

**MFSA**

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**MALTA FINANCIAL SERVICES AUTHORITY**

**BANKING SUPERVISION UNIT**

**BANKING RULES**

*LARGE EXPOSURES OF CREDIT INSTITUTIONS  
AUTHORISED UNDER THE BANKING ACT 1994*

# **LARGE EXPOSURES OF CREDIT INSTITUTIONS AUTHORISED UNDER THE BANKING ACT 1994**

## **INTRODUCTION**

1. In terms of Article 4 of the Banking Act 1994 ('the Act') the competent authority ('the authority') as appointed under Article 3(1) of the Act may make Banking Rules as may be required for carrying into effect any of the provisions of the Act. The authority may amend or revoke such Banking Rules. The Banking Rules and any amendment or revocation thereof shall be officially communicated to banks and the authority shall make copies thereof available to the public.
2. The Rule on the regulation of large exposures of credit institutions ('the Rule') is being made pursuant to Article 16 of the Act.

*"The competent authority shall issue a Banking Rule as it shall consider appropriate for the regulation of large exposures."*

3. The Rule defines various terms which the Act requires the authority to define under Article 2 of the Act. It further describes the authority's policy on large exposures.
4. The Rule is modelled on the requisites of the European Union Directive 2006/48/EC of 14 June 2006 – Title V: Principles and Technical Instruments for Prudential Supervision and Disclosure, Chapter 2, Section 5: *Large Exposures* as amended from time to time and on the Committee of European Banking Supervisors' (CEBS), predecessor of EBA, publication dated 11<sup>th</sup> December 2009, entitled '[Guidelines on the implementation of the revised Large Exposures regime](#)', also as may be amended from time to time. Moreover, credit institutions are expected to peruse the said guidelines in conjunction with the Rule. The authority may provide credit institutions with sufficient flexibility regarding the implementation of specific aspects of the guidelines.

## **SCOPE AND APPLICATION**

5. The provisions of the Rule apply to all authorised credit institutions under the Act. For the purposes of this Rule the term "credit institution" shall cover the following:
  - a) a credit institution including its branches in third countries;
  - b) any private or public undertaking, including its branches, which meets the definition of "credit institution" and has been authorised in a third country.
6. The authority will monitor and control large exposures at both consolidated and unconsolidated (solo basis) level, as it considers appropriate, in accordance with the provisions of the Banking Rule on the Supervision on a *Consolidated Basis of Credit Institutions BR/10*. The requirements of the Rule which apply to 'credit institutions' should be understood to apply also to consolidated 'banking groups' and vice versa. The monitoring and limiting of large exposures of branches of third country institutions, is primarily subject to prudent supervision, the responsibility for which is vested in the home competent authorities. The authority's policy towards such branches is described in detail in paragraphs 53 to 55 below.

## DEFINITIONS

### (i) *An Exposure*

7. Concentration of risk is the major aspect concerning a credit institution's exposure to a customer. Risk spreading is the "golden rule" of financial activity and should be the prime responsibility of a credit institution. The measurement of a credit institution's exposure to a customer should therefore reflect and control the maximum loss should the customer or group of connected customers (customer) fail. An exposure is defined as any asset and off-balance sheet item as referred to under the *Standardised Approach of Banking Rule BR/04* without application of the risk weights or degrees of risk there provided for.

Consistent with this, an exposure would include the amount at risk arising from the reporting credit institution's:

- (a) claims on a customer including actual and potential claims which would arise from the drawing down in full of undrawn advised facilities (whether revocable or irrevocable, conditional or unconditional) which the credit institution has committed itself to provide;
  - (b) contingent liabilities arising in the normal course of business, and those contingent liabilities which would arise from the drawing down in full of undrawn advised facilities (whether revocable or irrevocable, conditional or unconditional) which the credit institution has committed itself to provide; and
  - (c) other on and off-balance sheet financial assets and commitments.
8. The exposure will be taken as the full amount, that is, the balance sheet value for on-balance sheet items and the book value for off-balance items, of the reporting credit institution's claims or exposures. As exposures should be reported on a gross basis, any credit balances and/or other risk mitigants, should not be offset against debit balances.
9. The amount at risk arising from interest rate contracts (including interest rate swaps, forward rate agreements and interest rate options purchased), foreign exchange rate contracts (including cross currency swaps, forward foreign exchange contracts and foreign exchange options purchased) and other derivative contracts such as commodity and equity derivatives, is not taken to be the nominal amount of a contract but rather a credit equivalent amount. The method for calculating the credit equivalent amount is the same applied in the Rule on *Capital Requirements of Credit Institutions BR/04*.
10. The following items will not be included in the measurement of an exposure:

- (i) Items deducted from own funds. All elements entirely covered by own funds may, with the agreement of the authority, be excluded from the determination of exposures, provided that such own funds are not included in the credit institution's computation of own funds in terms of *Banking Rule BR/03 – Own Funds of Credit Institutions*.
- (ii) Claims arising in the case of foreign exchange transactions, exposures incurred in the ordinary course of settlement during the two working days following payment.
- (iii) Claims arising in the course of settlement of purchases and sales of securities where such claims are outstanding up to a maximum of five working days following payment or delivery of the securities whichever the earlier<sup>1</sup>.
- (iv) Claims arising from the provision of money transmission including the execution of payment service, clearing and settlement in any currency and correspondent banking or financial instruments clearing, settlement and custody services to clients, delayed receipts in funding and other exposures arising from client activity which do not last longer than the following business day;
- (v) Claims arising from the provision of money transmission including the execution of payment services, clearing and settlement in any currency and correspondent banking, intra-day exposures to institutions providing the services.

