CALCULATING CAPITAL REQUIREMENTS FOR LARGE EXPOSURES

Introduction

1. Credit institutions shall monitor and control their large exposures in accordance with the Large Exposures Rule BR/02 and subject to this Annex as applicable. This Annex allows credit institutions to hold large exposures attributable to positions in securities[1] to exceed the 25% of their Own Funds limit, subject however, to the generation of extra capital requirements.

2. Compliance with the requirements set out in this Annex will also be monitored on a consolidated group basis for each institution.

Measurement of Exposures

3. (a) The overall exposures to individual customers[2] or groups of connected customers[3] must be calculated by summing the exposures which arise on the trading book with those in the banking book and deducting from this sum the exempt exposures as set out in the Large Exposures Rule BR/02. Furthermore, in accordance with Article 10(a) of the latter Rule, items deducted in the calculation of Own Funds will not be included in the measurement of an exposure.

   (b) Other than in relation to repurchase transactions, securities or commodities lending or borrowing transactions, the calculation of large exposures to clients and groups of connected clients for reporting purposes shall not include the recognition of credit risk mitigation.

4. By derogation from the Large Exposure limits on individual clients or group of connected clients as laid down in Banking Rule BR/02, the Authority may allow assets constituting claims and other exposures on recognised third-country investment firms and recognised clearing houses and exchanges to be subject to the same treatment as laid down in the section entitled "Exempt Exposures" in Banking Rule BR/02.

Large Exposures in the Trading Book

5. The exposures to individual customers which arise on the trading book include the following items:

   (i) the excess – where positive – of the credit institution's long positions over its short positions in all the financial instruments issued by the customer in question (with the net position in each of the different

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[1] *Includes equities and fixed/variable income securities.*
[2] *Reference to customers also includes counterparties.*
[3] *As defined in the Large Exposures Rule – BR/02.*

instruments being calculated according to the methods specified in Annex III – Position Risk - to the Rule);

(ii) in the case of the underwriting of a debt or equity instrument, the net exposure (calculated by deducting these underwriting positions which are subscribed or sub-underwritten by third parties on the basis of a formal agreement reduced by the factors set out in Annex IV);

(iii) the Settlement and Counterparty Risk exposures due to the transactions, agreements and contracts referred to in Annex II (excluding references to IRB) to this Rule with the customer in question, such exposures being calculated for the calculation of exposure values;

(iv) the excess – where positive – of the credit institution's long positions over its short positions in the same commodity and identical commodity futures, options and warrants (with the net position in each of the different commodities being calculated according to the methods specified in Annex V – Commodities Risk - to the Rule).

The exposures to groups of connected customers in the trading book must be calculated by summing the exposures to the individual customers in a group in accordance with (i) to (iv) above.

Credit institutions are only allowed to hold exposures in excess of the 25% limit arising from traded securities in cases mentioned in (i) to (ii) above and subject solely to the provisions of paragraphs 6 - 15 below.

Limits on Large Exposures

6. The Large Exposures Rule BR/02 determines the absolute limits on the size of exposures that may be undertaken by credit institutions that generate counterparty risk requirements in either the banking book or the trading book, although certain exposures are exempt from these limits (see paragraphs 45 - 51 of Large Exposures Rule BR/02). The limits are of two sorts: an overall limit on the aggregate of large exposures and limits on the size of exposures to individuals or connected groups of counterparty.

7. However, subject to, and in accordance with, Article 12 of the Large Exposures Rule BR/02, a credit institution may use the expanded definition of Own Funds (i.e., including Supplementary Own Funds[4]) in respect of an overall large exposure (banking and trading book combined) provided that the banking book element of the exposure already satisfies the limits based on Original Own Funds plus Additional Own Funds (i.e., excluding Supplementary Own Funds).

[4] *As defined in Appendix I 6.0.0 to the Own Funds Rule BR/03.*

Permitted Excesses

8. Credit institutions are only permitted to hold exposures in excess of the 25% limit in traded securities (i.e. non-counterparty risk) held in the trading book. Such exposures in excess of the 25% limit will then generate incremental capital requirements. Moreover, where a non-exempt exposure to a single counterparty exceeds the 25% large exposure limit but this is only as a result of long securities positions in the trading book, then **an amended capital base**[5] is used to measure the exposure. In such circumstances the **capital base**[6] may be amended to include any Supplementary Own Funds capital, as defined in the Own Funds Rule BR/03, eligible for inclusion in the capital base available to support the trading book. If the exposure exceeds the 25% limit of the amended capital base, incremental capital is required as set out in paragraph 10 below.

