Financial Services Commission

Guidance Notes

Concentration Risk

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Please be advised that this Guidance Note is dated and does not take into account any changes arising from the Capital Requirements Directive (2013/36/EU), transposed into local legislation as the Financial Services (Capital Requirements Directive IV) Regulations ("Gibraltar Regulations"), or the Capital Requirements Regulations (575/2013) ("EU Regulations") of the European Parliament and of the Council of 26 June 2013. Where there is a discrepancy between the contents of the Guidance Note and the requirements set in the Gibraltar and/or EU Regulations, the entity is to refer to and comply with the requirements set in the Gibraltar Regulations and the EU Regulations.

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1. Application

1.1. This Guidance Note applies to all locally incorporated credit institutions and investment firms to assist them in the treatment of large exposures for the purposes of the Capital Adequacy Directive, comprising Directive 2006/48/EC and Directive 2006/49/EC which have been implemented in Gibraltar via the Banking (Capital Adequacy of Credit Institutions) Regulations, and Financial Services (Capital Adequacy of Investment Firms) Regulations. The aim of the Guidance Note is to supplement the Regulations and it applies irrespective of what approach(es) the firm adopts. The EU Commission has asked CEBS to produce some advice in respect of Large Exposures, once this is available, this guidance may be revised.

1.2.

1.2.1. This Guidance Note sets out rules and guidance for large exposures and implements the large exposures requirements of articles 106 to 118 and paragraph 7 of Annex V of Directive 2006/48/EC and articles 28 to 32 of the Capital Adequacy Directive (2006/49/EC).

1.2.2. A large exposure may be in the form of a loan to a single borrower, or it may arise across many transactions involving different types of financial instruments with several counterparties within the same group of companies. Where a firm's exposure to its counterparty is large, it risks a large loss should the counterparty default. Such a loss may be sufficient on its own to threaten the solvency of the firm.

1.2.3. The purpose of this Guidance Note is to ensure that a firm manages its exposure to counterparties within appropriate limits, set in relation to its capital resources.

2. Identification of exposures

2.1.

2.1.1. Unless paragraphs 2.2 or 2.3 applies, an exposure is any of the items included in Guidance Note Credit Risk Standard Approach, section 2, whether held in the trading book or the non-trading book, without application of the risk weight or degrees of risk there provided for.

2.1.2. An exposure includes a trading book position in accordance with paragraph 4 and a notional position as described in paragraph 4.1.7.

2.2. An exposure does not include:

2.2.1. An exposure which is entirely deducted from a firm's capital resources;

2.2.2. in the case of foreign currency transactions, exposures incurred in the ordinary course of settlement during the two working days following payment; or

2.2.3. in the case of transactions for the purchase or sale of securities, exposures incurred in the ordinary course of settlement during the five working days following payment or delivery of the securities, whichever is earlier.

2.2.4. in the case of money transmissions including the execution of payment services, clearing and settlement in any currency and correspondent banking or financial instruments clearing, settlement and custodial services, delayed receipts in funding and other exposures arising from client activity which do not last longer than the following business day; nor

2.2.5. in the case of money transmissions including the execution of payment services, clearing and settlement in any currency and correspondent banking, intra-day exposures to institutions providing those services.

2.3. A credit institution shall in accordance with regulation 57(5) of the FSCACI analyse its exposures to collateral issuers, providers of unfunded credit protection and underlying assets for possible concentrations and take any necessary action and report any significant findings to the Commissioner. Please see Appendix B for further guidance on the application of regulation 57(5).

3. Identification of counterparties

3.1. An individual counterparty may be a natural or legal person.

3.2. Examples of a counterparty include:

3.2.1. the customer or borrower; this includes governments, local authorities, public sector entities, individual trusts, corporations, unincorporated businesses (whether as sole traders or partnerships) and non-profit making bodies;

3.2.2. where the firm is providing a guarantee, the person guaranteed;

3.2.3. for a derivatives contract, the person with whom the contract was made;

3.2.4. for exchange traded contracts novated through a central clearing mechanism, that central clearing mechanism;

3.2.5. where a bill held by a firm has been accepted by a credit institution, the acceptor; and

3.2.6. where a firm is funding the activities of a company that trades on an exchange (whether as principal or on behalf of clients), that company.

3.3. Identification of counterparties for guaranteed exposures

3.3.1. Subject to a firm meeting the conditions in relation to credit risk management, in the credit risk mitigation section of the Guidance Note on credit risk standardised approach, where an exposure to a counterparty is guaranteed by a third party, a firm may treat the exposure as an exposure to the third party and not to the counterparty.

3.3.2. In deciding whether or not to treat the exposure as an exposure to the third party, a firm must ensure that the identification of counterparties for concentration risk purposes is applied in a consistent manner.

3.3.3. Where the guarantee is denominated in a currency different from that in which the exposure is denominated, the amount of the exposure deemed to be covered must be calculated in accordance with the provisions on the treatment of currency mismatch for unfunded credit protection, in the credit risk mitigation section in the Guidance Note on credit risk standardised approach and, if applicable, paragraph 10 of the Guidance Note Credit Risk IRB Approach.

3.3.4. A mismatch between the maturity of the exposure and the maturity of the protection must be treated in accordance with the provisions on the treatment for maturity mismatch, the credit risk mitigation section in the Guidance Note on credit risk standardised approach and, if applicable, paragraph 10 of the Guidance Note on Credit Risk IRB Approach.

3.3.5. Partial coverage must be treated in accordance with the Guidance Note Credit Risk Standardised Approach and, if applicable, paragraph 10 of the Guidance Note Credit Risk IRB Approach.

3.3.6. A guarantee may only be treated in accordance with 3.3.1 if the firm complies with the eligibility requirements and other minimum requirements set out in Guidance Note Credit Risk Standardised Approach for the purposes of calculating risk-weighted exposure amounts under the standardised approach.

3.3.7. For the purpose of this rule, guarantee includes a credit derivative recognised under Guidance Note Credit Risk Standardised Approach and, if applicable, paragraph 10 of the Guidance Note Credit Risk IRB Approach, other than a credit linked note.

3.4. Groups of connected clients

3.4.1. The glossary defines a group of connected clients.

3.4.2. Relationships between individual counterparties which might be considered to constitute a single risk for the purposes of the definition of group of connected clients include:

3.4.2.1. undertakings in the same group;

3.4.2.2. companies whose ultimate owner (whether wholly or significantly) is the same individual or individuals, and which do not have a formal group structure;

3.4.2.3. companies having common directors or management; and

3.4.2.4. counterparties linked by cross guarantees.

3.4.3. The FSC would not regard the normal business relationships between companies which are competitors, and to which none of the relationships listed in 3.4.2.1 apply, as falling within the definition of group of connected clients.

3.5. Connected counterparties

3.5.1. For the purposes of this Guidance Note, and in relation to a firm, a connected counterparty means another person ('P') to whom the firm has an exposure and who fulfils at least one of the following conditions:

3.5.1.1. P is closely related to the firm; or

3.5.1.2. P is an associate of the firm; or

3.5.1.3. the same persons significantly influence the governing body of P and the firm; or

3.5.1.4. the firm has an exposure to P that was not incurred for the clear commercial advantage of the firm or the firm's group and which is not on an arm's length basis.

3.5.2. See Appendix A for further information on connected counterparties.

3.6. Exposures to counterparties, groups of connected clients and connected counterparties

3.6.1. A firm's total exposure to a counterparty must be calculated by summing its exposures to that counterparty.

3.6.2. A firm's total exposure to a group of connected clients must be calculated by summing its exposures to the individual persons within that group of connected clients.

3.6.3. A firm's total exposure to connected counterparties must be calculated by summing its exposures to all the firm's connected counterparties.

3.7. Exposures to trustees

3.7.1. If a firm has an exposure to a person ('A') when A is acting on his own behalf, and also an exposure to A when A acts in his capacity as trustee of an investment trust or unit trust or venture capital fund or pension fund, the firm may treat the latter exposure as if it was an exposure to a different person, unless such a treatment would be misleading.

3.7.2. When considering whether the treatment described in paragraph 3.1 is misleading, factors a firm should consider include:

3.7.2.1. the degree of independence of control of the fund, including the relation of the fund's board and senior management to the firm or to other funds or to both;

3.7.2.2. whether the beneficial owners of the fund are connected to the firm, or related to other funds managed within the group, or both; and

3.7.2.3. for a connected counterparty, whether the loan is made on an arm's length basis.

3.7.3. In deciding whether a transaction is at arm's length for the purposes of paragraph 3.5.1.4 and paragraph 3.6.3, the following factors should be taken into account:

3.7.3.1. the extent to which the person to whom the firm has an exposure ('A') can influence a firm's operations, through e.g. the exercise of voting rights;

3.7.3.2. the management role of A, where A is also a director of the firm; and

3.7.3.3. whether the loan would be subject to the firm's usual monitoring and recovery procedures if repayment difficulties emerged.

4. Measurement of exposures to counterparties and issuers.

4.1. Unless specifically mentioned, paragraph 4 applies both to non-trading book and trading book exposures.

4.2. Unless paragraph 4.3 applies, when calculating an exposure, a firm must include accrued interest and dividends due.

4.3. A firm may use the following method of calculating the total amount of a firm's total exposures in the non-trading book to a counterparty, connected counterparties, or group of connected clients as an alternative.

4.3.1. If the total amount of the exposures is less than 20% of the firm's capital resources, the accrued interest element need not be included in the calculation of the amount of the exposures in the non-trading book;

4.3.2. If the total amount of the exposures is more than 20% (but less than 25%) of the firm's capital resources, the firm must be able to demonstrate that the total amount of the exposures, including the accrued interest element, is below the 25% limit in paragraph 5.3.1 and that the 25% limit in paragraph 5.4.1 has not been exceeded.

4.4. The reason for paragraph 4.2 is the systems difficulties of including accrued interest in the total amount of exposures in the non-trading book.