For the purposes of exemptions listed in (iv) and (v) above, credit institutions should be guided by CEBS publication dated 28<sup>th</sup> July 2010, entitled '[Implementation guidelines on Article 106\(2\)\(c\) and \(d\) of Directive 2006/48/EC](#)' recast, and any subsequent amendments thereto. The authority deems that these guidelines are important for safeguarding a level playing field by local institutions in the application of the said exemptions.

11. Although risks arising from the settlement of the above transactions are not included for large exposure purposes, the control of such risks needs to be carefully considered by each credit institution since inadequate controls could be a cause of substantial loss for a credit institution.

**(ii) Own Funds**

12. For the purposes of measuring large exposures under the Rule, the own funds of a credit institution are the Total Own Funds excluding Supplementary Own Funds as defined in the *Own Funds Rule BR/03 (vide Own Funds computation, Appendix 1)*,

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<sup>1</sup> Where either counterparty to the transaction has settled, there will be no reportable exposure until two days after due settlement date (after which the replacement cost of the transaction will be considered to be an exposure).

item 6.0.0).

**(iii) An individual customer and a group of connected customers<sup>2</sup>**

13. Exposures are required to be notified and controlled according to the nature of the customer. An individual customer (vide BR/04 exposure classes) comprises natural and legal persons and includes individual trusts, corporations, sole traders, unregistered trading partners and non-profit making bodies.
14. Exposures towards individual entities within a group of connected customers need to be considered as one exposure. A group of connected customers exists, where:
  - (a) two or more natural or legal persons who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly, has control over the other or others, or
  - (b) two or more natural or legal persons between whom there is no relationship of control, as defined in (a) above, but who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, in particular funding or repayment difficulties, the other or all of the others would also be likely to encounter funding or repayment difficulties.

Interconnections can arise from one of the following scenarios:

- one client has control over the other;
- the clients are interconnected by some form of material economic dependency, as for instance:-
  - direct economic dependencies such as supply chain links or
  - dependence on large customers, or
  - the clients have a main common source of funding in the form of credit support, potential funding or direct, indirect or reciprocal financial assistance.

In order to determine the existence of a group of connected clients, in respect of exposures referred to points (m), (o) and (p) in *Appendix 2 Section I-1 – Credit Risk: Standardised Approach of the Capital Requirements Rule BR/04*, where there is an exposure to underlying classes, a credit institution shall assess the scheme, its underlying exposures, or both. Treatment of exposures to schemes in underlying assets would be expected to be carried out in terms of the ['Guidelines on the implementation of the revised Large Exposures regime'](#) (pages 19 to 29 – Part II) referred to in paragraph 4 of this Rule. For that purpose, a credit institution shall evaluate the economic substance and the risks inherent in the structure of the transaction.

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<sup>2</sup> Vide CEBS publication dated 11<sup>th</sup> December 2009 entitled ['Guidelines on the implementation of the revised Large Exposures regime'](#) referred to in paragraph 4 of the Rule.

***(iv) Interpretation of Control<sup>3</sup>***

15. For the purposes of this Rule, ‘control’ means the relationship between a parent undertaking and a subsidiary or a similar relationship between any natural/legal person and an undertaking. This means that control is presumed to exist when an institution’s client owns directly, or indirectly through subsidiaries, more than half of the capital or voting power of an entity, unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control. However, control may also exist when an institution’s client owns less than half of the voting power of an entity or does not hold any participating interest in the entity at all.
16. In such cases the institution should refer to indicators of control that are seen in cases where the client(s) is(are) able to exercise one or more of these powers:-
- (a) power to direct the activities of the other entity<sup>4</sup> so as to obtain benefits from its activities;
  - (b) power to decide on crucial transactions such as the transfer of profit or loss;
  - (c) power to appoint or remove the majority of directors, the board of directors or equivalent governing body, where control of the entity is exercised by that board or body;
  - (d) power to cast the majority of votes at meetings of the board of directors, general assembly or equivalent governing body, where control of the entity is exercised by that board or body; and/or
  - (e) power to co-ordinate the management of an undertaking with that of other undertakings in pursuit of a common objective, for instance, in the case where the same natural persons are involved in the management or board of two or more undertakings.

The definition of control is aimed at describing the conditions for requiring a consolidated annual report. While the concept of connected clients within the large exposures regime includes control, it also covers interconnections arising through other means such as economic dependence. In cases where an institution needs to make a discretionary judgement, these indicators, along with other relevant indicators used for accounting purposes, could be used in order to identify a control relationship.

