BANK FOR INTERNATIONAL SETTLEMENTS

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The treatment of large exposures in the Basel capital standards – Executive Summary

A bank with a strong capital ratio may nevertheless fail if it experiences significant losses on large exposures in the event of a sudden failure of a counterparty or a group of connected counterparties ("a single counterparty"). The risk of large losses associated with the failure of a single counterparty is not captured by the risk-based capital standards of the Basel Committee on Banking Supervision (BCBS). The BCBS, in April 2014, introduced a new standard with the aim of ensuring that internationally active banks' exposures to single counterparties are appropriately monitored and limited. Although banks are also exposed to different types of concentration risk, such as sectoral and geographical concentration of asset exposures, the scope of the large exposures framework is limited to losses incurred due to a default of a single counterparty. The new standard comes into force on 1 January 2019. This Executive Summary provides an overview of the large exposures framework and discusses its most important elements.

What is new?

The large exposures framework sets prudent limits to large exposures, whereby a large exposure is defined as the sum of all exposures of a bank to a single counterparty that are equal to or above 10% of its Tier 1 capital. The limit is set at 25% of Tier 1 capital. However, in the case of exposure of a global systemically important bank (G-SIB) to another G-SIB, a more stringent limit of 15% of Tier 1 capital applies. The new framework requires a bank to report to national supervisors not only all large exposures, but also all other exposures that would have been a large exposure without considering the effect of credit risk mitigation or exemption clauses. Also, a bank must report its 20 largest exposures even if they do not satisfy the definition of a large exposure. If the limit is breached, which must be rare and exceptional, immediate reporting to the supervisor and rapid rectification are required.

Measuring exposures

What is a group of connected counterparties?

Under the large exposures framework, when a number of counterparties are connected with specific relationships and dependences in a way that a failure of one of the connected counterparties could lead to cascading failures of the rest, the limit applies to the summated exposures to the group of connected counterparties instead of those to an individual counterparty. The BCBS specifies that two parties are connected if at least one of the following criteria is satisfied: (i) a control relationship, where one of the counterparties has direct or indirect control over the other; and/or (ii) economic interdependence, where, if one of the counterparties were to experience financial problems, such as funding or repayment difficulties, the other would also encounter financial difficulties.

What kinds of exposures are considered and how are they valued?

All exposures as defined under the risk-based capital framework are subject to the large exposures framework. This includes on- and off-balance sheet exposures included in both the banking and the trading book. As part of the BCBS's efforts to avoid complexity, the large exposures framework uses, where practicable, the same value of exposures as the risk-based capital framework.

How is the exposure value for banking book positions measured?

Banking book on-balance sheet exposure values are based on accounting values. Off-balance sheet exposure values will be converted to credit exposure equivalents through application of the credit conversion factors.

How is the exposure value for over-the-counter (OTC) derivatives and securities financing transactions measured?

Banking book and trading book OTC derivatives subject to counterparty credit risk will be valued as the exposure at default according to the standardised approach for counterparty credit risk. The exposure values of securities financing transactions must be calculated using the comprehensive approach and supervisory haircuts as set out in the credit risk framework.

How do credit risk mitigation techniques adjust the exposure value?

The same eligible risk mitigation techniques as defined under the standardised approach for credit risk can be used to reduce exposure values. In particular, these are guarantees, credit derivatives, financial collateral and on-balance sheet netting. For hedged exposures with a maturity mismatch, the provision again closely follows the risk-based framework. They are treated conservatively and are recognised only when the original maturity is greater than one year and the residual maturity is greater than three months.

How is the exposure value for trading book positions measured?

The trading book exposure values are measured consistent with the market risk framework with an exception for the measures of exposure values of options. For options, the exposure values must be based on the changes in option prices that would result from a default of the respective underlying instrument. For example, the exposure value for a simple long call option would be its market value, and for a short put option would be equal to its strike price minus its market value.

How are long and short positions in the trading book offset?

Long and short positions in the trading book may be offset subject to certain conditions. A bank is allowed to offset long and short positions in the same issue, where the same issue is defined as the identical issue, coupon, currency and maturity. Positions in different issues from the same counterparty may be offset only when the short position is junior to the long position, or when the positions are of the same seniority. Netting across the banking book and trading book is not permitted.

Treatment for specific exposure types

The large exposures framework specifies treatment for specific exposure types. Exposures to sovereigns and their central banks are exempted, and the exposures to public sector entities may be exempted from the large exposures in the same way as for the credit risk capital requirements. To avoid disturbing the payment and settlement processes, intraday interbank exposures are exempted from the large exposures framework. For the investment in a structure including collective investment undertakings and securitisation vehicles, the large exposures framework requires a bank to apply a look-through approach when appropriate and also to assess possible additional risks related to: (i) the structure's specific features; and (ii) other third parties linked to the structure. This treatment is expected to contribute to strengthening the oversight and regulation of the shadow banking system as well. The large exposures framework sets out conditions under which a covered bond can be eligible to be assigned an exposure value of less than 100%. For exposures to central counterparties, clearing exposures to qualifying central counterparties are exempted, while the sum of both clearing and non-clearing exposures to non-qualifying central counterparties must be included in the measurement.

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