BANK FOR INTERNATIONAL SETTLEMENTS

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Financial Stability Institute

Large exposures standard – Executive Summary

In 2014, the Basel Committee on Banking Supervision (BCBS) issued the large exposures (LEX) standard, which seeks to monitor and limit the loss that an internationally active bank can face from a single client or from a group of connected counterparties. The standard came into force on 1 January 2019.

Objectives of the LEX standard

The LEX standard is part of the Basel III reform package that complements the BCBS's risk-based capital framework to achieve the:

- microprudential objective of serving as a backstop to the risk-based capital regime by protecting banks from incurring large losses from the default of a single counterparty or group of connected counterparties
- macroprudential objective of supporting efforts to manage systemic risks by reducing the interconnectedness between systemically important banks

Minimum requirements – the large exposure limit

A large exposure is defined as the sum of all exposure values of a bank to a single counterparty or to a group of connected counterparties that are equal to or above 10% of its Tier 1 capital.

The minimum requirements, ie the "large exposure limits" of the LEX standard, are as follows:

- The sum of all exposure values of a bank to a single counterparty or to a group of connected counterparties must not be higher than **25% of the bank's Tier 1 capital** at all times.
- For a global systemically important bank (G-SIB), a more stringent limit is imposed – a G-SIB's exposure to another G-SIB must not exceed **15% of its Tier 1 capital**.

If the limits are breached, immediate reporting to the supervisor and rapid rectification are required.

Level of application and scope of counterparties

The LEX standard is applicable at every tier within a banking group. 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.

Some counterparties are exempted from the LEX standard:

- sovereigns and entities connected with sovereigns, including their central banks
- exposures to qualifying central counterparties related to clearing activities
- intraday interbank exposures (to avoid disrupting payment and settlement processes)

Banks must consider exposures for large exposures purposes even when there is a structure (a fund or securitisation) between the bank and the exposures.

Connected counterparties

Under the LEX standard, when a number of counterparties have specific relationships and dependencies such that a failure of one of the counterparties could lead to cascading failures of the rest, the large exposure limit applies to the cumulative exposures to the group of connected counterparties.

The LEX standard specifies that two parties are connected if at least one of the following criteria is satisfied:

- a control relationship, where one of the counterparties has direct or indirect control over the other
- 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

Exposure measurement

All exposures as defined under the risk-based capital framework are subject to the LEX standard. These include on- and off-balance sheet exposures in both the banking and trading books, and instruments with counterparty credit risk under the risk-based framework. To reduce complexity, the LEX standard uses, where practicable, the same value of exposures as the risk-based capital framework. In general, the exposure values are based on the accounting value of the exposure.

In the **banking book**, on-balance sheet exposure values are based on accounting values. Off-balance sheet exposures are converted to credit exposure equivalents using credit conversion factors as defined in the standardised approach for credit risk.

In the **trading book**, exposure values are measured consistent with the market risk framework with an exception for options. For options, the exposure values are based on changes in option prices that would result from a default of the respective underlying instrument.

Examples of specific exposure measurements include:

- covered bonds – lower exposure value (but no less than 20% of nominal bond holding) if the bonds satisfy certain conditions
- over-the-counter derivatives subject to counterparty credit risk – valued as the exposure at default according to the standardised approach for counterparty credit risk
- securities financing transactions (SFTs) – according to the method implemented for calculating risk-based capital requirements for SFT exposures before 2019 or according to the revised comprehensive approach and supervisory haircuts with minimum floors (if these were introduced before 2022)

Eligible credit risk mitigation

Credit risk mitigation techniques that meet the minimum requirements and eligibility criteria as defined under the standardised approach for credit risk can also be used to reduce exposure values for large exposures purposes. For example:

- for both unfunded credit protection (ie guarantees and credit derivatives) and financial collateral, a bank must reduce the exposure value by the value of the protected or collateralised portion of the exposure, subject to applicable haircuts
- a bank can offset long and short positions in the trading book if the issuer, coupon, currency and maturity are identical. However, netting across the banking and trading books is not permitted
- hedged exposures with a maturity mismatch – recognised only when the original maturity is greater than one year and the residual maturity is greater than three months

Regulatory reporting

Banks must report to the supervisory authority:

- all exposures with values equal to or above 10% of the bank's Tier 1 capital
- all other exposures with values measured, without taking into account credit risk mitigation, being equal to or above 10% of the bank's Tier 1 capital
- all exempted exposures with values equal to or above 10% of the bank's Tier 1 capital
- the 20 largest exposures to counterparties that fall within the scope of application, irrespective of the values of these exposures relative to the bank's Tier 1 capital

This Executive Summary and related tutorials are also available in FSI Connect, the online learning tool of the Bank for International Settlements.