**EXPOSURES TO GOVERNMENT<sup>5</sup>**

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<sup>3</sup> Vide paragraphs 26 to 36 of the CEBS publication dated 11<sup>th</sup> December 2009 entitled [‘Guidelines on the implementation of the revised Large Exposures regime’](#) referred to in paragraph 4 of the Rule.

<sup>4</sup> For the purposes of this rule, a client is a natural or legal person (undertaking).

<sup>5</sup> Vide paragraph 37 of the CEBS publication dated 11<sup>th</sup> December 2009 entitled [‘Guidelines on the implementation of the revised Large Exposures regime’](#) referred to in paragraph 4 of the Rule.

17. Exposures to local governments, public corporations and other public sector entities will be generally included for large exposure purposes as exposures to individual customers. An exposure to such a body, whether resident in Malta or overseas, will however be considered as an exposure to a central government where either:
  - (a) the central government has guaranteed all the body's liabilities; or
  - (b) the central government has guaranteed the exposure and the guarantee is in an acceptable form.
18. In the case of a guarantee under paragraph 17 (b) above, the guarantee should be explicit and unconditional, and, in particular should not depend on the credit institution meeting or continuing to fulfil its contractual obligations to the customer in respect of the exposure, or performance conditions laid down by the guarantor being met either by the credit institution or the public sector body.

#### **CREDIT INSTITUTIONS' POLICY STATEMENTS**

19. Every credit institution is required to have sound administrative and accounting procedures together with adequate internal control mechanisms for the purpose of identifying, and recording all large exposures and subsequent changes to them in accordance with this Rule and for that of monitoring those exposures in the light of each credit institution's own exposure policies.
20. The authority expects each credit institution to set out its policy on large exposures taking into account the spreading of risk. Relevant factors which the authority will expect a credit institution to take into account when setting its policy and considering the acceptability of particular exposures are laid down in paragraphs 48 to 52 below and include, for example, the concentration risk arising from exposures to the same counterparties, groups of connected counterparties and counterparties in the same economic sector, geographic region or for the same activity or commodity, the application of credit risk mitigation techniques including in particular risks associated with large indirect credit exposures. Furthermore other relevant factors include the standing of the customer, the nature of the credit institution's relationship with the customer, the nature and extent of security to be taken against an exposure, the maturity of an exposure, and the credit institution's expertise in the particular type of transaction. Exposures to customers connected to the credit institution, for example, subsidiary or sister companies and to companies with common directors, should be prudently assessed in the light of the requirements of *Banking Rule BR/11 – Extension of the Applicability of the “Arm’s Length Principle” by Credit Institutions*.

#### **LIMITS FOR LARGE EXPOSURES**

21. The Rule provides for absolute limits on the size of exposures that may be undertaken by a credit institution.
22. The limits set by the Rule under paragraphs 23 and 24 apply to exposures to

customers or counterparties. The identity of a counterparty will generally be the borrower (customer), the person guaranteed, the issuer of a security in the case of a security held or the party with whom a contract was made in the case of a financial contract. Where an exposure to a client is guaranteed by a third party, or secured by collateral issued by a third party, a credit institution may:

- (a) Treat the portion of the exposure which is guaranteed as having been incurred to the guarantor rather than to the client, provided that the unsecured exposure to the guarantor would be assigned an equal or lower risk weight than a risk weight of the unsecured exposure to the client under the *Standardised Approach of the Capital Requirements Rule BR/04*;
- (b) Treat the portfolio of the exposure collateralised by the market value of recognised collateral as having been incurred to the third party rather than to the client, if the exposure is secured by collateral and provided that the collateralised portion of the exposure would be assigned an equal or lower risk weight than a risk weight of the unsecured exposure to the client under the *Standardised Approach of the Capital Requirements Rule BR/04*;

The approach referred to in point (b) above shall not be used by a credit institution where there is a mismatch between the maturity of the exposure and the maturity of the protection.

For the purpose of the above, a credit institution may use both the Financial Collateral Comprehensive Method and the treatment provided for in point (b) above only where it is permitted to use both the *Financial Collateral Comprehensive Method* and the method for the purposes of *paragraph 5 of Banking Rule BR/04*.

Where the credit institution adopts the treatment as provided for under this paragraph, then:-

- (a) where the guarantee is denominated in a currency which is different from that in which the exposure is denominated, the amount of the exposure deemed to be covered will be calculated in accordance with the provisions on the treatment of currency mismatch for unfunded credit protection under *Appendix 2 Section III.2 - Credit Risk Mitigation of BR/04*;
  - (b) a mismatch between the maturity of the exposure and the maturity of the protection will be treated in accordance with the provisions on the treatment of maturity mismatch as depicted under *Appendix 2 Section III.5 - Credit Risk Mitigation of BR/04*;
  - (c) partial coverage may be recognised in accordance with the treatment set out in *Appendix 2 Section III.4 - Credit Risk Mitigation of BR/04*.
23. An exposure of a credit institution to a customer or group of connected customers shall be considered to be a large exposure where its value (before the deduction of



eligible exemption) is equal to or exceeds 10% of its own funds.

