bis.org/publ/bcbs246.pdf>).

<sup>3</sup> Basel Committee, Standards: “Supervisory Framework for Measuring and Controlling Large Exposures” (April 2014) (<http://www.bis.org/publ/bcbs283.pdf>).

<sup>4</sup> See, for example, the Basel Committee Discussion Paper: “The Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability” (July 2013) (<http://www.bis.org/publ/bcbs258.pdf>).

<sup>5</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act § 65(e)(7), 12 U.S.C. §§ 5365(a)(1), 5365(e)(2) (2010).

<sup>6</sup> Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (proposed January 5, 2012).

<sup>7</sup> Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organisations and Foreign Non-bank Financial Companies, 77 Fed., Reg. 76628 (proposed December 28, 2012).

<sup>8</sup> See, 12 U.S.C. § 5365(e)(7)(A) (provision not effective until three years after date of enactment, July 21, 2010); 12 U.S.C. § 5365(e)(7)(B) (Federal Reserve may extend for an additional two years).

The EU's existing large exposure framework is contained in the Capital Requirements Regulation (No 575/2013, the "**CRR**")<sup>9</sup> which, as a "regulation", applies uniformly throughout EU member states and applies to all credit institutions and investment firms. The CRR is expected to be amended by regulatory technical standards to be published by the European Banking Authority.

### Large Exposure Reporting Requirement

The Final Standard defines a "Large Exposure" as the sum of all exposures of a bank to a counterparty or to a group of connected counterparties which is equal to or which exceeds 10% of the bank's eligible capital base (*i.e.*, Tier 1 capital). All Large Exposures are to be reported to national supervisors. The 10% standard represents a dilution of the stricter 5% Tier 1 capital threshold contained in the Proposal. By contrast to the Final Standard, current EU rules define a large exposure as one where the value of the exposure is equal to or exceeds 10% of overall regulatory capital (*i.e.*, including Tier 2 in addition to Tier 1 capital). In this respect, the Final Standard therefore heralds a significant tightening up of the large exposures regime currently in place in the EU. In the US, the proposed SCCL defines a large exposure by reference to capital stock (Tier 1 and Tier 2 capital) and surplus (excess of loan loss reserves) ("**Capital Stock and Surplus**"), which is less strict than the Basel Final Standard since the latter measures exposures by reference to Tier 1 capital only.

The Final Standard permits banks to calculate exposures using either the accounting value of the exposure, net of specific provisions and any value adjustments or, alternatively, the exposure value gross of specific provisions and value adjustments. On- and off-balance sheet exposures included in either the banking or trading book must be considered in the exposure value. To the extent that credit risk mitigation ("**CRM**") techniques are applied when calculating exposures, the CRM techniques used are also required to be reported to supervisors. Existing EU rules contain similar rules in these respects.<sup>10</sup>

In addition to the above, the Final Standard requires banks to report to national supervisors their 20 largest exposures to counterparties or groups of connected counterparties whether or not these meet or exceed 10% of a bank's Tier 1 capital. Existing EU rules contain a similar requirement.<sup>11</sup>

The Final Standard does not set out how intra-group exposures should be treated. Intra-group exposures in the EU have traditionally been monitored and supervised using Pillar II discretionary powers and this will continue to be the case.<sup>12</sup>

### Large Exposure Limit

In addition to reporting requirements to be triggered at the reaching of an exposure amounting to 10% of a bank's Tier 1 capital, banks must not allow the sum of all of their exposure values to a single counterparty or group of connected counterparties to exceed 25% of Tier 1 capital at any time (the "**Large Exposure Limit**"). The current EU large exposure limit of 25% of total eligible capital differs from the Large Exposure Limit, which references Tier 1 capital only.<sup>13</sup> The Proposal considered a far stricter requirement of 25% of Common Equity Tier 1 capital ("**CET 1**"),

<sup>9</sup> In the EU, Basel III has been implemented via the Capital Requirements Directive IV package ("**CRD IV**"), comprised of the CRR and the Capital Requirements Directive (2013/36/EU, the "**CRD**").

