

Regulatory framework for measuring and controlling large exposures (LEX10–LEX40)

10. Objectives, application, and definitions

Directive's objective

10.1 Throughout history there have been instances of banks failing due to concentrated exposures to individual counterparties or groups of connected counterparties. Large exposures regulation has been developed as a tool for limiting the maximum loss a bank could face in the event of a sudden counterparty failure to a level that does not endanger the bank's solvency.

10.2 A large exposures framework complements the Committee's risk-based capital standard because the latter is not designed specifically to protect banks from large losses resulting from the sudden default of a single counterparty or a group of connected counterparties. In particular, the minimum capital requirements (Pillar 1) of the Basel risk-based capital framework implicitly assume that a bank holds infinitely granular portfolios, i.e., no form of concentration risk is considered in calculating capital requirements. Contrary to this assumption, idiosyncratic risk due to large exposures to individual counterparties or groups of connected counterparties may be present in banks' portfolios. Although a supervisory review process (Pillar 2) concentration risk adjustment could be made to mitigate this risk¹, these adjustments are neither harmonised across jurisdictions, nor designed to protect a bank against very large losses from the default of a single counterparty or a group of connected counterparties. For this reason, the risk based capital framework is not sufficient to fully mitigate the microprudential risk from exposures that are large compared to a bank's capital resources. That framework needs to be supplemented with a simple large exposures framework that protects banks from traumatic losses caused by the sudden default of an individual counterparty or group of connected counterparties. To serve as a backstop to risk-based capital requirements, the large exposures framework should be designed so that the maximum possible loss a bank could incur if a single counterparty or group of connected counterparties were to suddenly fail would not endanger the bank's survival as a going concern.

10.3 The treatment of large exposures could also contribute to the stability of the financial system in a number of other ways. For example, material losses in one systemically important financial institution (SIFI) can trigger concerns about the solvency of other SIFIs, with potentially catastrophic consequences for global financial stability. There are at least two important channels for this contagion. First, investors may be concerned that other SIFIs might have exposures similar to those of the failing institution. Second, and more directly, investors may be concerned that other SIFIs have direct large exposures to the failing SIFI, in the form of either loans or credit guarantees.

¹ The market risk standard [MAR](#) also explicitly requires that trading book models for specific risk capture concentration risk.

Scope and level of application

10.4 This directive is constructed to serve as a backstop and complement to capital adequacy and measurement directives. As a consequence, it must apply and be implemented at the same level as the required application of risk based capital requirements listed in Section 20 of Proper Conduct of Banking Business Directive no. 201 on “Introduction, application, and calculation of requirements”, meaning on a consolidated basis and on the corporations listed in the said Section, including a foreign bank.

10.5 **Not adopted²**

10.6 The application of the Directive on a consolidated basis implies that the banking corporation is required to take into account all exposures to third parties in the consolidated group, and to compare the total to the Tier 1 capital of the group; in a foreign bank, Tier 1 capital means the “capital” in the foreign bank’s license.

Scope of counterparties and exemptions

10.7 A banking corporation must consider exposures to any counterparty, as defined in Sections 10.8a–10.18c. The only counterparties that are exempted from this Directive are sovereigns as defined in Section 30.32. Sections 30.32–30.60 set out the types of counterparties that are exempted from the large exposure limit or for which another specific treatment is necessary. Any exposure type not included in Sections 30.32–30.60 is subject in all respects to the large exposure limit.

10.7a Notwithstanding the provisions of Section 10.7, exposure to a corporation that belongs to the same banking counterparty group as the banking corporation is exempt from this Directive.

Definition of a large exposure

10.8 The sum of all exposure values of a banking corporation to a counterparties or to a group of connected counterparties, as defined in Sections 10.9–10c.18 must be defined as a large exposure if it is equal to or above 10 percent of the banking corporation’s Tier 1 capital after supervisory adjustments and deductions as defined in Proper Conduct of Banking Business Directive no. 202 on “Regulatory capital” (hereinafter, “Directive 202”) based on the most recent report submitted to the Banking Supervision Department in accordance with Reporting to Banking Supervision directive no. 838 on “Quarterly report on measurement and capital adequacy” (hereinafter, “Tier 1 Capital”). The exposure values must be measured as specified in Chapter 30 below.