### ***Single exposure limit***

24. A credit institution shall not incur an exposure, after taking into account the effect of the credit risk mitigation in accordance with paragraphs 41 to 48, to a client or group of connected clients the value of which exceeds 25% of its own funds.

Where that client is an institution or where a group of connected clients includes one or more institutions, that value shall not exceed 25% of the credit institution's own funds or €150 million, whichever is the higher, provided that the sum of the net exposure values, after taking into account the effect of the credit risk mitigation in accordance with paragraphs 41 to 48, to all connected clients that are not institutions, does not exceed 25% of the credit institution's own funds.

Where the amount of €150 million is higher than 25% of the credit institution's own funds, the value of the exposure, after taking into account the effect of credit risk mitigation in accordance with paragraphs 41 to 48, shall not exceed a reasonable limit in terms of the credit institution's own funds. That limit shall be determined by credit institutions, consistently with the policies and procedures to address and control concentration risk referred to in Annex 2B of Banking Rule BR/12, and shall not be higher than 100% of the credit institution's own funds.

Notwithstanding the above, the Authority retains the right to set a lower limit than the €150 million referred to in the preceding paragraph.

### ***Limits on exposures to customers connected to the credit institution***

25. Exposures to corporate bodies or persons connected to the lending credit institution, its officers or controllers require special care to ensure that a proper objective assessment is undertaken for the clear commercial advantage of the lending credit institution. In this respect reference is to be made to *Banking Rule BR/11 – Extension of the Applicability of the “Arm’s Length Principle” by Credit Institutions*.

### ***Exposures to Subsidiary Companies***

26. An exposure by way of investment in the share capital of a company or group of connected companies, as considered in terms of Article 15(1)(d) of the Act, may not exceed 15% of a credit institution's own funds. This measure does not apply when the shareholding is in another credit institution, a financial institution or in any company that is supervised by the Authority on a consolidated basis in terms of the Banking Rule on *Supervision on a Consolidated Basis (BR/10)*.
27. In monitoring exposures in terms of this Rule, the authority considers the limit established under paragraph 24 as inclusive of any investment referred to in paragraph 26.

### *Use of Group Own Funds*

28. A credit institution may incur an exposure to an individual customer or a group of connected customers within the limits established in paragraphs 23 and 24 measured on the basis of consolidated group own funds in accordance with paragraph 15 of the Banking Rule on the *Own Funds of Credit Institutions BR/03*.
29. Once a credit institution incurs an exposure pursuant to paragraph 28, other credit and/or financial institutions independently or collectively within a banking group of which the credit institution forms part, shall only incur an exposure with the same customer or group of connected customers of the parent to the extent that the exposure, including that incurred by the parent to the same customer or group of connected customers, is contained within the limits set under paragraphs 23 and 24 . For the purpose of this paragraph, banking group shall be construed to constitute purely a local banking group (or local sub-group of cross border banking group)
30. Annex VI - Large Exposures – of the Banking Rule on the *Capital Adequacy of Credit Institutions BR/08* allows credit institutions, under advice to the authority, to hold large exposures attributable to positions in certain securities in the trading book to exceed 25% of their Own Funds limit, provided that :
  - i. Such excesses relate strictly to securities held in the trading book
  - ii. An additional capital charge is generated in respect of the excess trading book exposure.

For the purpose of this Annex, where a credit institution incurs exposures in accordance with paragraph 32, the Own Funds limit shall be the Consolidated Group Own Funds.

### **NOTIFICATION OF EXPOSURES**

31. All notification of exposures under paragraphs 32 to 40 shall also include exposures which are exempt for the purposes of this Rule. The reporting schedules under Appendix 1 are to be used for this purpose.

#### ***Pre-notification of exposures exceeding 25% of Own Funds***

32. A credit institution shall at all times comply with the set limits. However there are very exceptional circumstances, as detailed in paragraph 43, in which a credit institution or banking group may enter into exposures which exceed 25% of own funds prior to eligible exemptions. When a credit institution or banking group proposes to incur such exposure, which either alone or together with other existing exposures to the same customer exceeds 25% of its own funds, this transaction must be notified immediately to the authority.

33. No credit institution shall take any measures which would cause existing or new exposures to exceed the maximum limits set out in the Rule.
34. Where, upon the publication of the Rule, or any amendments thereto, a credit institution is committed on an exposure which could exceed the maximum limits set in the Rule, that credit institution is duty bound to honour such commitment but has to pre-notify the authority accordingly subject to the provisions of paragraph 39.
35. Where, upon the publication of the Rule, or any amendments thereto, a credit institution is legally bound on an exposure by way of a loan which is already being utilised, that credit institution may retain its obligation until maturity subject to pre-notification to the authority in terms of the provisions of paragraph 39.