<sup>10</sup> CRR, Article 394(2).

<sup>11</sup> CRR, Article 394(1), second paragraph.

<sup>12</sup> In this respect the CRR states that "*competent authorities should pay particular attention to intra-group exposures*" (CRR, Recital 60).

<sup>13</sup> CRR, Article 395.

but this has been dropped. In the US, the Proposed SCCL contains a large exposure limit of 25% of Capital Stock and Surplus.

G-SIBs' exposures to other G-SIBs may not exceed 15% of Tier 1 capital (the Proposal considered a stricter G-SIB to G-SIB exposure limit of 10% of CET 1). The Proposed SCCL limits G-SIB to G-SIB exposures to 10% of Capital Stock and Surplus. In all cases, the Basel Committee has stated that breaches of the Large Exposure Limit should be exceptional, communicated immediately to the relevant supervisory authority, and quickly corrected.

### Identification of Connected Counterparties

Counterparties can be “connected” such that a bank must aggregate its exposures towards the counterparties as if they were a single counterparty. The justification is that the default of one counterparty could lead to the default of another connected counterparty (and so on) such that the exposures to both counterparties should be aggregated and treated as a single exposure.

Counterparties are connected if at least one of the following criteria is satisfied: (i) one of the counterparties, directly or indirectly, has control over the other counterparty (a “**control relationship**”); and/or (ii) if one of the counterparties were to experience financial problems, in particular funding or repayment difficulties, and the other(s) as a result would also likely encounter funding or repayment difficulties (“**economic interdependence**”).

A control relationship will exist where one entity has more than 50% voting rights in another entity. Further factors pointing towards the existence of a “control” relationship include: (i) the exercise by one body over another of significant influence on the appointment or dismissal of its administrative, management or supervisory body; and/or (ii) the ability of one body to exercise a controlling influence over the management or policies of another entity, such as by having consent rights over key decisions.

Determining whether a relationship of connectedness based on economic interdependence exists may require an even deeper forensic analysis of banks' client relationships. A bank must consider a range of indicative factors such as: (i) whether 50% or more of one counterparty's gross receipts or gross expenditures on an annual basis is derived from transactions with another counterparty; (ii) whether guarantees relating to exposures exist between counterparties; and (iii) whether the financial problems of one counterparty are likely to cause difficulties for other counterparties in terms of full and timely repayment of liabilities.

Although the concept of “connected counterparty” exists under current EU rules, the Final Standard requires a more granular analysis and is accordingly much stricter. Many banks will find little solace in the Basel Committee's assurance that an analysis of counterparty relationships is required only in cases where the sum of the exposures to one individual counterparty meets or exceeds a *de minimis* threshold of more than 5% of Tier 1 capital. Many consider that this is still too low.

### Treatment of Exposures to Central Counterparties

The Basel Committee noted the concern in the Proposal that imposing requirements on exposures to central counterparties (“**CCPs**”) could adversely affect incentives to centrally clear. Comments from industry also noted that the Proposal could, in an extreme case, require diversification of exposures in certain jurisdictions where there are insufficient available CCPs to clear with. Further, industry noted that CCPs are themselves agents of systemic risk mitigation and so should remain outside of the scope of the large exposures framework.<sup>14</sup> As a result of these

<sup>14</sup> See, The Clearing House, ISDA, GFMA, SFIG, AFME, etc., response to the Proposal available at: <http://www.bis.org/publ/bcbs246/tchambasisaagtf.pdf>.

concerns, the Basel Committee decided that exposures towards qualifying central counterparties<sup>15</sup> (“**QCCPs**”) should not be caught by the Final Standard, although the position would be considered again by 2017.<sup>16</sup> In relation to non-QCCP exposures, the Large Exposure Limit would apply. The Proposed SCCL does not contain an exemption for transactions with CCPs, which are treated as any other derivative transaction and subject to a large exposure limit of 25% of Capital Stock and Surplus.

