Saudi Banks Comments on "BCBS Consultative Document: Supervisory <u>Framework for Measuring and Controlling Large Exposures"</u>

<u>Definition of a large exposure</u>

i. Para 22: Please clarify whether the Corporate Large Exposure Limit is 25% of CET 1 or Tier 1 Capital or Is it 10% of eligible capital as specified;

ii. Para 24: (a) The recommended benchmarking of large exposure at 5% of the bank's capital is deemed to be on the lower side. It is suggested that the definition of large exposures be retained at 10% of eligible capital, as at present, since adequate cushion is available considering that it is well below the proposed legal exposure limit of 25% per single counterparty group; (b) The current threshold of 10% for large exposures is reasonable considering that commercial lending and project financing activities are largely on cash flow basis; reducing the threshold to 5% can have implications for regional economies where market growth/development are driven by fewer number of large corporations;(c) There is a need for clarification whether reporting will be based on approved exposure limits or outstanding or both;

iii. The 5% reporting requirement is a deviation from the existing threshold of 10%. Though the purpose in reducing the threshold is to strengthen the definition of a large exposure, we feel that reducing it to 5% does not directly address the objective of 'controlling large exposures.' Instead, it will just create additional reporting burden for banks. Reducing the threshold which will result to banks classifying more 'large exposures' does not minimize the probability of default of an exposure given that each exposure regardless of the threshold amount entails different levels of credit risk;

iv. Question 1: The tightening of definition of capital and reducing the threshold to half of the earlier level would be more appropriate for banks with significantly large capital. It would reduce the level of exposure that smaller banks can take up for government related infrastructure lending especially to counterparties that take up a large number of contracts;

v. The implementation of large exposure limits to be based on soft/advisory limits instead of based on hard or Pillar 1 type limits. The banks are not able to control effectively of the percentage of this limit. For example, even though that a bank is still complying with the minimum capital requirement under Pillar 1 after taking into the current year losses, it may breach the

large exposure limit. For the bank to reduce its the credit limits to large exposures immediately will not be practical approach whereas it will not be reasonable to expect the shareholders to inject additional capital even though from the regulatory requirements, the regulatory capital is being complied;

vi. The implementation of this standard to be implemented on staggered basis as the requirement to aggregate the exposure to cover both financing and bond/sukuk exposures in trading and banking book. As the current reporting requirement will not require the aggregation of these exposure, some changes of the current reporting approach and infrastructure needs to be done to provide the adequate time for the bank to make the necessary changes on the current reporting architecture;

vii. As the corporate structure is beyond the bank's control, any merger and acquisition activity may result the bank is breaching the limit arising from the requirement to add the related companies that are not consolidated previously. The guideline should cover among other the grace period to be provided by regulator for the bank to comply the large exposure limit due to changes of corporate structures of the borrower;

<u>Definition of connected counterparties</u>

i. Para 28 (Economic interdependence): In some countries, the government and quasi-government entities play a significant role in shaping economic development in conjunction with principal industrial entities in the private sector. Operationally, this creates much interdependency between principal contractors and sub-contractors. The paper provides much leeway in terms of interpretation and banks would welcome a practical approach on how this should be viewed. Additional objective criteria would be helpful to ensure consistent application of the standard;

ii. Para 33: There is a need to provide further clarification and certainty on the circumstances that the existence of control does not necessarily result in the parties forming a group of connected parties. For example, all companies that are listed company in the authorized stock exchange who can access the funding sources by its own strength and capabilities need to be automatically excluded from the group of connected parties;

iii. Para 34: Bullets # 1 and 3 under this Para may be excluded from the list of qualitative criteria for determining economic interdependence. The first

bullets deal with economic interdependence in terms of substantial part of one counterparties gross receipts or gross expenditure being derived from transactions with the other counterparty. The third bullet deals with economic interdependence in terms of significant part of the counterparty's production being for a single customer which cannot be easily replaced. These criterion will be very difficult to monitor and cannot be uniformly applied across different industries with varying structures. Moreover, groupings on the basis of the guidelines is likely to result in aggregation of various independent Group/Customers under one large Group of connected counterparties;