***Post notification of exposures***

36. Every credit institution and banking group is required to report all large exposures on a quarterly basis to the authority, using the reporting schedules found under Appendix 1 which have been developed taking into account the CEBS publication dated 11<sup>th</sup> December 2009, entitled '[Guidelines on reporting requirements for the revised Large Exposures regime](#)'.  
[Guidelines on reporting requirements for the revised Large Exposures regime](#)'.
37. A credit institution shall report the following information about every large exposure to the authority, including any large exposures exempted in terms of paragraph 43:
  - (a) the identification of the client or the group of connected clients to which a credit institutions has a large exposure;
  - (b) the gross exposure value before taking into account the effect of the credit risk mitigation, when applicable;
  - (c) where used, the type of funded or unfunded credit protection;
  - (d) The exposure value after taking into account the effect of the credit risk mitigation calculated for the purposes of paragraphs 45 to 48.

If a credit institution is subject to the provisions of the *Internal Ratings Based Approach* in terms of the provisions of *Capital Requirements Rule BR/04*, its 20 largest exposures on a consolidated basis, excluding those exempted from the application of paragraph 24, shall also be made available to the authority.

38. It is expected that credit institutions adopt policies which will not lead to the 10% limit being exceeded as a matter of course and the more the exposures exceed the 10% limit the more the respective credit institution's management will be expected to exercise diligence and prudence. Although 10% of own funds is the minimum threshold that will be applied for reporting purposes, the authority may prudently set a lower percentage for some credit institutions.

39. Should a credit institution find that for reasons beyond its control it has incurred an exposure to an individual customer, (e.g. following merger, amalgamation or buy-out), which results in it exceeding any of the limits set out in paragraph 24 above, it should report the matter immediately to the authority. The authority will discuss the circumstances of any such exposures and where the situation warrants it, may allow a limited period of time in which to comply with the limits.
40. Where the amount of €150 million referred to in paragraph 24 is applicable, the authority may allow on a case-by-case and strictly on an exceptional basis, the 100% limit in terms of the credit institution's own funds, to be exceeded.

## EXEMPT EXPOSURES

### *General Exemptions*

41. Exemptions applicable to exposures by reason of the security attached to any particular exposure are applicable solely to that specific exposure. Under no circumstances should any excess value in security on any single exposure be transferable to any other exposure with the same customer be it an individual or group of connected customers.
42. The authority expects every credit institution to apply the set exposure limits but certain types of exposures are exempt on the strength of the security taken. Single exposures or parts thereof falling under the following categories are exempted in calculating a credit institution's large exposures position in terms of the 25% limit set out in paragraph 24. Such exposures are however still considered large exposures for reporting purposes as required under paragraphs 32 to 40 of this Rule.
43. The following exposures are to be fully exempt from the application of paragraph 24:
  - (i) Asset items constituting claims on central governments or central banks which would unsecured receive a 0% risk weighting under the *Standardised Approach* of calculating a credit institution's capital requirements in terms of the *Capital Requirements Rule BR/04*;
  - (ii) Asset items constituting claims on international organisations or multilateral development banks which would unsecured receive a 0% risk weight under the *Standardised Approach* of calculating a credit institution's capital requirements in terms of the *Capital Requirements Rule BR/04*;
  - (iii) Asset items constituting claims carrying the explicit guarantees of central governments, central banks, international organisations multilateral development banks or public sector entities, where unsecured claims on the entity providing the guarantee would receive a 0% risk weight under the *Standardised Approach* of calculating a credit institution's capital requirements in terms of the *Capital Requirements Rule BR/04*;

- (iv) Other exposures attributable to, or guaranteed by, central governments, central banks, international organisations, multilateral development banks or public sector entities, where unsecured claims on the entity to which the exposure is attributable or by which it is guaranteed would receive a 0% risk weight under the *Standardised Approach* of calculating a credit institution's capital requirements in terms of the *Capital Requirements Rule BR/04*;
- (v) Asset items constituting claims on regional governments or local authorities of member states where those claims would be assigned a 0% risk-weight under the *Standardised Approach* of calculating a credit institution's capital requirements in terms of the *Capital Requirements Rule BR/04* and other exposures to or guaranteed by those regional governments or local authorities, claims on which would be assigned a 0% risk weight under the *Standardised Approach*;
- (vi) Exposures to counterparties referred to in *Appendix 2 Section I.1 – Credit Risk: Standardised Approach item 9.0 of Banking Rule BR/04*, if they would be assigned a 0% risk weight under the standardised approach. Exposures that do not meet this criteria, whether or not exempted from paragraph 24, shall be treated as an exposure to a third party;
- (vii) Asset items and other exposures secured to the satisfaction of the authority by collateral in the form of cash deposits placed with the lending credit institution or with a credit institution which is the parent undertaking or a subsidiary of the lending institution. Cash received under a credit-linked note issued by the credit institution and loans and deposits of a counterparty to or with the credit institution which are subject to an on-balance sheet netting agreement recognised under *Appendix 2 Section III, 1 - Credit Risk Mitigation* of the *Capital Requirements Rule BR/04* shall be deemed to fall under this item;
- (viii) Asset items and other exposures secured to the satisfaction of the authority, by collateral in the form of certificates of deposits issued by the lending credit institution or by a credit institution which is the parent undertaking or subsidiary of the lending credit institution and lodged with either of them;
- (ix) Exposures arising from undrawn credit facilities that are classified as low-risk off-balance sheet items in *Annex II of the Capital Requirements Rule BR/04 – Classification of off-balance sheet items*, and provided that an agreement has been concluded with the client or group of connected clients under which the facility may be drawn only if it has been ascertained that it will not cause the net 25% limit, referred to in paragraph 24, to be exceeded;
- (x) Covered bonds falling within the terms of *Appendix 2, Section I.2, paragraphs 12.1 to 12.7 of the Capital Requirements Rule BR/04*;
- (xi) Asset items constituting claims on regional governments or local authorities of