² Not adopted.

Definition of counterparty

10.8a A person, and in the case of an individual—his or her spouse as well.

Definition of connected counterparties

10.9 In some cases, a banking corporation may have exposures to a group of counterparties with specific relationships or dependencies such that, were one of the counterparties to fail, all of the counterparties would very likely fail. A group of this sort, referred to in this Directive as “a group of connected counterparties”, must be treated as a single counterparty. In this case, the sum of the banking corporation’s exposures to all the individual entities included within a group of connected counterparties is subject to the large exposure limit and to the regulatory reporting requirements as specified in Sections 20.1–20.4.

10.10 Two or more natural or legal persons shall be deemed “a group of connected counterparties” if at least one of the following criteria is satisfied.

- (1) Control relationship: one of the counterparties, directly or indirectly, has control over the other(s).
- (2) Economic interdependence: if one of the counterparties were to experience financial problems, in particular funding or repayment difficulties, the other (s), as a result, would also be likely to encounter funding or repayment difficulties.

10.11 Banking corporations must assess the relationship amongst counterparties with reference to Sections 10.10(1) and 10.10(2) above in order to establish the existence of a group of connected counterparties.

10.12

In assessing whether there is a control relationship between counterparties, banking corporations must automatically consider that the criterion in Section 10.10(1) is satisfied when there is “control”.

10.13 Without derogating from the provisions of Section 10.12, the banking corporation must **assess** connectedness between counterparties based on control using the following criteria as well:

- (1) Voting agreements (e.g., control of a majority of voting rights pursuant to an agreement with other shareholders);
- (2) Significant influence on the appointment or dismissal of an entity’s administrative, management or supervisory body, such as the right to appoint or remove a majority

of members in those bodies, or the fact that a majority of members have been appointed solely as a result of the exercise of an individual entity's voting rights;

- (3) Significant influence on senior management, e.g. an entity has the power, pursuant to a contract or otherwise, to exercise a controlling influence over the management or policies of another entity (e.g., through consent rights over key decisions).

(3a) The highest holding share among the holders of the means of control of any type; this criterion shall not apply to an "institutional investor" as defined in the Control of Financial Services (Provident Funds) (Investment rules that apply to institutional investors) Rules, 5772-2012, for which the means of control in the corporation does not exceed 20 percent.

10.14 Banking corporations should also refer to criteria specified in appropriate internationally recognised accounting standards for further qualitative guidance when determining control.

10.15 Where control has been established based on any of these criteria, a banking corporation may still demonstrate to the Supervisor of Banks in exceptional cases, e.g., due to the existence of specific circumstances and corporate governance safeguards, that such control does not necessarily result in the entities concerned constituting a group of connected counterparties.

10.16 In establishing connectedness based on economic interdependence, the banking corporation must consider, at a minimum, the following qualitative criteria:

- (1) Where 50 percent or more of one counterparty's gross receipts or gross expenditures (on an annual basis) is derived from transactions with the other counterparty (e.g., the owner of a residential/commercial property and the tenant who pays a significant part of the rent);
- (2) Where one counterparty has fully or partly guaranteed the exposure of the other counterparty, or is liable by other means, and the exposure is so significant that the guarantor is likely to default if a claim occurs;
- (3) Where a significant part of one counterparty's production/output is sold to another counterparty, which cannot easily be replaced by other customers;
- (4) When the expected source of funds to repay the loans of both counterparties is the same and neither counterparty has another independent source of income from which the loan may be serviced and fully repaid;
- (5) Where it is likely that the financial problems of one counterparty would cause difficulties for the other counterparties in terms of full and timely repayment of liabilities;

- (6) Where the insolvency or default of one counterparty is likely to be associated with the insolvency or default of the other(s);
- (7) When two or more counterparties rely on the same source for the majority of their funding and, in the event of the common provider's default, an alternative provider cannot be found – in this case, the funding problems of one counterparty are likely to spread to another due to a one-way or two-way dependence on the same main funding source.