iv. The suggested criteria with respect to economic dependencies (i.e. paragraph 34) will be overly burdensome for the banks in terms of consistent and accurate application since they are mainly of qualitative in nature. Further, criteria related to "economic dependencies" amongst the obligors may have implications for emerging and smaller markets compared to well diversified large markets economies; this may justify certain national discretion;

v. While the proposed approach for establishing connected counterparties based on control is relatively consistent, however, different banks may use different assessment approaches of connected counterparties based on economic interdependence and thus is difficult to harmonize across jurisdictions. Moreover, such subjectivity might potentially have bearing on the way large exposure are consistently measured and controlled across jurisdictions;

vi. The definition of economic interdependence in page 6 could be revisited. "substantial part of gross receipts or gross expenditures" as a single criterion would mean aggregation of all suppliers and customers of large corporate. This criterion should be triggered in conjunction with a second criteria related to ownership, management etc;

vii. Para 34 (2nd bullet): It is not clear why guarantors should only be aggregated with the guaranteed entity if the exposure is significant. We believe it should be aggregated in all cases where the consideration for extending credit to the guaranteed entity is the guarantee. Where the guaranteed entity is strong in its own right, then a case could be made for not aggregating;

viii. Para 35: is likely to create subjective value judgments and we think it would be more useful to have clearer definitions;

ix. The two broad principles of control and economic interdependence to determine whether two or more entities are deemed to be a group of connected parties should be subject to the following:

a. *Control*: We believe that barring the two criteria (a) majority shareholding more than 50% or (b) majority voting rights, the other criteria mentioned to establish connectivity through control based on exercise of significant influence on appointments or key decisions should be excluded as it will involve many issues of interpretation and in many cases may also be difficult to establish beyond a doubt.

b. *Economic Interdependence*: We agree with first 5 qualitative criteria listed under section 34 as they can more or less be established at a point in time. However, we suggest that the concepts of "substantial" and "significant" be clearly defined, say in terms of percentages, so that they can be uniformly assessed and applied by all banks. We have reservations on the remaining 3 criteria which are likely events in the future which may or may not happen and as the fifth criteria in a broad sense covers the remaining three criteria.

x. Connectedness is proposed to be based on (a) A substantial part of one counterparty's gross receipts or gross expenditures (on an annual basis) being derived from transactions with the other counterparty and (b) A significant part of the counterparty's production/ output is for a single customer which cannot easily be replaced. While the above principles appear to be well founded, this could lead to situations where aggregation of exposures of one large counterparty may have to be done with a number of clients of the bank who all deal with that one large counterparty. For example, if we have ten of a bank's clients dealing with a large counterparty, the bank will be required to aggregate exposure to such counterparty with the individual exposures to all these ten clients, in which case aggregated exposure to each one of the ten clients could exceed the prescribed large exposure limit of the bank. A similar aggregation requirement could arise when a number of small contractors conduct major part of their business with one main contractor and all of them avail facilities from one bank;

xi. Question 2: There are several areas in need of clarification in regard to defining connected parties: The four criteria of guidelines and also the guidance on establishing connectedness based on economic interdependence (page 6) would present large challenge to the information

systems and data infrastructure in banks to effectively implement. More specific detailed instructions, through sample cases for instance, would be needed in order to effectively guide banks in interpreting and complying with these guidelines;

Level of large exposure limit

i. Para 38: The Committee should share with industry the analysis, which has resulted in tightening the 25% limit. The recent amendment in the definition of capital under Basel-III has already resulted in reducing the eligible tier-1 capital instruments. It is, therefore, suggested that the banks should be allowed to have 25% of the total eligible capital (both Tier 1 & 2) instead of CET1 or Tier-1 only;
ii. Little substantive justification for a 25% limit has been expounded, which whilst commonly applied appears somewhat arbitrary and no request for comment on its appropriateness has been made. One may regard this as a missed opportunity;

Capital measure – definition of eligible capital

Question 3: The quantitative limit is proposed to be based on Tier 1 capital as this is the regulatory capital that will be available to absorb the potential losses arising from any deterioration of the credit counterparty in the future;