4.5. A firm must not offset non-trading book and trading book exposures.

4.6. The exposures to an individual counterparty which arise on the trading book must be calculated by summing the following items:

4.6.1. The excess where positive of the firm's long positions over its short positions in all the CRD financial instruments issued by the counterparty in question, in accordance with paragraph 4.9.6

4.6.2. The firm's net underwriting exposure to that counterparty; and

4.6.3. The exposures due to the transactions, agreements and contracts referred to with the counterparty in question.

4.7. For the purpose of calculating the value of an exposure, exposures are divided into counterparty exposures and issuer exposures.

4.7.1. For the purposes of this guidance note, an issuer exposure means:

4.7.1.1. any exposure in the trading book that gives rise to a position that is subject to the market risk capital requirement under the standard market risk PRR rules; and

4.7.1.2. any exposure in the non-trading book that, if it were in the trading book and subject to the standard market risk PRR rules:

4.7.1.2.1. (in the case of a derivative in relation to a CRD financial instrument) Would give rise to a notional position in the CRD financial instrument underlying that derivative; or

4.7.1.2.2. would give rise to a similar notional position in a CRD financial instrument other than the one that the firm actually holds.

4.7.2. For the purposes of this Guidance Note, the counterparty or issuer with respect to an exposure falling into 4.7.1.2.2 is the person who is or would be treated as the obligor under the standard market risk PRR rules in question.

4.7.3. For the purposes of this Guidance Note, a counterparty exposure means any exposure not within 4.7.1.2.2.

4.8. Counterparty Exposures

4.8.1.

4.8.1.1. Subject to 4.8.1.2 and 4.8.1.3, the value of a firm's counterparty exposures, whether in its non-trading book or its trading book, is the amount at risk.

4.8.1.2. A firm which has a trading book must calculate the value of its exposures in its trading book due to the transactions, agreements and contracts for the calculation of exposure values.

4.8.1.3. Exposures arising from the items referred to in the definition of financial derivative instruments must be calculated in accordance with one of the methods set out in the Guidance Note on financial derivatives, SFTs and long settlement transactions.

4.9. Issuer Exposures

4.9.1. Paragraph 4.9.2 applies to issuer exposures.

4.9.2. A firm must calculate the value of an exposure to the issuer of a security which is held in the firm's non-trading book as the sum of the excess, where positive, of the book value of all long positions over all short positions (the net long position), for each identical instrument issued by that issuer.

4.9.3. For the purposes of paragraph 4.9.2, short positions in one security may be used to offset long positions in a non-identical security issued by the same issuer if both the securities are denominated in the same currency, and:

4.9.3.1. where both the securities are fixed rate, they are within the same residual maturity time band, one year or less, or over one year; or

4.9.3.2. where both the securities are index linked, they are within the same residual maturity time band referred to in 4.9.3.1; or

4.9.3.3. both the securities are floating rate.

4.9.4. For the purposes of paragraph 4.9.2, a firm may, when calculating its net position in any security in the non-trading book, take into account counterparty exposures. However any counterparty exposure used in this way is still subject to the provisions of this Guidance Note about counterparty exposures.

4.9.5. This paragraph illustrates how the distinction between counterparty exposures and issuer exposures in paragraph 4.6 works. Say that a firm has a holding of shares in its non-trading book and it has bought a put option over those shares, which it also holds in its non-trading book. The holding of shares gives rise to a counterparty exposure to the issuer of those shares and the option gives rise to a counterparty exposure to the person who wrote the option. The option also gives rise to an issuer exposure to the issuer of the shares. The firm may use paragraph 4.9.4 to eliminate that issuer exposure by

netting its position to zero by taking into account its long non-trading book position in those shares. If it does so, the firm will still have counterparty exposures to the issuer of the shares and the counterparty under the option.

4.9.6. A firm must calculate the value of an exposure to the issuer of a security which is held in the firm's trading book by calculating the excess of the current market value of all long positions over all short positions in all the securities issued by that issuer.

4.9.7. For the purposes of paragraph 4.9.3, the short positions must be netted against the long positions in securities with the highest specific risk PRAs.

4.9.8. A firm must not offset an exposure to one issuer against an exposure to another issuer even where:

4.9.8.1. the issuers are a group of connected clients; and

4.9.8.2. the exposures are non-identical exposures which meet the conditions.

4.10. Forward agreements

4.10.1. A firm must include as a long position a commitment by it to buy:

4.10.1.1. a debt security or an equity at a future date; and

4.10.1.2. under a note issuance facility, at the request of the issuer, a security which is unsold on the issue date.

4.10.2. A firm must include as a short position a commitment by it to sell a debt security or an equity at a future date.

Interest rate, foreign currency and equity swaps

4.10.3. An interest rate leg of an equity swap, or an interest rate or currency swap, does not generate an issuer exposure.

4.10.4. Where the equity leg of an equity swap is based on the change in value of an individual equity, it must be treated as giving rise to an exposure to the issuer of the equity.

4.11. Option positions

4.11.1. When determining its exposure to an issuer arising from an option, a firm must value the notional principal of an option as the amount of principal underlying the option.

4.11.2. A firm must treat:

4.11.2.1. a written put option as a long position in the underlying security valued at the strike price or the market price of the underlying security, whichever is lower;

4.11.2.2. a purchased put option as a short position in the underlying security valued at the strike price or the market price of the underlying security, whichever is lower; and

4.11.2.3. a purchased call option as a long position in the underlying security equal to the book value of the option provided that the contract has been given a book value in the firm's accounts.

4.11.3. A written call option does not generate exposure to an issuer.

4.11.3.1. This rule applies in relation to an option if a firm has a waiver that covers the option and has option risk aggregation as described in paragraph 9.7 of the Guidance Note on market risk.

4.11.3.2. This rule also applies in relation to an option if a firm:

4.11.3.2.1. has been allowed to use a VAR model; and

4.11.3.2.2. the scope of the VAR model permission covers that option.

4.11.3.2.3. The firm may use the model described in 4.11.3.1 and 4.11.3.2 for the purpose of calculating the market value of that option to the extent that those values are relevant for the calculations.

4.12. Indices and baskets of equities or securities

4.12.1. Subject to paragraph 4.12.2, a firm must treat an index or basket of debt securities or equities as giving rise to a series of exposures to the issuers of the underlying securities or equities in accordance with the provisions of paragraphs 2 or 3 of the Guidance Note on Market Risk.

4.12.2. A qualifying equity index does not generate an exposure of the type described paragraph 4.12.1.

4.13. Securities financing transactions

4.13.1. A firm with securities financing transactions in its trading book or its non-trading book must calculate its exposure to:

4.13.1.1. the issuer of the security it has sold in a repurchase agreement; and

4.13.1.2. the counterparty (subject to paragraph 3.3.1 and paragraph 6).

Underwriting

4.13.2. In accordance with paragraph 8.31 of the Guidance Note on Market Risk, for the purposes of calculating the concentration risk capital component, a

firm should include net underwriting exposures to an issuer in the calculation of its total exposure to that issuer.

4.14. Exposures to undisclosed counterparties

4.14.1. A firm must not incur an exposure to an undisclosed counterparty unless:

4.14.1.1. It has satisfied itself that it will continue to meet the limits in paragraph 5 for non-trading book exposures and trading book exposures; and

4.14.1.2. It has made and retained a record of the steps it has taken to comply with 4.8.1.1.

5. Limits on exposures and large exposures

5.1. Definition of large exposure

5.1.1. A large exposure of a firm means its total exposure to a counterparty, connected counterparties, or a group of connected clients, whether in the firm's non-trading book or trading book or both, which in aggregate equals or exceeds 10% of the firm's capital resources.

5.2. Capital resources

5.2.1. For the purposes of the large exposure limits in paragraph 5 in the trading book and the non-trading book, a firm's capital resources means total tier one capital resources plus tier two capital resources after deductions.

5.2.2. For the purposes of monitoring against the trading book limits and charge regime, as set out in paragraphs 5.4.1 to 5.4.4, and calculating a firm's Concentration Risk Capital Component (CNCOM) in accordance with paragraph 5.4.6, a firm's capital resources may include tier three capital resources.

5.3. Large Exposure limits

5.3.1. A firm must ensure that the total amount of its exposures to the following does not exceed 25% of its capital resources:

5.3.1.1. a counterparty; or

5.3.1.2. a group of connected clients; or

5.3.1.3. its connected counterparties.

5.3.2. Paragraph 5.3.1 creates a single limit for each of the types of exposure listed in paragraph 5.3.1. Accordingly, if a connected counterparty is also a member of a group of connected clients the limit in paragraph 5.3.1 covers the

aggregate of the total amount of the firm's exposures to its connected counterparties and of the total amount of its exposures to that group of connected clients.

6. Exemptions

6.1. General exemptions

This section only applies to exposures, whether in the trading book or non-trading book, to counterparties which are not connected counterparties.

Firms should apply to the FSC to make use of these exemptions via the "Large Exposure Exemption Form" available on the FSC website.

6.1.1. In paragraph 6.1.2 and paragraph 6A, references to guarantees include credit derivatives recognised under the Guidance Note on Credit Risk Standardised Approach and, if applicable, the Guidance Note on IRB approach, other than credit linked notes. For this purpose paragraph 3.3.1.6 applies.