10.17 There may, however, be circumstances where some of these criteria detailed in Section 10.16 do not automatically imply an economic dependence that results in two or more counterparties being connected. Provided that the banking corporation can demonstrate to the Supervisor of Banks that a counterparty which is economically closely related to another counterparty may overcome financial difficulties, or even the second counterparty's default, by finding alternative business partners or funding sources within an appropriate time period, the banking corporation does not need to combine these counterparties to form a group of connected counterparties.

10.18 There are cases where a thorough investigation of economic interdependencies will not be proportionate to the size of the exposures. Therefore, the banking corporation is expected to identify possible connected counterparties on the basis of economic interdependence in all cases where the sum of all exposures to one individual counterparty exceeds 5 percent of Tier 1 capital.

Definition of counterparty that deals in speculative activity

10.18a A counterparty classified in the financial services industry in accordance with Appendix 5 in Chapter 651 of the Reporting to the Public Directives, and that is a customer that deals in speculative activity as noted in Proper Conduct of Banking Business Directive no. 330 regarding "Management of Credit Risk Derived from Trading Activity of Customers in Derivatives and Securities", as well as a customer that is a stock exchange member in accordance with the Securities Law, 5728-1968, excluding nostro Non-Bank Member as defined in the TASE rule book.

Definition of supervised counterparty

10.18b A supervised customer as defined in Proper Conduct of Banking Business Directive no. 330 regarding "Management of Credit Risk Derived from Trading Activity of Customers in Derivatives and Securities" as well as a customer that is a stock exchange member in accordance with the Securities Law, 5728-1968, excluding nostro Non-Bank Member as defined in the TASE rule book.

Definition of banking group of connected counterparties

10.18c A counterparty that is a banking corporation, including a banking corporation that controls it, as well as all the corporations they control. This definition does not apply to an entity holding a license for payment services provider with prudential importance in line with Section 36l of the Banking (Licensing) Law, 5741-1981, (hereinafter, "Holder of a license for payment services provider with prudential importance"), and also will not apply to a "banking corporation in formation" and a "new banking corporation", as

defined in Proper Conduct of Banking Business Directive no. 480 on “Adjustments to Proper Conduct of Banking Business Directives that apply to a new banking corporation”.

20. Requirements

Minimum requirement – the large exposure limit

- 20.1** The sum of all the exposure values of a banking corporation to a group of connected counterparties must not be higher than 25 percent of the banking corporation’s Tier 1 capital at all times.
- 20.1a** The sum of all the exposure values of a banking corporation to a counterparty of a type as described below must not be higher than 25 percent of the banking corporation’s Tier 1 capital at all times.
- (1) an “unknown” counterparty as described in Section 30.46 below;
 - (2) a counterparty that holds a Payment Services Provider with Prudential Importance license;
 - (3) a counterparty that is a bank or an insurance company that incorporated in a foreign country, provided the counterparty has a credit rating of A- or better.
- 20.1b** (a)The sum of all the exposure values of a banking corporation to a single counterparty that is not of a type listed in Section 20a.1 must not be higher than 15 percent of the banking corporation’s Tier 1 capital at all times.
- (b)The sum of all the exposure values of a banking corporation, excluding one that holds a Payment Services Provider with Prudential Importance license to a banking group of connected counterparties, must not be higher than 15 percent of the banking corporation’s Tier 1 capital at all times.
- 20.1c** The sum of all the exposure values of a banking corporation to a counterparty that engages in speculative activity, and that is not a supervised counterparty, must not be higher than 10 percent of the banking corporation’s Tier 1 capital at all times. This limitation shall also apply to the cumulative exposure of the said counterparties that belong to a group of connected counterparties.
- 20.1d** The sum of all the large exposure values shall not exceed 120 percent of Tier 1 Capital of the banking corporation at all times. In this regard, an exposure to a counterparty shall not be included if it is included in the exposure to a group of connected counterparties, and an exposure to a counterparty included in more than one group of connected counterparties shall be included only in the largest group of connected counterparties
- 20.2** The exposures must be measured as specified in Chapter 30; regarding this Directive, “Tier 1 Capital” is defined as in Section 10.8.
- 20.3** Breaches of the limit, which must remain the exception, must be approved by the Supervisor of Banks; the banking corporation must rectify the breach rapidly.

