



## Comments on: Supervisory framework for measuring and controlling large exposures

Section	Comment
<p>3. A large exposures framework complements the Committee's risk-based capital standard because the latter is not designed specifically to protect banks from large losses resulting from the sudden default of a single counterparty. In particular, the minimum capital requirements (Pillar 1) of the Basel capital framework implicitly assume that a bank holds infinitely granular portfolios, ie no form of concentration risk is considered in calculating capital requirements. Contrary to this assumption, these adjustments are neither harmonised across jurisdictions, nor designed to control traumatic losses from a single counterparty default. For this reason, the Committee has concluded that the existing risk-based capital framework is not sufficient to fully mitigate the microprudential risk of exposures that are large compared to a bank's capital resources. That framework needs to be supplemented with a simple large exposures framework that protects banks from traumatic losses caused by the sudden default of a certain counterparty or group of connected counterparties. To serve as a backstop to risk-based capital requirements, the large exposures framework should be designed so that the maximum possible loss a bank could incur if a single counterparty or group of connected counterparties were to suddenly fail would not endanger the bank's survival as a going concern.</p>	<p>It is recommended to set up a specific concentration surcharge framework. There are papers, such as those from Gordy and Vasicek in which there are closed formulas to apply a Granularity Adjustment.</p> <div data-bbox="1036 848 1101 911"></div> <div data-bbox="971 911 1169 957">dist_loan_port_val.pdf</div> <div data-bbox="1240 848 1305 911"></div> <div data-bbox="1198 911 1347 936">200255pap.pdf</div>
<p>20. The Committee believes that the large exposures framework should be based on a hard or Pillar 1-type limit, which would place it on the same footing as the Pillar 1 minimum capital requirements. This is to ensure that the large exposures standard is effective and consistent for internationally active banks. On this basis, breaches of the limit should be exceptional events, should be communicated immediately to the supervisor and should, normally, be rapidly rectified.</p>	<p>It is recommended to set up a hard limit as a function of the capital ratio.</p>
<p>26. In some cases, a bank may have exposures to a group of counterparties with mutual relationships or dependencies that imply that they are all likely to fail simultaneously. In other words, the group of counterparties poses a "single risk", akin to that of a single counterparty. Such a group is referred to as a group of connected counterparties. Thus, one of the main challenges in managing and controlling large exposures is the identification of groups of connected</p>	<p>There would be periods in the economic cycle of weak dependency and periods of strong dependency. It should be</p>

counterparties.	clear that dependency should be established under downturn conditions.
31. To assess connectedness through control, the Committee proposes that criterion (a) is met automatically if one entity owns more than 50% of the voting rights of another entity.	Exclude positions in a formal stock exchange.
34. For guidance on establishing connectedness based on economic interdependence, banks should consider, at a minimum, the following qualitative criteria: ... Where it is likely that the financial problems of one counterparty would cause difficulties for the other counterparties in terms of full and timely repayment of liabilities; ...	Exclude retail positions.
38. The Committee's 1991 Guidelines provide for a limit equal to 25% of total capital and its recent analysis suggests that there is scope for tightening this limit. The Committee therefore proposes that the large exposure limit should be 25% of Common Equity Tier 1 (CET1) or Tier 1 capital (see Part III-A). This represents a tightening of the recommended large exposure limit due to the tighter definition of capital employed.	The limit should be a function of the corresponding capital ratio.
78. Exposures to a single counterparty can arise in the trading book, and it is important that these exposures are added to any other exposures that lie within the banking book to calculate a bank's total exposure to a single counterparty, which is then subject to the large exposure limit.	It makes sense to add trading and banking book positions from the same counterparty.
83. Due to their distinct non-linear characteristics, options differ from other types of instruments. While the risk-based capital requirement approach tries to approximate the non-linear price changes of options resulting from underlying price changes by a set of alternatively available approaches, the approximation is only suitable for relatively small changes in the price of the underlying. But for the purpose of regulating large exposures, it is appropriate to consider a very large price movement; ie the sort of price movement that would occur if there were a jump-to-default by the underlying. Thus, the approaches used in the risk-based capital requirement are not appropriate. The same would apply for securitisations, hedge funds and CIU, where decomposition would technically not be feasible.	The jump-to-default approach seems to be the right way of doing it.
123. Currently, in most jurisdictions, exposures to central counterparties (CCPs) <sup>22</sup> are exempted from large exposure	It is not possible to set

<p>limits, mirroring the zero exposure value allocated to these exposures for risk-based capital requirement purposes.<sup>23</sup> The Committee has considered whether this is consistent with the objective of the large exposures framework, and whether it might be desirable to introduce a special treatment for them.</p>	<p>up hard limits to CCPs, but there should be a benefit in terms of diversification.</p>
<p>131. Policymakers are concerned that the failure of large, global financial institutions could generate negative externalities that fall on the rest of the financial system and harm the real economy. To address the risks associated with banks whose failure would have a high systemic impact, the Committee has developed a framework for assessing the global systemic importance of banks and imposing additional loss absorbency requirements on these firms.<sup>32</sup> One of the reasons why a bank could be identified as a global systemically important bank (G-SIB) is that it is highly interconnected with the rest of the financial system. If a highly interconnected bank were to fail it might cause other banks that are exposed to it to suffer losses and potentially trigger their failure; ie there would be interbank contagion. The social cost of such contagion would be greater still if the banks that were to fail due to contagion were also G-SIBs (ie those banks whose failure has the greatest global systemic impact).</p>	<p>There should be a similar definition to that of G-SIB for Local SIB.</p>