6.1.2. The following exposures are exempt from the limits describes in section 5 (Limits on exposures):

6.1.2.1. Asset items constituting claims on central governments or central banks which claims would unsecured receive a 0% risk weight under the standardised approach;

6.1.2.2. Asset items constituting claims on international organisations or multilateral development banks which claims would unsecured receive a 0% risk weight under the standardised approach;

6.1.2.3. Asset items constituting claims carrying the explicit guarantees of central governments, central banks, international organisations or multilateral development banks, where unsecured claims on the entity providing the guarantee would achieve a 0% risk weight under the standardised approach;

6.1.2.4. Other exposures attributable to, or guaranteed by, central governments, central banks, international organisations, multilateral development banks or public sector entities where unsecured claims on the entity to which the exposure is attributable or by which it is guaranteed would receive a 0% risk weight under the standardised approach;

6.1.2.5. Asset items constituting claims on EEA States' regional governments or local authorities which claims would receive a 0% risk weight under the standardised approach;

6.1.2.6. Other exposures to or guaranteed by EEA States' regional governments or local authorities claims on which would receive a 0%

risk weight under the standardised approach;

6.1.2.7. The following, where they would receive a 50% risk weight under the standardised approach, and only up to 50% of the value of the commercial property concerned:

6.1.2.7.1. Exposures secured by mortgages on offices or other commercial premises;

6.1.2.7.2. Exposures related to property leasing transactions concerning offices or other commercial premises;

6.1.2.8. asset items and other exposures secured by collateral in the form of cash deposits placed with the lending firm or with a credit institution which is the parent undertaking or a subsidiary undertaking of the lending firm;

6.1.2.9. asset items and other exposures secured by collateral in the form of certificates of deposit issued by the lending firm or by a credit institution which is the parent undertaking or a subsidiary undertaking of the lending firm and lodged with either of them; and

6.1.2.10. exposures arising from undrawn credit facilities that are classified as low risk off-balance sheet items and provided that an agreement has been concluded with the counterparty or group of connected clients under which the facility may be drawn only if it has been ascertained that it will not cause the limit in section 5 (limits on exposures) to be exceeded.

6.1.2.11. For the purposes of paragraph 6.1.3.11 (Loan secured by residential mortgages and leasing transactions):

6.1.2.11.1.1. the requirements set out for "Requirements for recognition of real estate collateral" will apply;

6.1.2.11.1.2. the value of the property must be calculated on the basis of valuation standards laid down by law, regulation or administrative provisions;

6.1.2.11.1.3. valuation must be carried out every three years;

6.1.2.11.1.4. the valuation rules set out in Annex VIII Part 3 point 62 to 65 of Directive 2006/48/EC;

6.1.2.11.1.5. residential property means a residence to be occupied or let by the borrower. For further information on how to reduce the exposure to residential properties, please see Section 66 of the FSCACI Regulations.

6A. Institutional Exemption

6A.1 Subject to regulation 66 of the FSCACI, a credit institution shall not incur an exposure after taking into account the effect of credit risk mitigation in accordance with regulations 65 to 70 of the FSCACI to a client or group of connected clients the value of which exceed 25% of its own funds.

6A.2 For the purposes of 6.A.1, where the client is an institution or where a group of connected clients includes one or more institutions, that value shall not exceed 25% of the credit institution's own funds or EUR 150 million, whichever is the higher, provided that the sum of exposure values, after taking into account the effect of the credit risk mitigation in accordance with regulations 65 to 70 of the FSCACI to all connected clients which are not institutions, does not exceed 25% of the credit institution's own funds.

6A.3 Where under 6A.2, the amount of EUR 150 million is higher than 25 % of the credit institution's own funds, the value of the exposure, after taking into account the effect of credit risk mitigation in accordance with regulations 65 to 70 of the FSCACI, shall not exceed a reasonable limit in terms of the credit institution's own funds.

6A.4 The limit under 6A.3 shall be determined by the credit institution consistently with the policies and procedures in paragraph 7 of Schedule 7 of the FSCACI, to address and control concentration risk and that limit shall not be higher than 100% of the credit institution's own funds.

6A.5 A credit institution shall at all times comply with the limits laid down in 6A.1 to 6A.4 in respect of its exposures.

6A.6 If an exposure exceeds any limit specified above, that fact shall be reported without delay to the Commissioner who may, where circumstance warrant it, allow the credit institution a specified short period of time in which to comply with the limits, failing which he may use his powers of intervention under the FSCACI.

6A.7 Where the amount of EUR 150 million referred to in 6A.2 is applicable, the Commissioner may, on application, allow on a case-by-case basis the 100% limit in terms of the credit institution's own funds to be exceeded.

6A.8 Section 66 of the FSCACI Regulations provides that the following exposures shall be exempt from the application of regulation 64(1) to (3) of the FSCACI Regulations -

(a) covered bonds falling within paragraphs 68 to 70 of Part 1 of Schedule 6;

(b) asset items constituting claims on EEA States' regional governments or local authorities where those claims would be assigned a 20% risk weight under regulations 28 to 33 and other exposures to or guaranteed by those regional governments or local authorities, claims on which would be assigned a 20% risk weight under those regulations;

(c) notwithstanding sub-regulation (2)(f), exposures (including participations or other kinds of holdings) incurred by a credit institution to its parent undertaking, to other subsidiaries of that parent undertaking or to its own subsidiaries, in so far as those undertakings are covered by the consolidated supervision to which the credit institution itself is subject or

with equivalent standards in force in non-EEA States[1]*; exposures that do not meet these criteria, whether or not exempted from regulation 64(1) to (3), shall be treated as exposures to a third party;*

(d) asset items constituting claims on and other exposures (including participations or other kinds of holdings) to regional or central credit institutions with which a credit institution is associated in a network which are responsible, under those provisions, for cash-clearing operations within the network;

(e) asset items constituting claims on and other exposures to credit institutions incurred by credit institutions operating on a non-competitive basis, providing loans to promote specified sectors of the economy under some form of government oversight and restrictions on the use of the loans, provided that the respective exposures arise from such loans which are passed on to the beneficiaries via other credit institutions;

(f) asset items constituting claims on and other exposures to institutions, which do not constitute such institutions' own funds, do not last longer than the following business day and are not denominated in a major trading currency;

(g) asset items constituting claims on central banks in the form of required minimum reserves held at those central banks which are denominated in their national currencies;

(h) asset items constituting claims on central governments in the form of statutory liquidity requirements held in government securities which are denominated and funded in their national currencies provided that, at the discretion of the Commissioner, the credit assessment of those central governments assigned by a nominated external credit assessment institution is investment grade;

(i) 50% of medium to low risk off-balance-sheet documentary credits and of medium to low risk off-balance sheet undrawn credit facilities referred to in Schedule 2 and, subject to the Commissioner's agreement, 80% of guarantees other than loan guarantees which have a legal or regulatory basis and are given for their members by mutual guarantee schemes possessing the status of credit institutions;

(j) statutorily required guarantees used when a mortgage loan financed by issuing mortgage bonds is paid to the mortgage borrower before the final registration of the mortgage in the land register, provided the guarantee is not used as reducing the risk in calculating the risk weighted assets.".

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[1] The Commission will use the Basel Committee on Banking Supervision Report to G20 Leaders on Basel III Implementation to measure whether any non-EEA State has adopted equivalent standards. The Commission nevertheless reserves the right to carry out any further analysis which it considers necessary to determine whether any non-EEA State has adopted equivalent standard.

7. Treasury Concession

7.1. Subject to 7.1.2 and to paragraph 11.1, a firm may treat as exempt from the limits in paragraph 5 an exposure to a counterparty provided that:

7.1.1.the exposure satisfies the exposure conditions in paragraph 7.3;

7.1.2.the counterparty is a concentration risk group counterparty; and

7.2. The firm is subject to international best practices on dealing with group risk.

7.3. The total amount of the exposures that a firm may treat as exempt under this rule must not exceed 50% of the firm's capital resources.

7.4. Any exposures that would, but for paragraph 7.1.2, fall to be treated in accordance with paragraph 7 remain subject to the limits in paragraph 5.

7.5. The exposure conditions referred to in paragraph 7.1.1. are as follows:

7.5.1.The exposure must satisfy one or more of the following conditions:

7.5.1.1. It is a loan made by the firm with a maturity of one year or less in the course of the firm carrying on a treasury role for other members of its group;

7.5.1.2. It is a loan to the parent undertaking of the firm made in the course of a business carried on by the firm of lending to its parent undertaking cash that is surplus to the needs of the firm, provided that the amount of the surplus fluctuates regularly; or

7.5.1.3. It arises from the firm or a counterparty operating a central risk management function for members of the firm's group for exposures arising from derivatives; and

7.5.2.The exposure must be held in the firm's non-trading book.

8. Integrated Groups

8.1. This paragraph applies to a firm if it is part of a local integrated group and it gives notice in accordance with paragraph 11.1 that it will apply paragraph 8.

8.2. If paragraph 8 applies to a firm, it must apply paragraph 8 to all exposures coming within the scope of paragraph 8 and not just some of them.

8.3. If paragraph 8 applies to a firm, then subject to paragraph 10, it may, on a solo basis, treat an exposure to a concentration risk group counterparty as exempt from the limits in paragraph 5.

8.4. An undertaking is a member of a firm's integrated group if, in relation to the firm, that undertaking satisfies the following conditions:

8.4.1.it is a concentration risk group counterparty;

8.4.2.it is an institution or a financial holding company, financial institution, asset management company or ancillary services undertaking;

8.4.3. it is subject to the same risk evaluation, measurement and control procedures as the firm;

8.4.4. It is incorporated in Gibraltar and the centre of its main interests is situated within Gibraltar; and

8.4.5. There is no current or foreseen material or legal impediment to the prompt transfer of own funds or repayment of liabilities from the counterparty to the firm.

8.5.

8.5.1. This rule defines own funds for the purposes of paragraph 8.4.4.

8.5.2. In the case of a locally incorporated credit institution and investment firm, own funds means capital resources.

8.5.3. In the case of any other undertaking own funds means any item that would be capital resources if the undertaking were a locally incorporated credit institution and investment firm.

8.6. Firms should refer to the Guidance Note on the standardised approach to credit risk (guidance relating to 0% risk weights for intra-group exposures under the standardised approach).

8.7. A firm must ensure that the rules listed in paragraph 8.7 are complied with on a consolidated basis in accordance with the following:

8.7.1. The rules apply in relation to the firm's local integrated group rather than in relation to the firm;

8.7.2. The rules apply in relation to exposures of members of the local integrated group to members of the residual block; and

8.7.3. The local integrated group and the residual block must each be treated as a single undertaking.

8.8. The rules referred to in paragraph 8.6 are:

8.8.1. paragraph 5.3.1;

8.8.2. paragraph 5.4.1 (other than paragraph 5.4.1.2);

8.8.3. paragraph 5.4.3 (with the deletion of the time limit set out in paragraph 5.4.1; and

8.8.4. paragraph 7.