9. Where a credit institution is a subsidiary of another locally authorised credit institution and it has exposures exceeding the 25% large exposures limit but the parent bank has made arrangements to protect the subsidiary if problems occur, the additional capital cover, if any, may be held in the parent bank rather than the subsidiary. The additional capital cover will be determined by the size of the exposure (together with other exposures to the same counterparty entered into by the parent bank) in relation to the parent bank's capital base. Such exposures are subject to paragraph 46(iv) of the Large Exposures Rule BR/02.

Pre-notification of Exposures exceeding 25% of Capital Base

10. When a credit institution proposes to enter into an exposure, including 'exempt exposures' and exposures due to securities in the trading book, which either alone or together with other existing exposures to the same counterparty exceeds 25% of capital, the fact must be notified to the Authority before the institution becomes committed to the exposure. Pre-notification may take the form of notifying counterparty limits to the Authority. Where limits have been pre-notified and the Authority has agreed to the limits proposed, exposures which do not exceed these limits need not be further pre-notified to the authority.

Incremental Capital

11. A credit institution, under advice to the Authority, may exceed the 25% limit subject to the following conditions being met simultaneously:

    (1) The exposure on the **banking book** to the customer or group of customers in question does not exceed the limits set out in Banking Rule BR/02, these limits being calculated with reference to Original

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[5] *The amended capital base consists of Original Own Funds, Additional Own Funds and Supplementary Own Funds as defined in Own Funds Rule BR/03.*

[6] *The capital base refers to Original Own Funds and Additional Own Funds only.*

Own Funds plus Additional Own Funds, so that the excess arises entirely on the trading book;

(2) the credit institution meets an **additional capital requirement** in respect of the excess over the limits set out in Banking Rule BR/02. The additional capital requirement shall be calculated by selecting those components of the **trading book** exposure to the customer or group of customers in question which attract the highest Specific Risk requirements[7] and/or settlement/counterparty risk requirements[8], the sum of which equals the amount of the excess referred to in paragraph 11(1) above. The calculation for determining the incremental capital requirement involves the following sequential steps:

a) Net any short securities positions against long securities positions, netting the short items against the highest long specific risk weighted items (Note: the specific risk weights of netted items need not be identical).

b) Rank the remaining net long securities positions in order according to specific risk weighting factors (i.e. lowest weighted items first, highest weighted items last).

c) Taking the lowest weighted items first, apply these exposures to the difference between the non securities exposure to the counterparty and 25% of the amended capital base (i.e. the "headroom" up to 25% of the amended capital base is employed to cover the lowest weighted exposures).

d) Incremental capital is required for remaining net long securities exposures as follows:

i) if the credit institution has exceeded the 25% limit for 10 days or less, the specific risk weighting for exposures ranked in excess of 25% of the amended capital base are multiplied by 200%.

ii) if the credit institution has exceeded the 25% limit for more than 10 days, the specific risk weightings for exposures ranked in excess of 25% of the amended capital base are multiplied by the following factors:

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7 *The weightings for Specific Risk are those found in Annex III – Position Risk.*

8 *The weightings for Counterparty/Settlement Risk are those found in Annex II – Counterparty/ Settlement Risk.*

Table 1

Excess exposure over 25% of amended capital base (acb)	**Factor applied to specific risk weighting**
Up to 40% of acb	200%
From 40% to 60% of acb	300%
From 60% to 80% of acb	400%
From 80% to 100% of acb	500%
From 100% to 250% of acb	600%
Over 250% of acb	900%

An example of the calculation of the incremental capital requirement for trading book securities exposures in excess of the 25% limit is set out in **Appendix VI – A** to this Annex.

12. Where 10 days or less has elapsed since the excess occurred, the trading book exposure to the customer or group of connected customers in question must not exceed 500% of the amended capital base.

13. Any trading book excesses which have persisted for more than 10 days must not, in aggregate, exceed 600% of the bank's amended capital base.

14. The Authority shall establish procedures to prevent credit institutions from deliberately avoiding the additional capital requirements that would otherwise be incurred on exposures exceeding the limits mentioned in Banking Rule BR/02 once those exposures have been maintained for more than 10 days, by means of temporarily transferring the exposures in question to another company, whether within the same group or not, and/or by undertaking artificial transactions to close out the exposure during the 10-day period and create a new exposure. Credit institutions shall maintain systems which ensure that any transfer which has this effect is immediately reported to the Authority. The Authority shall notify EBA, the Council and the Commission of those procedures.

15. A credit institution must report to the Authority at least quarterly all cases where the limits have been exceeded during the preceding three months. In each case in which the limits have been exceeded the amount of the excess and the name of the customer concerned must be reported.