- 20.3a If there is a change in in the exposure to a counterparty or to a group of connected counterparties resulting from the merger of borrowers or from changes in control of a counterparty or a group of connected counterparties, and a result there was a breach in the limitations, the amount of the breach shall be reduced equal quarterly amounts within 2 years from the date of the change.

Regulatory reporting

- 20.4 Banking corporation must report to the Banking Supervision Department in accordance with Reporting to Banking Supervision Directive no. 810D.

30. Measurement of exposure

General measurement principles

- 30.1 The exposure values a banking corporation must consider in order to identify large exposures to a counterparty are all those exposures defined in the measurement and capital adequacy directives. A banking corporation must consider both on- and off-balance sheet exposures included in either the banking or trading book and instruments with counterparty credit risk under Proper Conduct of Banking Business Directive no. 203A on “Handling counterparty credit risk” (hereinafter, Directive 203A).
- 30.2 An exposure amount to a counterparty that is deducted from capital must not be added to other exposures to that counterparty for the purpose of the large exposure limit.³

Definition of exposure value

- 30.3 The exposure value must be defined as the accounting value of the exposure.⁴
- 30.4 The exposure value for instruments that give rise to counterparty credit risk and are not securities financing transactions (SFTs) must be the exposure at default (EAD) according to the standardised approach for counterparty credit risk (SA-CCR).⁵
- 30.5 The banking corporation should calculate the exposure value for their securities financing transaction (SFT) exposures based on the method implemented for calculating capital requirements for these exposures.

³ This general approach does not apply where an exposure is 1,250% risk-weighted. When this is the case, this exposure must be added to any other exposures to the same counterparty and the sum is subject to the large exposure limit, except if this exposure is specifically exempted for other reasons.

⁴ Net of specific provisions and value adjustments. In this regard, specific allowances for credit losses—include writeoffs, credit loss allowances in respect of debts that are 90 days or more in arrears, and allowances for credit losses in respect of non-interest accruing debts.

⁵ See Directive 203A.

30.6 For the purpose of this directive, off-balance sheet items will be converted to a credit equivalent credit conversion factors as follows:

(1) A credit conversion factor rate of 100 percent on liabilities (including contingent) for providing credit or issuing guarantees, except for liabilities as noted in Sections 83(a) and 83(b) of Proper Conduct of Banking Business Directive no. 203 on “The Standard Approach—Credit Risk (hereinafter, “Directive 203”) and excluding in this case the use of said contingent liability in receiving guarantees recognized as mitigating credit risk as noted in Part D of Directive 203, in accordance with the amount recognized as a credit risk mitigant.

(2) Conversion coefficients as detailed in Sections 83(i) through Section 86a of Directive 203, with a floor of 10 percent.

Eligible credit risk mitigation techniques

30.7 Eligible credit risk mitigation (CRM) techniques for large exposures purposes are those that meet the minimum requirements and eligibility criteria for the recognition of unfunded credit protection⁶ and financial collateral that qualify as eligible financial collateral based on Directive 203.

30.8 Cancelled.

30.9 A banking corporation must recognise an eligible CRM technique in the calculation of an exposure whenever it has used this technique to calculate the capital requirements, based on Directive 203.