8.9. A firm must comply with paragraph 8 and applies paragraph 5 on a consolidated basis.

8.10. For the purposes of paragraph 8, and in relation to a firm, a member of the residual block means a concentration risk group counterparty which is not a member of the firm's locally integrated group.

8.11. For the purposes of paragraph 8, a firm must calculate the capital resources of the locally integrated group in accordance with (Method 2 of Annex I of the

Financial Groups Directive (Deduction and Aggregation Method)) and apply the limits set out in paragraph 8 to those capital resources rather than the capital resources of the firm.

8.12. The combined effect of paragraph 8.2 and paragraph 8.6.3 is that exposures between members of the locally integrated group are exempt.

9. Wider Integrated Group

9.1. Paragraph 9 applies to a firm if:

9.1.1. It has a wider integrated group waiver; and

9.1.2. It is a member of a locally integrated group (as per section 8).

9.2.

9.2.1. If Paragraph 9 applies, paragraph 8 does not apply.

9.2.2. If paragraph 9 applies to a firm, it must apply paragraph 9 to all exposures coming within the scope of paragraph 9 and not just some of them.

9.3. If paragraph 9 applies to a firm, then subject to paragraph 10, it may, on a solo basis, treat an exposure to a concentration risk group counterparty as exempt from the limits in paragraph 5.

9.4. For the purposes of paragraph 9:

9.4.1. the wider integrated group of a firm consists of each concentration risk group counterparty that satisfies all the conditions for membership of the firm's locally integrated group except for paragraph 8.3.4;

9.4.2. a diverse block means all undertakings in the wider integrated group designated as a single diverse block by a wider integrated group permission; and

9.4.3. in relation to a firm, a member of the residual block means a concentration risk group counterparty which is not a member of the firm's locally integrated group or wider integrated group.

9.5. A firm to which paragraph 9 applies must ensure that the rules listed in paragraph 9.6 are complied with on a consolidated basis on the following basis:

9.5.1. The rules apply in relation to the firm's locally integrated group rather than in relation to the firm;

9.5.2. The rules apply in relation to exposures of the members of the locally integrated group to members of each of the following:

9.5.2.1. Each diverse block; and

9.5.2.2. The residual block; and

9.5.3. The locally integrated group, each diverse block, and the residual block must each be treated as separate single undertakings

9.6. The rules referred to in paragraph 9.5 are:

9.6.1.1. Paragraph 5.3.1;

9.6.1.2. Paragraph 5.4.1 (other than BIPRU paragraph 5.4.1.2);

9.6.1.3. Paragraph 5.4.3 (with the deletion of the time limit set out in paragraph 5.4.3); and

9.6.1.4. Paragraph 7.

9.6.2. Paragraph 8.9 and paragraph 8.11 apply for the purposes of paragraph 9 in the same way that they apply to paragraph 8.

9.6.3. As part of the process of applying for a wider integrated group waiver, a firm should agree with the FSC the number, nature and size of the diverse blocks. The basis of the diverse blocks will depend on the nature, scale and diversity of the business of the firm, its locally integrated group and its wider integrated group. In general, the FSC will expect to permit a firm to establish no more than four diverse blocks. However, there may be circumstances in which the nature and scale of a firm, its locally integrated group and its wider integrated group would warrant the creation of additional diverse blocks. Each member of a firm's wider integrated group will be allocated to a diverse block. Blocks may be diverse according to geography, business or a combination of both.

10. Trading Book Excess

10.1. Paragraph 10 applies to a firm applying the treatments set out in paragraph 8.

10.2. A firm must calculate the CNCOM that would have applied if the list in paragraph 8.8 or, as the case may be, paragraph 9.6 had applied paragraph 5.4.1.2 in relation to the locally integrated group.

10.3. A firm must then calculate the percentage of the amount calculated under paragraph 10.2 which is attributable to exposures of the firm.

10.4. A firm must add the result of the calculation in paragraph 10.3 to the CNCOM applied to the firm on a solo basis in accordance with paragraph 5.4.6 to paragraph 5.2.1.

11. Notification Procedures

11.1.

11.1.1. A firm may not apply paragraph 7 or paragraph 8 unless it has given one month's prior notice to the FSC that it intends do so.

11.1.2. The written notice referred to in 11.1.1 must explain how the firm meets the relevant conditions and how it will ensure that it will still meet the requirements of this Guidance Note on a continuing basis when using the relevant treatment.

11.1.3. A firm may stop applying paragraph 7 or paragraph 8 if it has given one month's prior notice to the FSC that it intends do so.

11.1.4. If a firm stops applying paragraph 7 or paragraph 8 it may start to apply it again if it notifies the FSC under 11.1.1 that it intends do so.

11.1.5. A firm need only give the FSC the notice required in 11.1.1 once and not with respect to each exposure.

11.2. A firm must notify the FSC if it becomes aware that any exposure that it has treated as exempt under paragraph 7, or any counterparty that it has been

treating as a member of its locally integrated group, or, if paragraph 9 applies, its wider integrated group has ceased to meet the conditions for application of the relevant treatment. A firm may give that notification in the first report due in the large exposures sheet after the obligation to notify arises.

12. Systems and controls and general

12.1. A firm must be able to demonstrate to the FSC that it has written policies and procedures to address and control the concentration risk arising from exposures to counterparties, groups of connected counterparties, and counterparties in the same economic sector, geographic region or from the same activity or commodity, the application of credit risk mitigation techniques, including in particular risks associated with large indirect credit exposures (for example to a single collateral issuer) and that its policies and procedures are implemented.

12.2. Other than in relation to repurchase transactions, securities or commodities lending or borrowing transactions, exposures must be reported on a gross basis, not including the recognition of credit risk mitigation.

12.3. A firm must have sound administrative and accounting procedures and adequate internal control mechanisms for (a) the purposes of identifying and recording all large exposures and subsequent changes to them, and (b) for monitoring those large exposures in the light of the firm's own exposure policies.

12.4. A firm must take reasonable care to establish and maintain adequate systems and controls to identify, monitor, and control exposures to apparent undertaking of the firm, a subsidiary undertaking of the firm, or a subsidiary undertaking of the firm's parent undertaking,

12.5. In line with the general principle, a firm must not:

12.5.1. treat an exposure as having been transferred to another person if that transfer is temporary; or

12.5.2. treat an exposure as having been closed out by a transaction or arrangement if that transaction or arrangement is artificial;

12.5.3. if that transfer, transaction or arrangement would otherwise have the effect of reducing the CNCOM or preventing or reducing a breach of the limits in this Guidance Note.

12.6. A firm must notify the FSC if it enters into a transfer, transaction or arrangement of the type mentioned in paragraph 12.5.

Exemption to Large Exposures Position for Performance Fees or Management Fees

13. Formal dispensation from the large exposure position will be provided where an exposure is strictly in relation to performance fees or management fees due in

respect of portfolio management services provided by a firm only, subject to the following 4 criteria being met:

13.1. There is a time limit on the exposure of 30 days i.e. the fees due must be paid/received within 30 days and there is certainty regarding this; and

13.2. The client agreement in place permits the firm to take the fees due from the account(s) of the client and to liquidate any positions which it needs to in order to take said fees; and

13.3. The firm has either by physical control of the client's assets, or by other legal mechanisms, the ability to recover its fees from the client's assets and the client has sufficient liquid assets to cover those fees (the cash and market value of the assets must be at least twice that of the fee due); and

13.4. At least one of the following is applied -

13.4.1. the exposure is subject to the limits set out in Section 6A of this guidance note (i.e. Section 64 of the FSCACI Regulations), or

13.4.2. where the limits are breached, the funds due have not been irrevocably committed in any way or for any use by the firm, and the firm's own funds will not be detrimentally affected in any way.

14. This policy will remain in place until such time as further guidance on this matter is issued by CESR and/or the EU Commission and is publicly available.

15. Where a firm intends to apply the above, it must advise the FSC of this in each instance and must indicate in the relevant reporting return the date on which the FSC has acknowledged receipt of said notification under "date approved" in column P of the Large Exposures sheet.

Appendix A – Connected Clients

The large exposures regime is a regime designed to limit the impact on an institution of a counterparty failing.

Idiosyncratic risk represents the effects of risks that are particular to individual borrowers.

The objective of the definition on connected clients in the CRD is to identify clients so closely linked by idiosyncratic risk factors that it is prudent to treat them as a single risk.

Definition of a group of connected clients in Article 4(45) of Directive 2006/48/EC

"Group of connected clients" means:

(a) two or more natural or legal persons, who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly, has control over the other or others; or

(b) two or more natural or legal persons between whom there is no relationship of control as set out in point (a) but who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, in particular funding or repayment difficulties, the other or all of the others would be likely to encounter funding or repayment difficulties.

The concept of connected clients is applied in two different contexts in Directive 2006/48/EC. Apart from large exposures, it is also applied when categorizing clients in the retail market portfolio (see Article 79 of Directive 2006/48/EC). However, in these guidelines the FSC is focusing on the application of Article 4(45) in relation to the large exposures regulation only.

The definition of connected clients as per Article 4(45) of Directive 2006/48/EC refers to interconnections arising from one of the following:

- one client has control over the other;
- the clients are interconnected by some form of material economic dependency, as for instance:
    - direct economic dependencies such as supply chain links or dependence on large customers, or
    - the clients have a main common source of funding in the form of credit support, potential funding or direct, indirect or reciprocal financial assistance.

The definition of control in Article 4(9) of Directive 2006/48/EC is specifically aimed at describing the conditions for requiring a consolidated annual report. While the concept of connected clients within the large exposures regime includes control, as defined in Article 4(9), it also covers interconnections arising through other means such as economic dependence.