Member States where those claims would be assigned a 20% risk-weight under the *Standardised Approach of the Capital Requirements Rule BR/04* and other exposures to or guaranteed by those regional governments or local authorities, claims on which would be assigned a 20% risk weight under the *Standardised Approach of the Capital Requirements Rule BR/04*.

- (xii) Notwithstanding sub-paragraph (vi) above, exposures including participations or other kinds of holdings, incurred by the reporting credit institution to its parent undertaking, to other subsidiaries of that parent undertaking or to its own subsidiaries, in so far as those undertakings are covered by the supervision on a consolidated basis to which the credit institution itself is subject, in accordance with this Rule, and the provisions of the Capital Requirements Directive or with equivalent standards in force in a third country; exposures that do not meet this criteria, whether or not exempted from paragraph 43, shall be treated as exposures to a third party;
- (xiii) Asset items constituting claims on and other exposures, including participations or other kinds of holdings, to regional or central credit institutions with which the reporting credit institution is associated in a network in accordance with legal or statutory provisions and which are responsible, under those provisions, for cash-clearing operations within the network;
- (xiv) Asset items constituting claims on and other exposures to credit institutions incurred by credit institutions operating on a non-competitive basis, providing loans under legislative programmes or their statutes, to promote specified sectors of the economy under some form of government oversight and restrictions on the use of the loans, provided that the respective exposures arise from such loans that are passed on to the beneficiaries via other credit institutions;
- (xv) Asset items constituting claims on and other exposures to institutions (i.e. credit institutions and investment firms), provided that those exposures do not constitute such institutions' own funds, do not last longer than the following business day and are not denominated in a major trading currency;
- (xvi) Asset items constituting claims on central banks in the form of required minimum reserves held at those central banks which are denominated in their national currencies;
- (xvii) Asset items constituting claims on central governments in the form of statutory liquidity requirements held in government securities which are denominated and funded in their national currencies, provided that, at the discretion of the authority, the credit assessment of those central governments assigned by a nominated ECAI is investment grade;

- (xviii) 50% of medium/low risk off-balance sheet documentary credits and of medium/low risk off-balance sheet undrawn credit facilities referred to in *Annex II of the Capital Requirements Rule BR/04 – Classification of off-balance sheet items*, and subject to the authority's agreement, 80% of guarantees other than loan guarantees which have a legal or regulatory basis and are given for their members by mutual guarantee schemes possessing the status of credit institutions;
  - (xix) Legally required guarantees used when a mortgage loan financed by issuing mortgage bonds is paid to the mortgage borrower before the final registration of the mortgage in the land register, provided the guarantee is not used as reducing the risk in calculating the risk weighted assets.
44. Exemptions listed in paragraph 43 above are allowed due to the peculiar nature of the particular exposures, and because such claims are normally liquid or easily realisable and generally likely to involve a low degree of risk. The term "guarantee" other than credit linked notes, shall include credit derivatives recognised as a credit protection under the *Capital Requirements Rule BR/04*. Furthermore the recognition of funded or unfunded credit protection rule as detailed under paragraph 45, shall be subject to compliance with the eligibility requirements and other minimum requirements set out under *Appendix 2 Section III - Credit Risk Mitigation of Banking Rule BR/04* for the purposes of calculating risk-weighted exposure amounts under the *Standardised Approach* of calculating the relative capital requirements. Where a credit institution relies upon its own estimates of LGD and conversion factors for an exposure class and recognises such effects in calculating the value of exposures for the purposes of the limits set out under paragraphs 24, the recognition of credit protection shall be subject to the relevant requirements set out under *Appendix 2 Section II - Internal Ratings Based Approach of Banking Rule BR/04* when calculating a credit institution's capital requirement.

For the purpose of this Section, a reporting credit institution shall not take into account the real estate collateral referred to in *Appendix 2, Section III.2 – Credit Risk Mitigation of Banking Rule BR 04 (items 1.3.12 – 1.3.14)*, unless permitted under paragraph 47 of this Rule.