30.10 In accordance with provisions set out in Directive 203,⁷ hedges with maturity mismatches are recognised only when their original maturities are equal to or greater than one year and the residual maturity of a hedge is not less than three months.

30.11 If there is a maturity mismatch in respect of credit risk mitigants (collateral, onbalance sheet netting, guarantees and credit derivatives) recognised in Directive 203, the adjustment of the credit protection for the purpose of calculating large exposures is determined using the same approach as in Directive 203.⁸

30.12 Where a banking corporation has in place legally enforceable netting arrangements for loans and deposits, it may calculate the exposure values for large exposures purposes according to the calculation it uses for capital requirements purposes – i.e., on the basis of net credit

⁶ The term “unfunded credit protection” refers to collaterals and credit derivatives, the handling of which is described in Chapter D of Directive 203 (Sections 140–141, 189–201b).

⁷ See Directive 203, Sections 143 and 204.

⁸ See Directive 203, Sections 202–205.

exposures subject to the conditions set out in the approach to on-balance sheet netting in Directive 203.⁹

Recognition of CRM techniques in reduction of original exposure

30.13 A banking corporation must reduce the value of the exposure to the original counterparty by the amount of the eligible CRM technique recognised, in accordance with Directive 203.

The recognized amount is:

- (1) the value of the protected portion in the case of unfunded credit protection;
- (2) the value of the portion of claim collateralised by the market value of the recognised financial collateral when the banking corporation uses the simple approach for capital requirements purposes (Sections 129 and 182–185 of Directive 203).
- (3) the value of the collateral as recognised in the calculation of the counterparty credit risk exposure value for any instruments with counterparty credit risk, such as over-the-counter derivatives;
- (4) the value of collateral adjusted after applying the required haircuts, in the case of financial collateral when the banking corporation applies the comprehensive approach. The haircuts used to reduce the collateral amount are the supervisory haircuts under the comprehensive approach.¹⁰ Internally modelled haircuts must not be used.

Recognition of exposures to CRM providers

30.14 Whenever a banking corporation is required to recognise a reduction of the exposure to the original counterparty due to an eligible CRM technique, it must also recognise an exposure to the CRM provider. The amount assigned to the CRM provider is the amount by which the exposure to the original counterparty is reduced (except in the cases defined in Section 30.29).

Calculation of exposure value for trading book positions

30.15 A banking corporation must add any exposures to a single counterparty arising in the trading book to any other exposures to that counterparty that lie in the banking book to calculate its total exposure to that counterparty.

⁹ See Directive 203, Sections 139 and 188.

¹⁰ Supervisory haircuts are arranged in Directive 203, Sections 151–153.

30.16 The exposures considered in this section correspond to concentration risk associated with the default of a single counterparty for exposures included in the trading book. Therefore, positions in financial instruments such as bonds and equities must be constrained by the large exposure limit, but concentrations in a particular commodity or currency need not be.

30.17 The exposure value of straight debt instruments and equities must be defined as the accounting value of the exposure (i.e., the market value of the respective instruments).

30.18 Instruments such as swaps, futures, forwards and credit derivatives must be converted into positions based on Directive 208.¹¹ These instruments are decomposed into their individual legs. Only transaction legs representing exposures in the scope of the large exposures framework need be considered.¹²

30.19 In the case of credit derivatives that represent sold protection, the exposure to the referenced name must be the amount due in the case that the respective referenced name triggers the instrument, minus the absolute value of the credit protection.¹³ For credit-linked notes (CLN), the protection seller needs to consider positions both in the bond of the note issuer and in the underlying asset referenced by the note. For positions hedged by credit derivatives, see Sections 30.25–30.28.