Interpretation of control

The institution must first rely on the CRD definition of control (Article 4(9) of Directive 2006/48/EC), which is taken from the accounting definition (Article 1 of Directive 83/349/EEC on consolidated accounts). Control means the relationship between a parent undertaking and a subsidiary or a similar relationship between any natural/legal person and an undertaking.

This means that control is presumed to exist when the client owns directly, or indirectly through subsidiaries, more than half of the capital or voting power of an entity, unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control.

A client owning 50% of the shares/voting power of another client may be able to exercise one or more of the powers mentioned below. This is even the case when there are two equal partners/owners who share the power and govern the entity jointly.

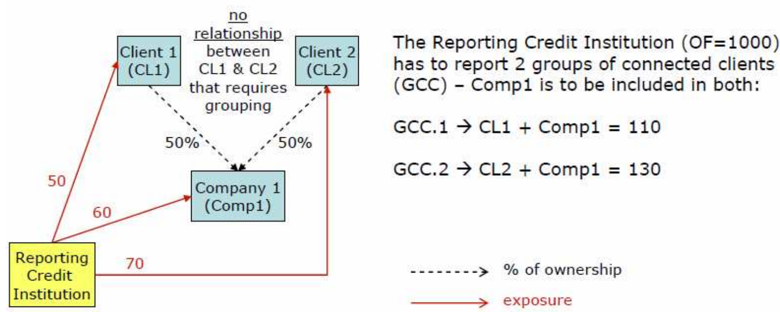
However, control may also exist when the client owns less than half of the voting power of an entity or does not hold any participating interest in the entity at all.

In those cases, the institution should refer to indicators of control that are seen in cases where the client is able to exercise one or more of these powers:

- power to direct the activities of the other entity so as to obtain benefits from its activities;
- power to decide on crucial transactions such as the transfer of profit or loss;
- power to appoint or remove the majority of directors, the supervisory board, the members of the board of directors or equivalent governing body where control of the entity is exercised by that board or body;
- power to cast the majority of votes at meetings of the board of directors, general assembly or equivalent governing body where control of the entity is exercised by that board or body; and/or
- power to co-ordinate the management of an undertaking with that of other undertakings in pursuit of a common objective, for instance, in the case where the same natural persons are involved in the management or board of two or more undertakings.

In cases where the institution needs to make a discretionary judgement, these indicators, along with other relevant indicators used for accounting purposes, could be used in order to identify a control relationship.

There will be some situations where there could be a requirement to include an entity in more than one group of connected clients, for example, in the case of an entity in which two persons/companies hold 50:50 participations if they exercise equal control on the entity, but are not otherwise interconnected in the sense of Article 4(45) of Directive 2006/48/EC (see Figure below). The same applies to a case where a client has entered into a “shareholders’ agreement” with other shareholders so as to obtain the majority of the voting power of an entity and this implies that all of the shareholders involved have control over the entity. A natural or legal person that is a partner in one or more (limited) partnerships also exercises control over these (limited) partnerships and (limited) partnerships are, therefore, to be included in the group of connected clients of every one of their partners.



The entire exposure to a connected client must be included in the calculation of the exposure to a group of connected clients; it is not limited to, nor proportional to, the formal percentage of ownership.

It follows from the definition of connected clients that horizontal groups according to Article 12 of the Directive 83/349/EEC on consolidated accounts, which draw up consolidated accounts and a consolidated annual report, are to be grouped as connected clients. This is the case if an undertaking is related to one or more other undertakings because they all have the same parent or are managed on a unified basis. This management may be pursuant to a contract concluded between the undertakings, or provisions in the Memoranda or Articles of Association of those undertakings, or if the administrative management or supervisory bodies of the undertaking and of one or more other undertakings consist for the major part of the same persons.

It follows from the control criterion that exposures to entities within the same group as the reporting institution are to be regarded as a single risk. All entities within the same group are connected clients, although exposures to some or all of them may be exempted from the large exposures regime.

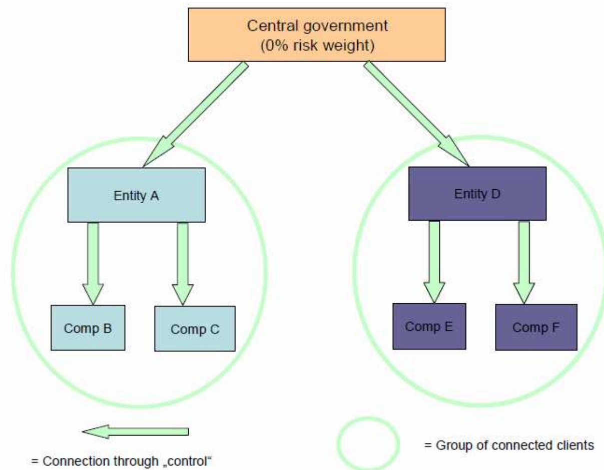
It should be understood that the control situation is not just for a transitional period but that it should be a reasonably stable state. In Article 4(45) of Directive 2006/48/EC the wording "*unless it is shown otherwise*" is used. It should be interpreted in the sense that if the institution is able to demonstrate that what seems to be a control relationship truly is not, then, there is no requirement to group the clients. Most notably, this would be the case for owners of shares without voting rights. However, in cases where control exists, it is not relevant that the client, for the time being, does not actually exercise its potential control. Accordingly, voluntarily self-imposed limitations on the exercise of control such as legal ring-fencing or statements of a similar nature issued by the client do not obviate the need to consider such clients as connected.

Exemption from the requirement to group clients in relation to "control"

For entities where the majority of the shares are directly owned by the central government (in the example below entities A and D), and where exposures to the central government[2] receive a 0% risk weight under Directive 2006/48/EC, there is no requirement to group these entities as a group of connected clients. This also applies to entities controlled by regional or local authorities treated as a central government which

[2] It was implicitly understood in the original advice from THE FSC of April 2008 that this exemption is limited to those governments whose exposures receive 0% risk weight (and their regional and local authorities) under the Standardised Approach to credit risk, as such default is outside the scope of the risks that the large exposures regime is designed to address.

receives a 0 % risk weight under Directive 2006/48/EC. In such cases, even though the owner has control over each entity, the risk connected with the exposure to one entity is normally not related to the risk of the exposures to other entities. In addition, the failure of one entity, which is a separate legal person, does not necessarily impose a duty on the owner to invest more capital. If the owner still decides to do so, it is assumed that this ultimately could be financed by raising revenues. This exemption, however, does not apply to further sub-structures of these entities (in the example below entities B, C, E and F). In such cases, these entities and their subsidiaries are to be included in a group of connected clients. This also applies to other cases of interconnections.



Interpretation of economic interconnection (single risk)

Scope of large exposures regime in relation to concentration risk

Geographic and sectoral concentration risks fall outside the scope of the large exposures regime and are addressed by other means such as concentration risk under Pillar 2 of the CRD. Institutions that operate in a well-defined geographic area only, or in an area dominated by one specific industry (sector), are not more affected in their conduct of business by the connected clients' rule than other institutions. Sectoral concentration is a common risk affecting all entities in the same industry; geographic risk is a risk affecting all entities in the same region, whereas economic interconnection is an idiosyncratic risk that arises in addition to sectoral and geographic risk.

Sectoral and geographical risks can be described as a dependency linked to an external factor (such as, for example, a certain product market or a specific region) which affects all entities active in the sector or region in the same manner. Idiosyncratic risk is where, in a bilateral interrelationship, financial problems of one entity are transferred via this interrelationship to another entity which otherwise would not be concerned.

Interpretation of economic interconnection

Even if the issue of control of one client over another does not apply, an institution is obliged to determine whether there exists a relationship of economic dependence between clients. If it is likely that the financial problems of one client would cause difficulties for the other(s) in terms of full and timely repayment of liabilities, there exists a single risk that needs to be addressed. An economic dependence between clients may be mutual or only one way.

Dependence might arise in the context of business interconnections (such as supply chain links, dependence on large customers or counterparty exposures, financial dependency) which are not linked to respective sectoral or geographic risks, and suggests that the

clients involved are exposed to the same idiosyncratic risk factor. If this idiosyncratic risk materializes, the solvency of one or both obligors can be threatened. Consequently, interdependencies between enterprises (or persons) due to bilateral business relationships may lead to default contagion which is independent from sectoral or geographic risk. The fact that the existence of common idiosyncratic risk factors may lead to default contagion for otherwise independent clients, is the core of the concept of economic interconnection.[3]

The rationale for the definition of economic interconnection in Article 4(45) (b) is to identify economic dependencies that a client cannot overcome without experiencing repayment difficulties. However, even if a client is depending on another client through, for instance, a business relationship, it could still be possible for the client to find a replacement for this business partner (in case of his default), or to compensate for such a loss by other means, for example, through reduction of costs, concentration on other sectors etc. This may cause practical problems, such as lower margins or other inconveniences, but as long as the institution comes to the conclusion that the client will be able to experience such a situation without facing substantial, existence-threatening repayment difficulties, there is no requirement to consider such clients to be interconnected. On the other hand, if it is likely that a client would not be able, for example, to experience the loss of an important customer, i.e. the institution comes to the conclusion that the failure of such a customer would lead to substantial, existence-threatening repayment difficulties for the client, then these clients shall be considered to be interconnected.

The following examples are illustrative of possible economic dependence between clients, where institutions should carry out further investigations regarding the need to group these clients:

- when one counterparty has guaranteed fully or partly the exposure of the other counterparty, or is liable by other means and the exposure is so significant for the issuer that the issuer is likely to default if a claim occurs. If the exposure is not significant, meaning that the potential liability, if it materializes, would not threaten the issuer’s solvency, then such relationships are covered through the Credit Risk Mitigation rules or counterparty substitution;
- the owner of a residential/commercial property and the tenant who pays the majority of the rent;
- significant part of production/output is for one single customer;
- significant part of receivables or liabilities of the client is to one counterparty;
- a producer and vendor that this producer is depending on and which it would take time to replace;
- undertakings that have an identical customer base, consisting of a very small number of customers and where the potential for finding new customers is limited;
- if the institution becomes aware that clients have been considered as interconnected by another institution; and
- for the retail market:
  - the debtor and his/her co-borrower;
  - the debtor and his/her spouse/partner if by contractual arrangements or marriage laws both are liable and the loan is significant for both; or

[3] This definition of a common idiosyncratic risk factor was developed for the purpose of analyzing aspects of the IRB model, but it is applicable also for large exposures purposes.