#### **SECURED EXPOSURES**

45. While the authority will take security into account when considering the acceptability of a credit institution's exposure up to 25% of its own funds, the presence of security taken on its own account will not be considered by the authority to be an acceptable reason for an exposure to exceed 25%. However, where the security fully or partially covers exposures to a given counterparty which qualify for exemption in line with paragraph 43 (vii) and (viii) of this Rule or cash deposits (which in this context includes CDs issued by the lending bank) placed with the reporting lending institution or with a credit institution which is the parent undertaking or a subsidiary of the reporting lending institution, the existence of that security will be considered sufficient justification for an exposure to exceed 25% of the credit institution's own

funds and such exposures are exempt from the limits set out in this Rule on a net basis.

46. In the case of an exposure secured by a cash deposit, the lender's (reporting credit institution) legal title to the deposit should be fully protected. The deposit should have identical or longer maturity than the exposure. Where the cash deposit is in a different currency from the exposure, an appropriate margin over the amount of the secured portion of the exposure should be maintained to cover fluctuations in the relevant exchange rates. The margin should take account of the nature of the arrangements for ensuring that any resultant deficiency in the margin following an exchange rate change is made up. For the purposes of this paragraph, reference to cash deposit shall also mean reference to subparagraphs 43(vii) and (viii) of this Rule.
47. A credit institution may reduce the exposure value by up to 50% of the value of the residential property<sup>6</sup> concerned, if either of the following conditions is met:-
- a) The exposure is secured, by mortgages on residential property by shares in Finnish residential housing companies, operating in accordance with the Finnish House Company Act of 1991, or subsequent equivalent legislation;
  - b) The exposure relates to a leasing transaction under which the lessor retains full ownership of the residential property leased for as long as the lessee has not exercised his option to purchase.

The valuation of the property shall be calculated to the satisfaction of the authority, on the basis of the prudent valuation standards laid down by the applicable law, regulation or administrative provisions. Valuation shall be carried out at least once every three years for residential property.

The requirements as per *Appendix 2 of Capital Requirements Rule BR/04*, of *Credit Risk Mitigation* shall apply.

A credit institution may reduce the exposure value by up to 50% of the value of the commercial property concerned only if the overseas regulatory authority concerned in the Member State where the commercial property is situated allow the following exposures to receive a 50% risk weight in accordance with the *Standardised Approach of the Capital Requirements Rule BR/04*:

- a) Exposures secured by mortgages on offices or other commercial premises.
- b) Exposures related to property leasing transactions concerning offices of other commercial premises.

The value of the property shall be calculated, to the satisfaction of the authorities (i.e.

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<sup>6</sup> 'Residential property' shall mean a residence to be occupied or let by the owner.



the authority and overseas regulatory authority), on the basis of prudent valuation standards laid down by law, regulation or administrative provisions. Commercial property shall be fully constructed, leased and produce appropriate rental income.

48. (a) Subject to subparagraph (c) below, for the purposes of calculating the value of exposures in terms of paragraphs 23 and 24 of this Rule, credit institutions using the *Financial Collateral Comprehensive Method* under *Appendix 2 Section III - Credit Risk Mitigation of Banking Rule BR/04* are permitted to use a value lower than the value of the exposure, but not lower than the total of the fully-adjusted exposure values of their exposures to the client or group of connected clients. For these purposes, 'fully-adjusted exposure value' means that calculated under *Appendix 2 Section III - Credit Risk Mitigation of Banking Rule BR/04* taking into account volatility adjustments, and any maturity mismatch (E\*). Where a credit institution utilises the fully-adjusted exposure value as calculated in the *Financial Collateral Comprehensive Method*, the exemptions listed in paragraph 47 shall not be applied by the credit institution in question.
- (b) subject to subparagraph (c), a credit institution permitted to use own estimates of LGDs and conversion factors for an exposure class under *Appendix 2 Section II - Internal Ratings Based Approach of Banking Rule BR/04* may be permitted, where it is able to the satisfaction of the authority to estimate the effect of financial collateral on their exposures separately from other LGD-relevant aspects, to recognise such effects in calculating the value of exposures for the purposes of paragraphs 23 and 24.

Credit institutions shall prove to the satisfaction of the authority as to the suitability of the estimates produced by the credit institution for use for the reduction of the exposure value for the purposes of compliance with the provisions of paragraphs 23 and 24.

Where a credit institution is permitted to use its own estimates of the effects of financial collateral, it must do so on a basis consistent with the approach adopted in the calculation of capital requirements.

Credit institutions permitted to use own estimates of LGDs and conversion factors for an exposure class under the *Internal Ratings Based Approach of Banking Rule BR/04* which does not calculate the value of their exposures using the method referred to in subparagraph (a) of this paragraph, may use the *Financial Collateral Comprehensive Method* or treat the exposure as having been incurred to the third party rather than to the client if the exposure is guaranteed by collateral under the conditions there laid down.

For the purpose of the exposure weighted average LGD for all retail exposures not lower than 10% and secured by residential properties and not benefitting from guarantees from central governments, such asset items constituting claims on and other exposures to institutions incurred prior to 31<sup>st</sup> December

2009 shall continue to be subject to the same treatment as applied in accordance with paragraph 47 of this Rule and the previous deleted Article 116 of EU Directive 2006/48, as they stood prior to 7<sup>th</sup> December 2009, however not longer than until 31<sup>st</sup> December 2012.