30.20 The measures of exposure values of options under this framework differ from the exposure value used for capital requirements. The exposure value must be based on the change(s) in option prices that would result from a default of the respective underlying instrument. The exposure value for a simple long call option would therefore be its market value and for a short put option would be equal to the strike price of the option minus its market value. In the case of short call or long put options, a default of the underlying would lead to a profit (i.e., a negative exposure) instead of a loss, resulting in an exposure of the option's market value in the former case and equal the strike price of the option minus its market value in the latter case. The resulting positions will in all cases be aggregated with those from other exposures. After aggregation, negative net exposures must be set to zero.

¹¹ See Directive 208 Sections 718(x–xii).

¹² A future on stock X, for example, is decomposed into a long position in stock X and a short position in a risk-free interest rate exposure in the respective funding currency, or a typical interest rate swap is represented by a long position in a fixed and a short position in a floating interest rate exposure or vice versa.

¹³ In the case that the market value of the credit derivative is positive from the perspective of the protection seller, such a positive market value would also have to be added to the exposure of the protection seller to the protection buyer (counterparty credit risk; see Section 30.4 of this Directive. This situation can generally occur if the present value of the periodic premiums that were agreed upon but not yet paid exceed the absolute market value of the credit protection.

30.21 Exposure values of banking corporations' investments in transactions (ie index positions, securitisations, hedge funds or investment funds) must be calculated applying the same rules as for similar instruments in the banking book (see Sections 30.42–30.54). Hence, the amount invested in a particular structure may be assigned to the structure itself, defined as a distinct counterparty, to the counterparties corresponding to the underlying assets, or to the unknown client, following the rules described in Sections 30.42–30.47.

30.22 Covered bonds held in the trading book are subject to the treatment described in Sections 30.38–30.41.

Offsetting long and short positions in the trading book

30.23 Banking corporations may offset long and short positions in the same issue (two issues are defined as the same if the issuer, coupon, currency and maturity are identical). Consequently, banking corporations may consider a net position in a specific issue for the purpose of calculating a bank's exposure to a particular counterparty.

30.24 Positions in different issues from the same counterparty may be offset only when the short position is junior to the long position, or if the positions are of the same seniority.

30.25 Similarly, for positions hedged by credit derivatives, the hedge may be recognised provided the underlying of the hedge and the position hedged fulfil the provision of Section 30.24 (the short position is junior or of equivalent seniority to the long position).

30.26 In order to determine the relative seniority of positions, securities may be allocated into broad buckets of degrees of seniority (for example, "Equity", "Subordinated Debt" and "Senior Debt").

30.27 Banking corporations that find it excessively burdensome to allocate securities to different buckets based on relative seniority shall not recognise offsetting of long and short positions in different issues relating to the same counterparty in calculating exposures.

30.28 In addition, in the case of positions hedged by credit derivatives, any reduction in exposure to the original counterparty will correspond to a new exposure to the credit protection provider, following the principles underlying the substitution approach stated in Section 30.14, except in the case described in 30.29.

30.29 When the credit protection takes the form of a credit default swap (CDS) and either the CDS provider or the referenced entity is not a financial entity, the amount to be assigned to the credit protection provider is not the amount by which the exposure to the original counterparty is reduced but, instead, the counterparty credit risk exposure value calculated according to the SA-CCR.¹⁴ For the purposes of this paragraph, financial entities comprise:

- (1) regulated financial institutions, defined as a parent and its subsidiaries where any substantial legal entity in the consolidated group is supervised by a regulator that imposes prudential requirements consistent with international norms. These include, but are not limited to, prudentially regulated insurance companies, broker/dealers, banks, thrifts and futures commission merchants; and
- (2) unregulated financial institutions, defined as legal entities whose main business includes: the management of financial assets, lending, factoring, leasing, provision of credit enhancements, securitisation, investments, financial custody, central counterparty services, proprietary trading and other financial services activities identified by supervisors.

30.30 Offsetting between the bank book and the trading book is prohibited.

30.31 When the outcome of the offsetting is a net position vs. a counterparty, there is no need to view the net exposure as an exposure with regard to large exposures (see Section 30.16).