- the debtor and a collateral provider or guarantor, provided that the collateral or guarantee is so substantial for the issuer to the extent that his/her/its ability to service the liabilities will be affected if the guarantee or collateral is claimed by the institution.

It is not possible to give a comprehensive list of possible cases of economic interconnection. Each case will have its own characteristics, and the identification of interconnected clients requires thorough knowledge of the customer/client and not least a consciousness of connected risks among the institution's staff.

Interpretation of economic interconnection through a main source of funding

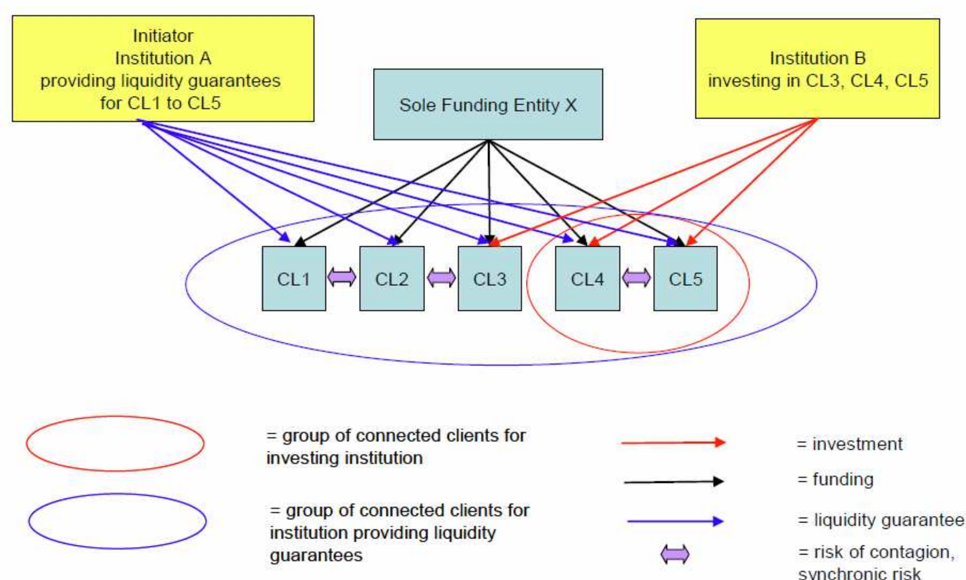
In relation to interconnection and funding in general, Article 4(45) of Directive 2006/48/EC requires institutions to identify clients that are connected because of funding relationships. This means that funding problems of one entity are likely to spread to another due to dependence on the same funding source. "Dependency" in this context means that the source of funding is not easily replaceable and that the clients in this case are not able to overcome their funding dependence on this entity even by taking on practical inconvenience or higher costs. The intention is not to include cases where the respective counterparties draw on the same market (e. g. the market for commercial paper), but when the funding of the clients is based on the same source. Furthermore, it should be noted, that it is a basic principle of the large exposures regime, that in the determination of interconnections, the quality of management or the credit quality of the entities concerned is not taken into account.

In the example below, the ability of CL1 to CL5 to refinance their business depends on the solvency/reputation of the initiating and guaranteeing institution A and on the quality of the underlying assets of each individual entity (CL1 to CL5). As institution A is directly/indirectly responsible for the whole structure (green colour) and also the lender of last resort, A shall consider CL1 to CL5 as one connected client.

From the perspective of the investing institution B, in general, the same shall apply. However, if institution B is able to demonstrate that CL1 to CL5 do not represent a single risk, institution B may treat them as separate counterparties. A single risk shall be assumed if there is risk of contagion or synchronic risk between the respective entities CL1 to CL5. Synchronic risk can emerge from, for example:

- use of one funding entity;
- same investment advisor (e.g. investment committee);
- similar structures;
- reliance on commitments from one source (such as guarantees, credit support in structured transactions or non-committed liquidity facilities) and its solvency, and;
- similar underlying assets.

In the example below CL1, CL2 and CL3 on the one hand and CL4 and CL5 on the other hand have similar risks, i.e. there is either a risk of contagion or synchronic risk. The general assumption in this example is that all five are interconnected because they depend on institution A and have a common source of funding. However, if institution B which invests in conduits CL3 to CL5 can demonstrate that the risk of contagion/synchronic risk is limited to conduits CL4 and CL5, i.e. CL3 and CL4 and CL5 do not constitute a single risk and that the common source of funding for all the conduits can be easily replaced, it may only consider CL4 and CL5 as interconnected and treat CL3 as another single client.



An illustrative case in relation to connected clients due to a common source of funding is the following: where a bank has committed itself to be the existing or potential funder or provider of credit support to more than one conduit or SPV under similar conditions and where it is possible that all of these commitments may materialize into exposures at the same time because they are dependent on the same funding entity. As an example, an entity provided liquidity for a number of different conduits, and relied on issuing commercial paper (CP) in order to finance the conduits. The conduits had no other source of funding and invested in long-term assets. As the asset quality of the conduits came into question, the loss of trust in the market was immediate and significant, and the funding entity was unable to issue new commercial paper. Consequently, it could not provide the necessary funds to refinance all the conduits. Therefore, the bank, as the main guarantor for the conduits, had to fund the whole structure. Although the different conduits were not invested in the same assets and were legally independent as they were owned by separate trusts, it is obvious that the different conduits constituted a group of connected clients as they formed a single risk. This risk was not a sectoral risk, as it was the specialization in product and niche in the money market or, more specifically, the market for commercial paper, which caused the dependence. The moment there was no market for new commercial paper of the funding entity, the limited scope, competence and solidity of these SPVs became evident.

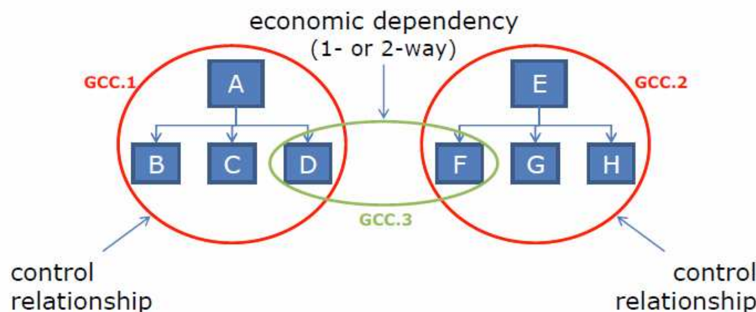
While the above example refers specifically to conduits and the problems experienced in the commercial paper market, it should be noted that the requirement to connect clients due to a common source of funding is not dependent on either the type of entity being funded nor the form of funding used, but rather it is dependent on entities receiving all or the majority of their funding from a common source which cannot easily be replaced. As in general, for the concept of interconnection, it requires a case by case assessment.

However, it should be noted that a common source of funding due solely to geographic location does not, in itself, lead to a requirement to connect clients. Small and medium sized entities will, in many cases, not have the capacity or commercial incentive to use other than their local bank, and in addition, for most of them the personal relationship with their banker is the key to better financial services. This fact does not in itself justify these clients be regarded as interconnected, even though they have a common source of funding. Such a situation differs from funding dependencies described in this chapter because the motivation for sharing a common source of funding is the geographic location and because such a common source of funding can normally be replaced.

Clients that are depending on their existing source of funding simply because they are not creditworthy do not belong in this category. In the same way, being clients of the same institution does not in itself create a requirement to group the clients. It is not required that an institution should collect information about whether it's clients share an external common source of funding, however, institutions shall take into account accessible information in this regard.

Relation between interconnections through control and interconnections through economic interconnection

Interconnections arising through control and interconnections arising through economic interconnection are two different concepts and a mandatory requirement to interlink them could lead to far reaching grouping requirements. Therefore, there is no general requirement to link these two concepts together which the following example (see Figure below) shall illustrate: The reporting institution has identified two groups of connected clients (GCC) based on the control criterion. In addition, there is evidence that clients D and F are economically interdependent as set out in Section D (e.g. 1-way dependency of F towards D). If the financial problems of client F are not likely to result in difficulties in terms of full and timely repayment of liabilities for other members of the group of connected clients in GCC.1, there is no need to include client F in GCC.1 – D and F are to be included in a third GCC. Only in the case when financial problems spread from one GCC into the other GCC (risk of contagion of the whole group) because of the economic dependency between two of their members, is there a need to treat the two groups as one single GCC.



Control and management procedures in order to identify connected clients

Identification of possible connections between clients should be an integral part of an institution's credit granting and surveillance process. It is in the interests of the institution to identify all possible connections in order that it has a clear understanding of its cluster risk. Institutions shall increase their efforts to identify connections as exposures grow or reach a certain threshold. While an institution should in general examine interconnections for all exposures, the FSC expects that institutions intensively investigate possible economic connections with appropriate documentation for all exposures that exceed 2% of own funds at a solo or consolidated level.

Having information about connected clients is essential in limiting the impact of unforeseen events. In this regard, institutions shall use all available information to identify connections; this includes publicly available information. The data that needs to be collected may go beyond the institution's client and include legal or natural persons

connected to the client. Information about business links or economic dependencies is not usually captured by the existing information systems of banks. The necessary inputs require utilising "soft information" that typically exists at the level of individual loan officers and relationship managers. Institutions shall take reasonable steps to acquire this information.

