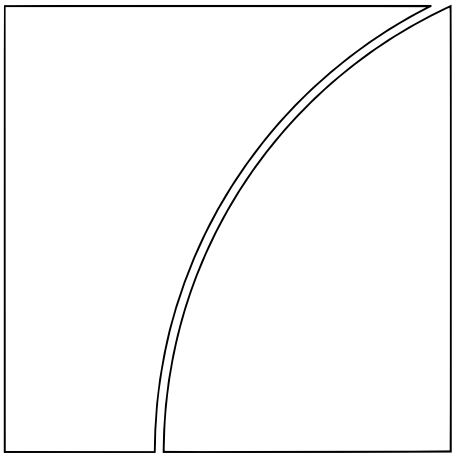
Basel Committee on Banking Supervision

LEX

Large exposures

LEX10

Definitions and application



This chapter describes the scope of the large exposures framework and the definitions of a large exposure and connected counterparties.

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Cross references to LEX30 updated.

BANK FOR INTERNATIONAL SETTLEMENTS

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Rationale and objectives of a large exposures framework

10.1

Throughout history there have been instances of banks failing due to concentrated exposures to individual counterparties or groups of connected counterparties. Large exposures regulation has been developed as a tool for limiting the maximum loss a bank could face in the event of a sudden counterparty failure to a level that does not endanger the bank's solvency.

10.2

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 or a group of connected counterparties. In particular, the minimum capital requirements (Pillar 1) of the Basel risk-based 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, idiosyncratic risk due to large exposures to individual counterparties or groups of connected counterparties may be present in banks' portfolios. Although a supervisory review process (Pillar 2) concentration risk adjustment could be made to mitigate this risk, these adjustments are neither harmonised across jurisdictions, nor designed to protect a bank against very large losses from the default of a single counterparty or a group of connected counterparties. For this reason, the risk-based capital framework is not sufficient to fully mitigate the microprudential risk from 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 an individual 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.

10.3

The treatment of large exposures could also contribute to the stability of the financial system in a number of other ways. For example, material losses in one systemically important financial institution (SIFI) can trigger concerns about the solvency of other SIFIs, with potentially catastrophic consequences for global financial stability. There are at least two important channels for this contagion. First, investors may be concerned that other SIFIs might have exposures similar to those of the failing institution. Second, and more directly, investors may be concerned that other SIFIs have direct large exposures to the failing SIFI, in the form of either loans or credit guarantees. The Committee is of the view that the large exposures framework is a useful tool to mitigate the risk of contagion between global systemically important banks, thus supporting global financial stability. As a second example, this framework is also seen as a useful tool to contribute to strengthening the oversight and regulation of the shadow banking system in relation to large exposures, particularly the treatment of exposures to funds, securitisation structures and collective investment undertakings.

Scope and level of application

10.4

The large exposures framework is constructed to serve as a backstop and complement to the risk-based capital standards. As a consequence, it must apply at the same level as the risk-based capital requirements are required to be applied following SCO10, ie at every tier within a banking group.

10.5

The large exposures framework is applicable to all internationally active banks. As with all other standards issued by the Committee, member jurisdictions have the option to set more stringent standards. They also have the option to extend the application to a wider range of banks, with the possibility – if they deem it necessary – to develop a different approach for banks that usually fall outside the scope of the Basel framework.

10.6

The application of the large exposures framework at the consolidated level implies that a bank must consider all exposures to third parties across the relevant regulatory consolidation group and compare the aggregate of those exposures with the group's Tier 1 capital.

Scope of counterparties and exemptions

10.7

A bank must consider exposures to any counterparty. The only counterparties that are exempted from the framework are sovereigns as defined in LEX30.31. LEX30.31 to LEX30.59 sets out the types of counterparties that are exempted from the large exposure limit or for which another specific treatment is necessary. Any exposure type not included in LEX30.31 to LEX30.59 is subject in all respects to the large exposure limit.

Definition of a large exposure

10.8

The sum of all exposure values of a bank to a counterparty or to a group of connected counterparties, as defined in LEX10.9 to LEX10.18, must be defined as a large exposure if it is equal to or above 10% of the bank's Tier 1 capital (as defined in CAP10.2). The exposure values must be measured as specified in LEX30.