- (c) A credit institution which is permitted to use the methods described in subparagraphs (a) and (b) above in calculating the value of exposures for the purposes of paragraphs 23 and 24 shall conduct periodic stress tests of their credit risk concentrations, including in relation to the realisable value of any collateral taking.

The stress tests shall address risks arising from potential changes in market conditions that could adversely impact the credit institutions' adequacy of own funds and risks arising from the realisation of collateral in stressed situations.

The credit institution shall satisfy the authority that the stress tests carried out are adequate and appropriate for the assessment of such risks.

In the event that such a stress test indicates a lower realisable value of collateral taken than would be permitted to be taken into account under (a) and (b) as appropriate, the value of collateral permitted to be recognised in calculating the value of exposures for the purposes of paragraphs 23 and 24 shall be reduced accordingly.

Such credit institutions shall include the following in their strategies to address concentration risk:

- i) Policies and procedures to address risks arising from maturity mismatches between exposures and any credit protection on those exposures;
- ii) Policies and procedures in the event that a stress test indicates a lower realisable value of collateral than taken into account while making use of the methods described in subparagraphs (a) and (b) above;
- iii) Policies and procedures relating to concentration risk arising from the application of credit risk mitigation techniques, and in particular large indirect credit exposures (example to a single issuer of securities taken as collateral).

## **EXPOSURE TO COUNTRIES**

49. The authority does not consider it appropriate to publish guideline large exposure thresholds for the acceptable level of exposures to countries. However, credit institutions are expected to set prudent limits for country exposures on the basis of their own risk assessments. The nature of the relative exposure/s will be the primary factor in considering an acceptable level of exposure. The authority will also monitor closely credit institutions' country risk exposures, taking into consideration the provisions of the Banking Rule on *Credit and Country Risk Provisioning BR/09*. Furthermore, credit institutions are bound by the provisions of Banking Rule BR/12 to identify, measure, monitor and control concentration risk including to countries and allocate internal capital where considered necessary.

## **EXPOSURES TO ECONOMIC SECTORS**

50. Each credit institution is expected to prudently expose itself to a particular industrial sector depending upon its own expertise and knowledge of that sector. A credit institution's aggregate exposure to any particular economic sector is not bound by the limits under paragraphs 23 and 24 of this Rule. However, the authority expects managements of credit institutions to exercise their discretionary power with prudence in this respect.
51. Credit institutions shall provide the authority with sufficient evidence that they have prudent lending policies which take into account the dangers from over-exposures to particular economic sectors and that such policies would be adjusted from time to time to reflect changes in the market conditions and economic trends. The authority will however continue to monitor a credit institution's exposures to the various economic sectors. Furthermore, credit institutions are bound by the provisions of Banking Rule BR/12 to identify, measure, monitor and control concentration risk including to specific economic sectors and allocate internal capital where considered necessary.

## **CONCENTRATION OF RISKS**

52. The authority expects that credit institutions do not unnecessarily expose themselves to a concentration of risks. Should a credit institution in the opinion of the authority be unduly concentrating risks, the authority may request such credit institution to justify these exposures. The authority may request such credit institution to review its lending policies. The authority may also take any other measure it may deem appropriate under the prevailing circumstances. Furthermore, credit institutions are bound by the provisions of Banking Rule BR/12 to identify, measure, monitor and control concentration risk and allocate internal capital where considered necessary. Moreover credit institutions are required to analyse, to the extent possible, their exposures to collateral issuers, providers of unfunded credit protection and underlying assets pursuant to paragraph 14 (last paragraph) of this Rule for possible concentrations and where appropriate take action and report any significant findings to their authority.

## **EXPOSURES UNDERTAKEN BY BRANCHES OF THIRD COUNTRY CREDIT INSTITUTIONS**

53. The provisions of this Rule do not apply to a local branch of a third country institution. Prior to authorisation to a third country institution to establish a local branch under paragraphs 29 to 32 of the *Applications procedures and requirements for authorisations of licenses for Banking Activities (BR/01)*, the authority, require the foreign institution to provide its policies for large exposures, in respect of those transactions which could be undertaken by that branch, as part of the business plan submitted in terms of BR/01. Any limits set by the third country institution for its local branch shall not exceed the limits under this Rule as applied to the own funds of

the third country institution. The authority may however discuss such policy with the third country institution's home supervisory authority and may, if necessary, request the institution to review such limits for the purposes of its operations through the local branch.

54. Subsequent to authorisation, the third country institution is bound to discuss with the authority any changes in such limits.
55. The authority will need to be satisfied that the exposures undertaken by the branch are adequately monitored and controlled by the third country credit institution. Moreover, the authority will monitor closely exposures of branches of third country institutions to the third country institution's home country.

#### **OFFENCES AND PENALTIES**

56. Any person who commits an offence in terms of this Rule as provided for under Article 35 of the Act is liable to such penalties as may be prescribed pursuant to the said article.