Exposure measure – definition of exposure

i. Question 4 (page 10): (a) As the objective of the standard is to manage the potential losses arising from the default of the large exposure, it is proposed to allow the bank to use the internal model (when they have received supervisory approval for being used for Pillar 1 capital requirement purposes) to measure large exposure. Using this model will provide much better reflection on the potential losses of the credit risk by exposing to the large counterparty; (b) Standardized approach should be used, in consistency with the goal of not introducing model risk to the measurement;
ii. Para 63-66: The calculation of CCFs for traditional off balance sheet items should be in line with Basel standardized approach (i.e. 20%, 50%, or 100% under the risk-based capital requirement). The application of CCF in

line with existing Basel-II/III rules are adequate to estimate the risk of large exposures;

iii. Question 5(Page 11): In the context of the objectives of the BCBS' large exposures framework, PFE models - whether internally developed or not - are a more appropriate measure than the add-ons developed for capital calculations under the CEM approach. This is because the former estimate a worst (or at least bad) case scenario for a portfolio of trades with a specific counterparty, whereas the latter are calibrated to a lower confidence (expected positive exposure) level and, thus, incorporate inter-counterparty portfolio effects;

iv. For purposes of the large exposure framework, we are of the view that banks should adopt the same approach for calculating counterparty credit risk as for risk-based capital requirement purposes, which is the PFE approach;

v. Generally, if an internal model based approach is approved by the regulatory authority for calculation of exposure, it should also be allowed to be used for measuring large exposures as well. However, for reasons cited in the consultative document, the general measurement principles rather than a model based approach could apply;

vi. Question 6(page 12):

   a. The proposal to deviate from the risk-based capital requirements rules for banks' investments in securities financing is proposed to be reconsidered. It is proposed that the bank is allowed to calculate the exposure values using the Internal Models Method (IMM) that produce more risk sensitive estimates compared with comprehensive approach for Securities Financing Transactions (SFT);

   b. In SFT's the collateral serves as a credit mitigant and under the comprehensive approach the exposure computation takes into account haircuts for fluctuations in collateral and exposure values. If the collateral and exposures are in different currencies additional downward adjustments are made to account for volatility of collateral due to future fluctuations in exchange rates. The difference between volatility adjusted exposure amount and the volatility adjusted collateral amount is the adjusted exposure amount after risk mitigation. The proposal is to reduce model risk and apply the comprehensive approach which is more conservative than the IMM approach. Currently, banks in Saudi do not have IMM approved and

so this proposal is consistent with the local market conditions. The comprehensive approach proposed by the committee appears appropriate for computation of exposure values of SFT's;

vii. Question 7:
   a. The definition of "traditional" off-balance sheets commitments that will be subject to 100% CCF is not clearly explicit in the document. What are the financial facilities that will be categorized as traditional off-balance sheets is proposed to be clearly stated in the guideline;
   b. Considering that trade finance exposure are short-term and self-liquidating, we believe that the same CCF used for the Standardized Approach to these exposures will achieve the objectives of the large exposure framework in a way consistent with the risk-based capital requirement rules;

viii. Since the large exposure framework is focused on maximum possible losses in the event of default (and not for risk capital calculation purposes where reduced CCFs are permitted) it stands to reason that a flat 100% CCF should apply for traditional off-balance sheet commitments less any cash margins held;

<u>Recognition of credit risk mitigation techniques</u>

i. Para 74: This suggests that collateral needs to be immediately available to mitigate credit risk. This is not aligned with IFRS guidance on provisioning where consideration is given to the timings of expected inflows from recoveries and collateral. Accordingly, there is merit of considering other forms of collateral;

ii. Question 8: While we agree with the proposed hybrid approach, in our opinion recognizing the effect of CRM by creating additional exposure to the credit risk mitigation provider for the purpose of measuring large exposure can be operationally burdensome to some banks;