In relation to the identification of interconnected clients, every institution should have in place a robust process for determining connected clients. The institution must be in a position to demonstrate to its competent authority that its process is commensurate to its business. In addition, the process should be subject to on-going review by the institution to ensure its appropriateness. It will rarely be possible to implement automated procedures for identifying economic interconnections; therefore, case by case analysis and judgement will be required. Consequently, for the identification of economic interconnections, institutions need to rely primarily on the expertise of their loan officers and risk managers. Therefore, an institution's board of directors and senior management must ensure that adequate processes for the identification of economic interconnections are in place and risk managers and loan officers are sufficiently trained in this regard. Furthermore, institutions should also monitor for changes to interconnections, at least in the context of their normal periodic loan reviews and when substantial expansions of the loan are planned.

A crucial point in the process is the first time an exposure is granted to the client, or the first time an exposure reaches a level that requires individual handling from the institution. At this point, there is normally a loan officer involved and personal contact between the loan officer and the client. This opportunity to collect information relevant to disclosure of connected clients should be utilised.

Normally, the institution's largest exposures will be allocated to loan officers dedicated to following the client on a regular basis. This includes personal contact as well as scrutinizing accounts and reports. The occasions to develop a deeper understanding of the client's business and possible dependencies are there and the collection of such information is a normal part of conducting prudent banking.

The institution has to assess for example the diversity of the client's customer base, or of the tenants. In cases where the institution has identified interconnection, it has to acquire information on the other entity(ies) in the group of connected clients if this is necessary to form a view on the creditworthiness of its customer. The institution, however, is not obliged to investigate, whether the other entity, to which its client is interconnected, itself is part of other groups of connected clients, as long as the other entity is not a client of the institution.

Notwithstanding the above, all interconnections to the knowledge of an institution shall be recognised, independently of the size of the exposure. As the determination of interconnection is dependent on the one hand on economic judgement, and on the other hand on the information available to, or gathered on a best effort basis by the institution.

Appendix B - Treatment of exposures to schemes with underlying assets according to Article 106(3) of Directive 2006/48/EC

Article 106(3) of amended Directive 2006/48/EC is transposed into regulation 57(5) of the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007 ("FSCACI") which states:

> *57.(5) In order to determine the existence of a group of connected clients, in respect of the exposures in regulation 29(1)(m), (o) and (p), where there is an exposure to underlying assets, a credit institution shall assess the scheme or its underlying exposures, or both.*

Relevant sections of the FSCACI regulations 29(1)(m), (o) and (p) states:

> *29.(1) For the purposes of the standardised approach, each exposure shall fall within one of the following classes…–*
>
> *(m) securitisation positions; …*
>
> *(o) claims in the form of collective investment undertakings; or*
>
> *(p) other items.*

In order to determine the existence of a group of connected clients, in respect of exposures referred to in points (m), (o) and (p) above, where there is an exposure to underlying assets, a credit institution shall assess the scheme, its underlying exposures, or both. For that purpose, a credit institution shall evaluate the economic substance and the risks inherent in the structure of the transaction.

In respect to the treatment of schemes with underlying assets set out in this appendix, until 31 December 2015, institutions may treat schemes acquired before the 31 January 2010 according to the treatment of schemes that was required prior to the implementation of the guidelines. The FSC acknowledges that the implementation of some specific aspects of the guidelines will have costs for the supervised institutions as they will give rise to changes in the current procedures.

Exposures can arise not only through direct investments of institutions but also through investments in schemes[4] which themselves invest in underlying assets. Consequently, when an institution invests in a scheme it is exposed on the one hand to the risk associated with the scheme manager/depositor and on the other hand to the credit and market risk linked to the underlying assets of the scheme. Therefore, ideally, the underlying assets of a scheme should always be taken into account when calculating exposures for large exposure purposes.

Regulation 57(5) of the FSCACI makes clear that institutions have to separately assess for large exposure purposes, schemes with underlying assets in order to determine the existence of groups of connected clients. Institutions are required to assess whether the scheme itself, its underlying assets or both are interconnected with the institution's clients (including other schemes) and, therefore, should be grouped together with such connected clients for the purpose of the large exposure requirements.

The European Banking Authority ("EBA") advised in its "guidelines on the implementation of the Large Exposures regime" (dated 11 December 2009) that there is

[4] Such as collective investment undertakings (CIUs) and structured finance/structured finance vehicles (e.g. securitisations)

evidence to suggest that institutions' exposures to schemes with underlying assets are not being consistently (or prudently) treated for the purposes of determining the existence of a group of connected clients with regard to the large exposure requirements. This leads to the increased risk of the large exposure limits being breached and consequential risks of firm failure, which can result in negative externalities.

The EBA included guidelines on the appropriate treatment of various structured finance/structured finance vehicles which provides further clarity on the schemes as set out in regulation 57(5) of the FSCACI. The following is based on the guidelines issued by the EBA.

Treatment of schemes with underlying assets

Potential losses stemming from schemes with underlying assets can arise from two sources: the risk associated with the scheme itself and the risk associated with the underlying assets of the scheme. Regulation 57(5) of the FSCACI makes clear that these two sources of risk need to be taken into account in the determination of the existence of a group of connected clients. The different nature of the two sources implies that different factors should be taken into account when assessing the materiality of the risks stemming from each source, and therefore the need to apply "look-through" to cope with the risk stemming from the underlying assets or to limit the investment in a specific scheme to cope with the risk stemming from the scheme itself. In the case of the risk stemming from the underlying assets one important factor would be the degree of diversification in the scheme. While in the case of the risk stemming from the scheme itself the legal framework applicable to the fund managers would be an important factor to take into account.

Institutions should apply the following approach or combination of approaches for the treatment of exposures to schemes with underlying assets according to regulation 57(5) of the FSCACI for the purpose of determining the interconnections of the underlying assets in the scheme with other clients:

Full look-through:

The institution may identify and monitor over time all exposures in a scheme and assign them to the corresponding client(s) or group(s) of connected clients.

Partial look-through approach:

The institution may look-through to the x known exposures in a scheme and assign them to the corresponding client(s) or group(s) of connected clients. The remaining exposures shall be treated as unknown exposures in accordance with (c) below.

Unknown exposures:

All unknown exposures (including schemes where the institution does not look-through by any of the methods described above and which are not sufficiently granular) are to be regarded as a single risk and shall, therefore, be considered as one unknown client. A scheme may be considered as sufficiently granular if its largest exposure is smaller than 5% of the total scheme.

Structure-based approach:
If an institution can ensure (e.g. by means of a CIU's mandate) that the underlying assets of the scheme are not connected with any other direct or indirect exposure in the institution's portfolio (including other schemes) that is higher than 2% of the institutions own funds, it may treat these schemes as separate unconnected clients.

Institutions shall consider the risk arising from the scheme itself separately[5], in addition to the risk stemming from the underlying assets. Therefore, investments in single schemes (including the group of unknown exposures referred to in c)) shall be limited to 25% of own funds according to Article 111(1) of Directive 2006/48/EC.

Institutions should adhere to the following principles when applying the approaches above:

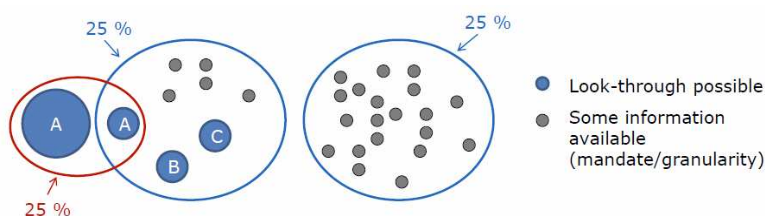
- For funds of funds, the granularity criterion may be applied on the level of the underlying assets of the underlying funds.
- Monitoring shall be carried out on an ongoing basis, but at least once every month
- If an institution is aware of interconnections between the underlying assets of a scheme, they shall be recognised for the purposes of establishing the existence of a "group of connected clients". However, there is no requirement to intensively analyse interconnections between those underlying assets.
- The respective exposure amounts only need to be included in proportion to the institutions' share of interests in the scheme.
- Until 31 December 2015, institutions may treat schemes acquired before the 31 January 2010 according to the treatment of schemes that was required prior to the 31 December 2010.

Institutions should, whenever feasible, use the more risk sensitive approaches and should be able to demonstrate to the competent authorities that regulatory arbitrage considerations have not influenced their choice.

Where an institution cannot ensure that there are no interconnections between the institution's clients and the underlying assets of a scheme, prudential treatment cannot allow for such exposures and schemes to be considered as independent counterparts. All unknown exposures from schemes should be considered as belonging to one single group of connected clients.

Illustrative examples

"Individual unknown clients" (partial look-through / granular portfolios / structure-based approach):

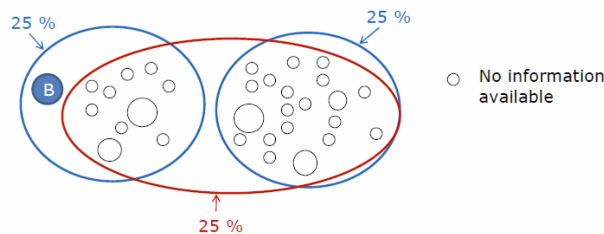


The above examples show on the left-hand side a scheme to which partial look-through is applied. The institution identified the counterparts (exposures) A, B,

[5] Such interconnections may arise due to "servicer risk" or "originator risk" in e.g. securitisations, or due to reliance on a central manager in the case of CIUs.

and C of the scheme. Because the institution has also an exposure to A in its portfolio, it must add these two exposures (the small and the large circle with "A") for large exposure purposes. Exposures B and C have no correspondence in the institution's portfolio; they may be treated as single exposures. The other unknown exposures of the scheme (grey circles in the scheme on the left) shall be treated as an unknown client. The scheme on the right-hand side represents an example where the institution applies the "structure-based approach". In this example, the institution is not aware of the counterparties in the scheme, but can, nevertheless, ensure, that they are not connected with any direct or indirect exposures in the institution's portfolio (including other schemes) that are higher than 2% of the institution's own funds. In this case, the institution may treat the scheme as a separate unconnected client. Please note, that nevertheless the general rule applies for both schemes, and that single schemes are, in general subject to the 25% limit.