### Treatment of Exposures to Collective Investment Undertakings, Securitisation Vehicles and Other Structures

The Final Standard contains technically demanding due diligence standards for banks investing in a structure which itself has exposures to underlying assets, such as collective investment undertakings (*e.g.*, funds), and securitisations. In the case of securitisations, the standards build upon and enhance existing due diligence standards contained within CRD IV.

If a bank is able to demonstrate to national supervisors that its exposure value (*i.e.*, the amount invested in the structure) to each underlying asset of the structure is smaller than 0.25% of its Tier 1 capital then a bank may assign the exposure amount to the structure itself and is not required to “look through” the structure to identify the structure’s underlying assets. If, on the other hand, the bank’s exposure amount to an underlying asset of the structure is equal to or exceeds 0.25% of its Tier 1 capital, then the bank must “look through” to identify the counterparty corresponding to such assets and then add these exposures to any other direct or indirect exposure to the same counterparty. If a bank is unable to identify the underlying assets of a structure and where such assets cannot be assigned to the structure itself due to their being equal to or in excess of 0.25% of Tier 1 capital, then the bank is required to assign such exposures to an “unknown client” and aggregate all other unknown exposures to the unknown client, to which the large exposure limit of 25% of Tier 1 capital would apply.

The Final Standard contains additional due diligence requirements in respect of third parties (*e.g.*, originators, fund managers and liquidity providers) who may constitute an additional risk factor inherent in the structure itself rather than in the underlying assets. As a result, the Basel Committee notes that banks may need to connect their investments in structures with a common risk factor to form a group of connected counterparties. For example, an originator to a securitisation would usually be regarded as a distinct counterparty such that the sum of the bank’s investments in all of the securitisations with which the originator is involved would be subject to the large exposure limit, with the exposure value being the total value of the various investments.

These standards are not entirely new for many banks in Europe, who have been preparing themselves for the forthcoming rules on the treatment of exposures to structures with underlying assets as a result of the publication of a European Banking Authority consultation paper which has some similarity to the Final Standard, albeit it was intended to flesh out the standards of the existing large exposures framework that is a hold-over from the

<sup>15</sup> A QCCP is a CCP licensed to operate as a CCP and based and supervised in a jurisdiction where the relevant regulator has established and publicly indicated that it applies to the CCP on an on-going basis domestic rules and regulations that are consistent with the CPSS-IOSCO Principles for Financial Market Infrastructures.

<sup>16</sup> The Basel Committee has separately published final standards on “capital requirements for bank exposures to central counterparties”, although these do not contain large exposure requirements (<http://www.bis.org/publ/bcbs282.htm>, April 2014).

pre-Basel III world.<sup>17</sup> Due diligence of counterparties is required in relation to a wider range of structured investments than just securitisations.

## Conclusion

Banks should consider ways in which they may avoid concentrations of exposures so as to fall below the Large Exposure Limit. Banks taking on a large loan may, for example, enter into sub-participations with other parties in respect of parts of the loan, or may consider credit default swap or other CRM techniques to avoid having to increase the Tier 1 capital base. The revised criteria for determining connected counterparties based on economic inter-dependence raises questions as to how to measure economic inter-connectedness given its potentially wide scope. Finally, the market will be concerned to ensure that the Proposed SCCL in the US is materially aligned with the Final Standard so as to avoid divergent and inconsistent standards.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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<sup>17</sup> See, the European Banking Authority Draft Regulatory Technical Standards (EBA/CP/2013/07) of May 2013: "*On the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets under Article 379 of the proposed Capital Requirements Regulation*", available at:

<http://www.eba.europa.eu/documents/10180/205075/CP-on-RTS-on-Large-Exposures---Art--379-8--CRR.pdf>.