<u>Calculation of exposure value for trading book positions</u>

i. Question 9: There are several issues that need to be taken into consideration in the proposal in the draft to document to include the exposure values for trading position as follows:

a. As the objective of holding the bond in the trading book for the short-term (mostly less than 1 year), by adding this exposure could result the bank is required to hold capital that is not reflective on the potential credit risk to be exposed by the bank;
b. By including the equity position of the trading book, it could result the definition of the Credit Default Risk is extended to market risk which should not be the case. As the exposure in the trading book for equity with the intention for the short term, the requirement to hold the additional capital is not reflective on the potential credit risk to be exposed by the bank;
c. The requirement for trading book to Mark-to-Market (MtM) could result the total large exposures will be varied on monthly basis. In the situation the Large Exposures Limit is breached due to the changes of market value of these instruments, the clear guidance need to be provided to the bank in addressing this non-compliance issue;
d. As the exchange traded product such as futures and option are done through the Exchange and the counterparty credit risk will be the exchange, the proposal to include these products are proposed to be reconsidered;
e. As most of the swap contracts and forward contracts are done with the bank, how these derivatives instruments are relevant to the Large Exposures framework that mostly relevant to the corporate customers?
f. The proposal of including the trading book positions as part of the Large Exposures needs to be reviewed and reconsidered for some of the products as mentioned above.

ii. The approaches proposed by the committee for computation of exposure in the trading book for large exposure purposes is similar to the methods adopted for risk based capital computations except for options. Hence this is considered appropriate. In respect of options, as these have non-linear characteristics the proposed approach where exposures are considered based on changes in their prices that would result from a default of the underlying instrument as brought out by the committee is also considered appropriate. However banks would need to have automated procedures to

calculate large exposures for reporting purposes, if the number of such option transactions is larger in number;

iii. While we acknowledge that decomposing swaps, futures, forwards and credit derivatives into their individual legs provide information on the maximum loss that a bank could incur from dealing in them, applying this method might give rise to a material complexity for some banks. We are of the view that the standardized measurement method used for risk-based capital requirement still will achieve the objectives of the large exposure framework in a way consistent with the risk-based capital requirement rules;

iv. Para 81: A potential consideration is the timing of the capital figure; If major losses have occurred during the year, and therefore not reflected in the capital figure, the large exposures would be understated i.e. - the market value of the exposure is the appropriate metric only if the P&L since purchase has been reflected in the bank's retained earnings. The opposite scenario would occur if there was a major gain);

v. We agree with the Committee's proposal in measuring the exposure for debt instruments, equities, swaps, futures, forwards and credit derivatives. However, for options, we are of the opinion that the 'jump to default of the underlying ' is only applicable to options on bonds and equities and not to FX /currency since the latter will never be zero (i.e. will always have a value).

<u>Offsetting long and short positions in the trading book</u>

i. Question 10: The decision by the Committee that netting across the banking and trading book position should not be permitted as the two books are managed separately are not consistent with the earlier proposal in the draft document to include the trading book. If using the same rationale, the trading book should also be excluded from the Large Exposures as the position is managed separately under the Treasury Division. As the result, the short position in the trading book should be allowed to be offsetting with the long positions in banking book to be consistent with the requirement to include the trading book in the Large Exposure;

ii. We agree with the proposal that for the purpose of offsetting positions in different issues on the same name, a short position may only be netted

against a long position if the short position is junior to the long position, of if they are of the same seniority. However, determining the relative seniority of positions may not always be straightforward;

iii. The proposal is to allow the offsetting of long and short positions by the same issuer depending on certain conditions related to seniority of long and short positions. This is a relaxation of the approach used for capital calculations but it is appropriate for large exposures and so the bank strongly supports this. Further, the proposal stops short of allowing netting for same issuer across trading and banking books – we recommend that this be allowed as well;

iv. Para 93: Netting across the trading and banking books should be permitted notwithstanding the fact that risks in the two books are managed separately;