Definition of connected counterparties

10.9

In some cases, a bank may have exposures to a group of counterparties with specific relationships or dependencies such that, were one of the counterparties to fail, all of the counterparties would very likely fail. A group of this sort, referred to in this framework as a group of connected counterparties, must be treated as a single counterparty. In this case, the sum of the bank's exposures to all the individual entities included within a group of connected counterparties is subject to the large exposure limit and to the regulatory reporting requirements as specified in LEX20.1 to LEX20.4.

10.10

Two or more natural or legal persons shall be deemed a group of connected counterparties if at least one of the following criteria is satisfied.

1. Control relationship: one of the counterparties, directly or indirectly, has control over the other(s).
2. Economic interdependence: if one of the counterparties were to experience financial problems, in particular funding or repayment difficulties, the other(s), as a result, would also be likely to encounter funding or repayment difficulties.

10.11

Banks must assess the relationship amongst counterparties with reference to LEX10.10(1) and LEX10.10(2) above in order to establish the existence of a group of connected counterparties.

10.12

In assessing whether there is a control relationship between counterparties, banks must automatically consider that criterion LEX10.10(1) is satisfied if one entity owns more than 50% of the voting rights of the other entity.

10.13

In addition, banks must assess connectedness between counterparties based on control using the following criteria:

1. Voting agreements (eg control of a majority of voting rights pursuant to an agreement with other shareholders);
2. Significant influence on the appointment or dismissal of an entity’s administrative, management or supervisory body, such as the right to appoint or remove a majority of members in those bodies, or the fact that a majority of members have been appointed solely as a result of the exercise of an individual entity’s voting rights;
3. Significant influence on senior management, eg an entity has the power, pursuant to a contract or otherwise, to exercise a controlling influence over the management or policies of another entity (eg through consent rights over key decisions).

10.14

Banks are also expected to refer to criteria specified in appropriate internationally recognised accounting standards for further qualitative guidance when determining control.

10.15

Where control has been established based on any of these criteria, a bank may still demonstrate to its supervisor in exceptional cases, eg due to the existence of specific circumstances and corporate governance safeguards, that such control does not necessarily result in the entities concerned constituting a group of connected counterparties.

10.16

In establishing connectedness based on economic interdependence, banks must consider, at a minimum, the following qualitative criteria:

1. Where 50% or more of one counterparty's gross receipts or gross expenditures (on an annual basis) is derived from transactions with the other counterparty (eg the owner of a residential/commercial property and the tenant who pays a significant part of the rent);

2. Where one counterparty has fully or partly guaranteed the exposure of the other counterparty, or is liable by other means, and the exposure is so significant that the guarantor is likely to default if a claim occurs;
3. Where a significant part of one counterparty's production/output is sold to another counterparty, which cannot easily be replaced by other customers;
4. When the expected source of funds to repay the loans of both counterparties is the same and neither counterparty has another independent source of income from which the loan may be serviced and fully repaid;
5. 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;
6. Where the insolvency or default of one counterparty is likely to be associated with the insolvency or default of the other(s);
7. When two or more counterparties rely on the same source for the majority of their funding and, in the event of the common provider's default, an alternative provider cannot be found – in this case, the funding problems of one counterparty are likely to spread to another due to a one-way or two-way dependence on the same main funding source.

10.17

There may, however, be circumstances where some of these criteria do not automatically imply an economic dependence that results in two or more counterparties being connected. Provided that the bank can demonstrate to its supervisor that a counterparty which is economically closely related to another counterparty may overcome financial difficulties, or even the second counterparty's default, by finding alternative business partners or funding sources within an appropriate time period, the bank does not need to combine these counterparties to form a group of connected counterparties.

10.18

There are cases where a thorough investigation of economic interdependencies will not be proportionate to the size of the exposures. Therefore, banks are expected to identify possible connected counterparties on the basis of economic interdependence in all cases where the sum of all exposures to one individual counterparty exceeds 5% of Tier 1 capital.