Illustrative example "treat as one unknown client":



The above example shows two schemes. For the scheme on the left-hand side a partial look-through is applied. The institution identified counterpart (exposure) B of the scheme. Exposures B has no correspondence in the institution's portfolio, therefore it may be treated as a single exposure. For the other exposures in both schemes (white circles) there is no information available. Therefore they shall be considered together and be treated as one unknown client. Please note, that nevertheless for both schemes the general rule applies, that single schemes are in general subject to the 25% limit.

Treatment of tranched products

In cases of non-structured finance exposures, the losses derived from the default of counterparty in the scheme is proportionate to a direct investment in the underlying assets. In the case of structured finance/structured finance vehicles, the calculation of the losses also depends on the credit enhancements linked with the specific tranches. As far as these enhancements are legally enforceable, they should be taken into account for large exposure purposes in a way consistent with the large exposure mitigation framework. The proposed treatment recognises the credit risk mitigation that subordination of tranches provides to the structure, which is consistent with the general

requirement for institutions to use the most risk sensitive approach feasible. The tranches benefit from large exposures reduction by credit enhancement.[6]

The thinking behind the proposed treatment is the following: for any given position that an investor may hold in a securitisation, there is a protection stemming from subordinated tranches equal to the size of this subordination. No matter which underlying exposure defaults first, a given position will always be protected by the junior tranches, by an amount equal to their size. Thus, the initial exposure to a given name should be "adjusted" and reduced by an amount equal to the size of all junior tranches. The adjustment will, of course, also depend on the share that is invested in the tranche.

For granular portfolios, where the size of each counterparty is smaller than the size of first loss tranches, the proposal would require for the investors in the first loss tranche to recognise a large exposure equal to each underlying name, and for the investors into the senior tranche, no large exposure at all.

The analysis will have to be conducted for every tranche (T) in which an institution holds a position.

The proposal has to be dynamic because the limits vary as losses affect the underlying pool. Continuous evaluation of the scheme's performance would, therefore, be necessary (see example 1 below).

However, there are two concerns that could make it advisable to add a conservative layer in the recognition of the mitigation. First, it is not always easy to reassess the portfolio on a continuous basis. It is possible that the first loss tranche is exhausted, but the institution that invests in the more senior tranche has not yet recognised this fact for large exposures purposes. For that reason, it is worth exploring the need to clarify the risk management standards that banks should comply with in order to benefit from any such mitigation effect.

Second, there is a risk that as a consequence of the reassessment once the first loss is exhausted, some of the positions in certain names could result in sudden large exposures breaches (as the mitigation effect of the first loss tranche disappears). The institution may then be forced to reduce their exposure to comply with the limits regardless of the market conditions, they, therefore, run the risk of selling at a loss (this may depend on how liquid the instrument is). The offset of tranches held by the institution protects it to a certain degree from taking losses.

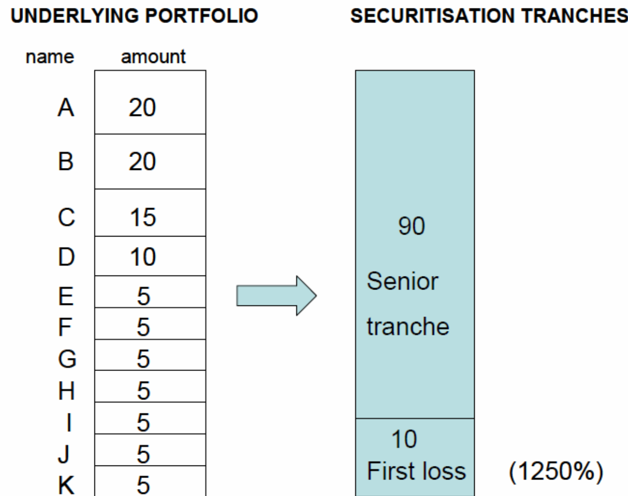
The following examples illustrate how this would work under the different approaches. The examples only refer to the credit risk arising from the underlying assets and do not refer to the risk arising from the scheme itself.

EXAMPLE 1

A. FULL LOOK-THROUGH (this example illustrates the case where the look-through is applied)

The structure of the product is as follows:

[6] This section is only about the mitigation provided by a tranched structure and does not refer to other credit enhancements that could also be attached to the scheme such as guarantees or credit lines. This is because the recognition of these types of enhancements is not exclusive of these products but more general and, therefore, the general rules for recognition would apply.



Assuming that Institution 1 has invested 90 in the Senior tranche and Institution 2 has invested 10 in the first loss tranche.

The treatment for large exposures purposes should be the following:

Institution 1, on the senior tranche must recognise:

0 with debtors D to K

5 with debtor C

10 with A and B

Institution 2, on the first loss tranche:

5 with debtors E to K

10 with debtors A to D

Assuming that in the next period counterparty K defaults and a loss of 5 is registered. Then, once this loss is known institutions 1 and 2 must reassess the exposures. Therefore, just after the default:

Institution 1, on the senior tranche must recognise:

0 with debtors E to J

5 with debtor D

10 with debtor C

15 with A and B

Institution 2, on the first loss tranche:

5 with debtors A to J

B. <u>PARTIAL LOOK-THROUGH</u>

This example assumes that only the names A and B are known, for the rest, the institutions only know that the maximum amount invested is 20.

The treatment for large exposures purposes should be the following:

Institution 1, on the senior tranche must recognise:

10 with A and B

10 to add to the rest of the unknown exposures

Institution 2, on the first loss tranche:

10 with debtors A and B

10 to add to the rest of the unknown exposures

C. <u>STRUCTURE-BASED APPROACH</u>

This example assumes that no names are known, institutions only know that the maximum amount which can be invested in each counterparty is 20 and counterparties can only belong to the UK pharmaceutical sector, and the institution has no other direct or indirect investments in that sector.

The treatment for large exposures purposes should be the following:

Institution 1, on the senior tranche must recognise:

10 to the scheme (no effect because an exposure to the scheme of 90 is already recognised)

Institution 2, on the first loss tranche:

10 to the scheme (no effect because an exposure to the scheme of 10 is already recognised)

D. <u>RESIDUAL APPROACH</u>

This example assumes that no names are known and the institutions do not know the maximum amount invested in each counterparty nor have any clue as to the nature of the investments (structure).

The treatment for large exposures purposes should be the following:

Institution 1, on the senior tranche must recognise:

90 to add to the unknown exposures

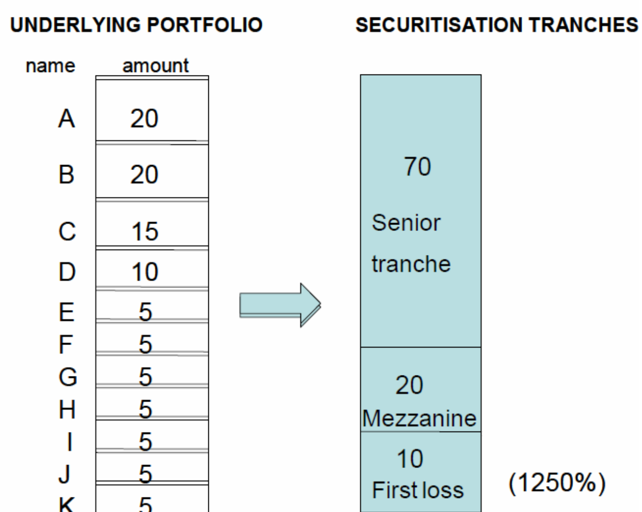
Institution 2, on the first loss tranche:

10 to add to the unknown exposures

More examples on how the full look-through approach could be implemented for more complex structures are provided below:

<u>EXAMPLE 2</u>

In this example a mezzanine tranche is added to the structure and a haircut of 50% is used to compute the mitigation effect for the mezzanine tranche. Since THE FSC is not in a position to recommend the use of a specific haircut, the haircut used in this example is just an illustration of how a haircut could be used, but of course the haircut in each specific case should depend on the risks outlined above: 1) lags in the reassessment and 2) losses that can stem from the required re-composition of the portfolio once the first loss is exhausted, given the sudden emergence of large exposures breaches.



The treatment for large exposures purposes should be the following:

Institution 1 on the Senior tranche:

0 with A to K

Institution 2 on Mezzanine tranche:

0 with E to K

5 with D

10 with C

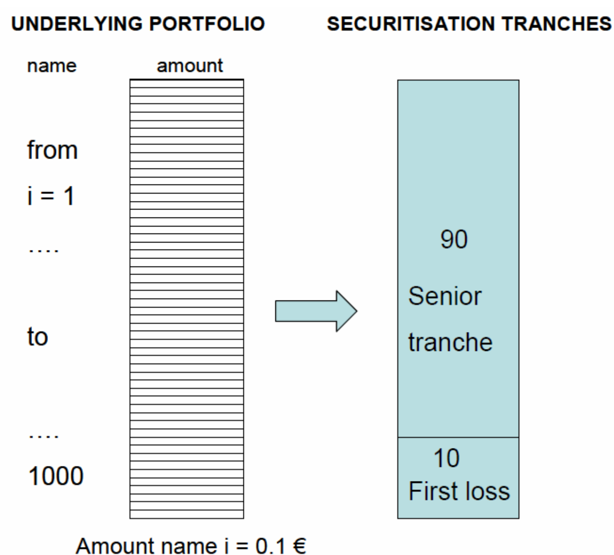
15 with A and B

Institution 3 on First Loss tranche:

5 with E to K

10 with A to D

<u>EXAMPLE 3</u>



The treatment for large exposures purposes should be the following:

Institution 1 on the Senior tranche:

0 with debtors I = 1 to 1000

Institution 2 on the First loss tranche:

0.1 with debtors I = 1 to 1000

The FSC recognises that the variety and diversity of structured finance/structured finance vehicles can be large and therefore case by case specificities should be properly accounted for when implementing these principles.