<u>Interbank exposures</u>

i. Para 99-103: The interbank exposures should not be subjected to the 'hard limit', due to generally short tenor of these exposures and these exposures should only be subjected to 'soft/advisory limit'. The overnight exposure should be excluded from the large exposure limit for interbank transactions, as the interbank market serves as the funding source during liquidity stress conditions;

ii. Para 99-100: Bank exposures have the potential to be large. From a capital perspective preferential capital risk weights are applied to banks under the standardized approach. This may be considered a precedent to allow a higher limit for large exposures to these entities;

iii. Question 11: Under the Contingency Funding Plan, the bank needs to borrow from only limited number of banks in the interbank market. By limiting the amount of exposures that can be extended by any particular bank could exaggerate the liquidity problems in the financial institution during the crisis. It is proposed that the committee's proposal to apply the large exposure limits to interbank exposures in the same way that is applied to any other exposures to third party to be reconsidered. Further, the proposal for only some limited exemptions for interbank exposure should be reviewed by allowing all interbank exposures to be excluded from the Large Exposure;

iv. Imposing a general limit on interbank exposures would present challenge to banks to manage short term liquidity and have potential impact on the efficient functioning of the local money market. The committee approach

for selectively excluding some relevant inter-bank exposures from large exposure computations as outlined in the paper is necessary and unavoidable for the smooth day to day operations of banks;

v. We suggest giving consideration to exempt intraday / overnight interbank exposures from the large exposure framework;

vi. Para 103: Even though this Para provides some flexibility to the regulator to allow for the breaching of the limit by the bank under interbank market disruption, it will not address the fundamental issues that the interbank market should not be subject to any regulatory limits as under the normal circumstances, the internal limits for the single exposures that is currently implemented by the bank should be adequate to manage and control the large exposure for the bank. In the case of the standard setter decides to extend the large exposures to bank, the adequate grace period needs to be provided to the bank to comply with this new limit. However, in the case of countries with limited number of Islamic Banks, it will be a major challenge for the banks to comply the proposed limit on 5% of Capital Base. It is proposed the limit is higher for the financial institution that participating in the interbank market;

vii. Subject to tight definitions and under stipulated conditions (as illustrated by way of examples in the document), we suggest that all intraday interbank exposures should be exempted from the requirement for large exposure calculations as (a) it will not be easy to monitor and control such exposures and (b) they are essential for smooth functioning of different payment and settlements systems. As for overnight interbank exposures, we agree that any exemptions will have to be on a very selective basis under exceptional conditions to be specified by the regulator;

<u>Collective investment undertakings, securitisations and other vehicles</u>

i. Para 105: It is practically quite difficult to identify underlying counterparties in case of cross-border and complex structured exposures;

ii. Question 12 (Page 21): The rules of the granularity threshold of 1% is not clear in the document. The requirement for the mandatory application of the look-through approach to the transactions where an underlying exposures may exceed the granularity threshold will raise several issues as including: (a) The ability of the bank to ensure the exposure can be efficiently consolidated at the bank level. As this exercise will involve the manual process, there is the high possibility the exposure is not correctly and timely captured; (b) By

implementing this rule, there is the possibility that the bank will breach the regulatory limits. The grace period should be given by the bank to comply this rules; (c) Whether this look-through approach will be applicable for the interbank exposures where the bank is investing in the fund management where the fund manager subsequently do the placement in the interbank market;

iii. Although the committee recommends a threshold of 1% of the total value of the transaction to determine granularity, there may be other considerations that could impact granularity. It appears that the threshold needs to be re-considered based on feedback from banks. Although the look-through-approach is appropriate, an analysis of the investment using the look-through-approach will involve a huge effort to determine the underlying names and determining exposures from a large exposure perspective;

iv. The granularity threshold of 1% of total value of a single investment/transaction is on the low side; perhaps an additional condition pertaining to size of the transaction could also be added, or a national discretion is sought;

v. Para 105: Prior to the LTA granularity threshold, it may be efficient to firstly consider the combined transactions volume in relation to C&R, say, if less than 5% of C&R then it may not be required to proceed with the LTA test on materiality / risks grounds. (This could also be considered for fully or partially opaque structures);

vi. Question 13(page 25): More guidance especially on the measurement methodology should be provided to banking industry to ensure more consistent approach in addressing the issues being identifies as the additional risks in the large exposure framework before this proposal is included in the guidelines to be issued to the industry;

vii. The treatment of identified additional risks can potentially present challenge to banks to implement as a wide array of additional risks can exist in different asset structures, and grouping of unknown client therefore adds little informational value from a risk management perspective;

