First take

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Ten key points from Basel's new large exposures framework

On April 15th, the Basel Committee on Banking Supervision ("BCBS") released the final version of its "Supervisory Framework for Measuring and Controlling Large Exposures" ("SFLE") that builds upon longstanding BCBS guidance on credit exposure concentrations. While the document provides insight into the global prudential framework for large exposures and details the treatment of specific exposures, the release raises the important question of how it will impact the US's yet-to-be finalized Single Counterparty Credit Limit ("SCCL") that the Fed left out of the recently finalized Enhanced Prudential Standards ("EPS"). See PwC's *Enhanced prudential standards first take* (February 2014).

The BCBS approach is generally less stringent than the US's proposed SCCL. However, the SFLE does not clarify whether key exposures will ultimately be included such as securities financing transactions ("SFTs") and qualifying central clearing counterparties ("QCCPs") – which the SFLE subjects to *interim* measurement approaches. This lack of clarity further muddies the ultimate impact of the SFLE on the SCCL (as does the SFLE's long implementation timeframe through 2019). One thing is clear: evolving regulatory expectations are driving the need for increasingly granular data, and for new risk measures targeting macro (as well as micro) prudential bank supervision.

1. **BCBS sets the G-SIB to G-SIB limit at 15% of Tier 1 capital, which is more lenient than the SCCL proposal's 10% limit:** The key question is whether this signals a change in the US approach in an effort to harmonize regulatory regimes, or whether the Fed will exercise the BCBS option enabling national authorities to implement more conservative rules. The other wild card is whether an SFLE-like approach will be extended beyond US G-SIBs to more firms that are covered by the US EPS, e.g., those with over $50 billion in total assets.
2. **BCBS uses a more moderate capital measure – Tier 1:** The SFLE uses Tier 1 capital as the denominator for the limit ratio, whereas the SCCL proposes using the "Capital Stock and Surplus" or Common Equity Tier 1 capital, both of which are more stringent measures. Rather than introducing yet another facet in the multitude of ratios that firms face, we believe this development suggests the US may agree to use Tier 1 capital as the denominator, especially considering that Tier 1 capital serves as the basis for the complementary leverage ratios for US G-SIBs (including the supplementary leverage ratio recently finalized by US regulators, analyzed in our *Supplementary leverage ratio first take* (April 2014)).
3. **The SFLE factors fewer exposures into its limit, by using a narrower "control" definition of connected counterparties than does SCCL:** Under the SFLE, connectedness between two counterparties is automatic when the 50% voting rights threshold is crossed; however, the SCCL framework relies upon a 25% threshold that defines connectedness as control or ownership of either a class of voting securities or total equity of the other entity, as well as financial statement consolidation. The SCCL's approach is generally more stringent and a more complicated way to make these connectedness determinations. However, SFLE firms must report all exposures.

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4. **Analysis of connected counterparties is complex under the SFLE's "economic interdependence" definition:** Compared to the proposed SCCL, the SFLE requires firms to perform substantially greater data analysis to identify and aggregate economically connected counterparty exposures. The burden to prove exposures are not connected is placed squarely on the banks, which face daunting challenges in following the many indirect routes through which exposures can be considered connected (including an exhaustive list of "minimum" qualitative criteria). This comes at a time when firms are still addressing sizable system infrastructure and data challenges. Firms are expected to go so far as to evaluate all potential connected counterparties to whom the firm's exposure would be greater than 5% of its Tier 1 capital.
5. **The level of detailed diligence required to refute connectedness extends to sponsors (e.g., private equity or hedge fund managers):** These entities may be in a position to exercise indirect "control" and "significant influence" over voting, thus establishing an economic interdependence that spans legal entities. Through this emphasis on connectedness (coupled with the broad definition of a "financial entity" [1]), the SFLE is also taking aim at the "shadow banking" sector that remains a consistent subject in regulators' speeches.
6. **Analyzing structured vehicle and other exposures may not be worth the effort:** In determining large exposures, banks are required to use a look-through approach for any assets in a collective investment undertaking (e.g., a mutual fund) or securitization vehicle. If the exposure to each underlying asset in a structure is less than 0.25% of the firm's Tier 1 capital, then the firm may consider the structure as a separate entity for large exposure purposes. Any single underlying asset that breaches the 0.25% threshold in the structure must be aggregated with the other connected counterparty exposures. If a bank is unable to determine the percentage exposure then all such structures are combined as if they were a single counterparty subject to the large exposure limit of 25% of eligible capital.
7. **Supervisory Approach for Counterparty Credit Risk ("SA-CCR") replaces Current Exposure Method ("CEM"), but adds its own challenges:** The introduction of the SA-CCR creates additional complexities and the burden of calculating exposures at default for OTC derivatives, exchange-traded derivatives, and long settlement transactions. The system and data challenges of running multiple sets of calculations for connected counterparty aggregations present a daunting task. Many of the largest firms use multiple family/customer and credit exposure aggregation methodologies for internal risk management purposes such as: limit management and delegation of authority, regulatory capital calculations (Advanced versus Standardized), accounting (Credit Valuation Adjustments), and Regulation F "Limitations on Interbank Liabilities" (for US firms). While certain exposures are exempt from the SFLE (e.g., SFTs, QCCPs, and intercompany and intraday transactions), the unwillingness of the BCBS to allow banks to apply the Internal Models Methodology once again highlights the regulatory trade-off between simplified measures that are comparable across firms and accuracy in representing the risks posed.
8. **SFLE credit risk mitigation aligns with US Standardized Approach:** It is apparent that the US Basel III Standardized Approach methodology for credit risk mitigation has influenced the SFLE, as the SFLE adopts a narrower approach to collateral recognition than the EU's Standardized Approach under CRD IV. For example, the SFLE denotes that only "eligible financial collateral" can be considered and that the risk mitigation effects of CDS can only be recognized if provided by a "regulated financial institution." The latter is important because the opportunity for risk transference could be significantly reduced, given the limited number of eligible counterparties under this definition.
9. **Better position netting treatment requires more granular data analysis:** Long and short positions in the trading book may be offset provided that banks can demonstrate that the short position is either of the same seniority or a junior security issued by the same counterparty.
10. **Basel kicks the QCCP and SFT can down the road:** While some of the exemptions like those for QCCPs and SFTs may be temporary given they are subject to future guidance, the banks are still required to measure and report exposures to CCPs which are subject to the large exposure limit of 25% of eligible capital. Motivation for deferring these issues is likely the desire to achieve harmonization between the BCBS framework and the US SCCL's inclusion of SFTs and QCCPs. Another factor could be the continuing industry debate about the various leverage ratios' differing treatment of SFTs.

[1] A financial entity is broadly defined as a financial institution whose main business includes the management of financial assets, lending, factoring, leasing, provision of credit enhancements, securitization, investments, financial custody, central counterparty services, proprietary trading, and other financial services activities identified by supervisors.

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Additional information

For additional information about PwC's Financial Services Regulatory Practice and how we can help you, please contact:

Dan Ryan
Financial Services Regulatory Practice Chairman
646 471 8488
daniel.ryan@us.pwc.com

David Sapin
Financial Services Regulatory Practice Leader
646 471 8481
david.sapin@us.pwc.com

Armen Meyer
Director of Regulatory Strategy
646 531 4519
armen.meyer@us.pwc.com

Contributors: Charles Andrews, Steve Pearson, David Fisher, and Kevin Clarke.

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