viii. In some cases, acquiring information about the underlying assets (i.e. names and exposure) in funds, securitizations and other vehicles with underlying assets may be challenging. Consequently, in our opinion, the mandatory application of the look-through approach (LTA) will not be feasible. In such cases, we propose using the risk-based capital requirements treatment for computing the credit risk exposure as a fall-back alternative instead of aggregating all unknown exposure under “the unknown client” to which the

large exposure limit would apply. For example, in our opinion it is appropriate to use the Backstop Concentration Ratio Approach (BCRA) (proposed under December 2012, “Revisions to the Basel Securitization Framework”, Consultative Document) as a fall-back to the proposed LTA method since it is expected to generate a conservative exposure value by virtue of its providing no recognition of credit enhancements benefitting the tranche;

ix. Para 115: The additional risk factors may also form part of an individual bank’s investment policy. For certain risk factors, a regulator may wish to provide guidelines that are to be incorporated within a bank’s investment policy to reduce system-wide exposure;

x. While the principle of the Look Through Approach to ascertain underlying exposures to counterparties is well founded, the 1% granularity test by itself may not be reasonable as a 1% exposure in an investment vehicle or securitization fund may not be significant vis a vis the banks CET1 or Tier 1 capital. Hence, we are of the opinion that aggregation should be considered when it satisfies not only the 1% granularity test but also when the individual exposure is equal to or higher than a certain percentage (say 0.5%) of a bank’s eligible capital;

<u>Exposures to central counterparties</u>

i. Para 123-130: For CCPs, second option should be used i.e. no hard limit should be applied on exposure taken on CCPs as first option is in contradiction to the spirit of the earlier guidelines regarding banks exposures to CCPs;

ii. Question 14(Page 27): (a) The second option is that no Pillar 1 hard limit would apply to a bank’s CCP exposures as in most of the countries, this CCP is mostly owned by the government owned entities as the clearing house for the securities market. As such, there should be no requirement to include the exposure with CCP in the Large Exposure framework; (b) Massive increases in systematic concentration risk would occur in central clearers. We look forward to receiving Basel’s proposals for aligning its large exposures work stream with other policy objectives;

iii. Among the two options the first one to propose a large exposure limit for exposure on CCPs would be defeating the purpose of CCPs requiring fulfilling their role to reduce systemic risk. The second option for banks to report exposures to CCPs to their regulator under the large exposure framework appears appropriate;

iv. We support the second option for exposures to Q-CCPs that will prescribe no hard limits but only reporting to the regulatory authorities. We suggest that the same rules should also apply to non-Q-CCPs due to lack of Q-CCPs in this region;

v. Considering that the February 2013 consultative document titled, “Margin Requirements for Non-Centrally Cleared Derivatives”, is promoting central clearing through CCPs, we think that having a regulatory limit on exposure to CCPs would not be consistent with these reforms;

Large exposures rules for global systemically important banks

Para 132: Applying 10 % to 15 % exposure limit to D-SIBs like G-SIBs needs to be phased out;

General Comments

i. The diversity, and the level at which the information and data will be needed within different asset classes (some of which goes to single transaction level) to calculate large credit exposures will involve a significant investment in systems, data integration, as well as, in changing business practices and processes;

ii. The proposed revised definitions and rules for measurement and reporting of Large Exposures are much more complex compared to the existing simple provisions due to the following:
   - Revised rules for aggregation of exposures
   - Additional qualitative assessment for determining connected counterparties;
   - Netting provisions depending on credit quality and seniority of exposures;
   - Differentiation between the banking book and the trading book exposures;
   - Reporting of even exempted exposures (viz sovereign);
   - Look through approach in respect of exposures to CIUs, Securitization and other investment vehicles; and
   - Inclusion of internbank exposures.

   We believe that proposed changes will require additional investment in systems and procedures with a related increase in operational costs to ascertain, measure, monitor report and control large exposures on an

ongoing basis. However, we note that implementation in full is proposed only by January 1st, 2019 which should provide adequate time for a bank to comply with the final framework as and when issued.

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