Sovereign exposures and entities connected with sovereigns

30.32 As set out in Section 10.7 above, banking corporations' exposures to the State of Israel or the Bank of Israel are exempted from the provisions of this Directive. In addition, banking corporations' exposures to sovereigns and to their central banks as detailed in Sections 53–56 of Directive 203 are exempt as noted, provided they are attributed a risk weight of zero. This exemption also applies to public sector entities treated as sovereigns according to [Directive 203](#), provided they are attributed a risk weight of zero. Any portion of an exposure guaranteed by, or secured by financial instruments issued by, sovereigns would

¹⁴ See Directive 203A.

be similarly excluded from the scope of this framework to the extent that the eligibility criteria for recognition of the credit risk mitigation are met.

30.33 Where two (or more) entities that are outside the scope of the sovereign exemption are controlled by or economically dependent on an entity that falls within the scope of the sovereign exemption defined in Section 30.32, and are otherwise not connected, those entities need not be deemed to constitute a group of connected counterparties (pursuant to Sections 10.9–10.18).

30.34 However, a banking corporation must report—in Reporting to Banking Supervision Directive no. 810D—exposures subject to the sovereign exemption if these exposures meet the criteria for definition as a large exposure (see Section 10.8 above).

30.35 In addition, if a banking corporation has an exposure to an exempted entity which is hedged by a credit derivative, the banking corporation will have to recognise an exposure to the counterparty providing the credit protection as prescribed in Sections 30.14 and 30.29, notwithstanding the fact that the original exposure is exempted.

Interbank exposures

30.36 To avoid disturbing the payment and settlement processes, the following exposures are not subject to this directive, either for reporting purposes or for application of the large exposure limit:

- (1) intrabank intraday exposures
- (2) interbank exposures deriving from the regular settlement process of securities trading, up to 5 business days or until the security transfer date, whichever comes first.
- (3) Exposures of a payment service provider with prudential importance license holder to a group of banking counterparties deriving from operation of credit cards issued by the banking counterparty group for its customers.

30.37 In stressed circumstances, the Supervisor of Banks shall be able to approve a breach of an interbank limit ex post, in order to help ensure stability in the interbank market.

Covered bonds

30.38 Covered bonds are bonds issued by a bank and are subject by law to special public supervision designed to protect bond holders. Proceeds deriving from the issue of these bonds must be invested in conformity with the law in assets which, during the whole period of the validity of the bonds, are capable of covering claims attached to the bonds and which, in the event of the failure of the issuer, would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest.

30.39 A covered bond satisfying the conditions set out in Section 30.40 may be assigned an exposure value of no less than 20 percent of the nominal value of the banking corporation's covered bond holding. Other covered bonds must be assigned an exposure value equal to 100 percent of the nominal value of the banking corporation's covered bond holding. The counterparty to which the exposure value is assigned is the issuing bank.

30.40 To be eligible to be assigned an exposure value of less than 100 percent, a covered bond must satisfy all the following conditions:

- (1) it must meet the general definition set out in Section 30.38;
- (2) the pool of underlying assets must exclusively consist of:
 - (a) claims on, or guaranteed by, sovereigns, their central banks, public sector entities or multilateral development banks;
 - (b) claims secured by mortgages on residential real estate that would qualify for a 35 percent or lower risk weight under the capital adequacy framework that applies, and have a loan-to-value ratio of 80 percent or lower; and/or
 - (c) claims secured by commercial real estate that would qualify for the 100 percent or lower risk-weight under the capital adequacy framework that applies, and with a loan-to-value ratio of 60 percent or lower;
- (3) The nominal value of the pool of assets assigned to the covered bond instrument(s) by its issuer should exceed its nominal outstanding value by at least 10 percent. The value of the pool of assets for this purpose does not need to be that required by the legislative framework. However, if the legislative framework does not stipulate a requirement of at least 10 percent, the issuing banking corporation needs to publicly disclose on a regular basis that their cover pool meets the 10 percent requirement in practice. In addition to the primary assets listed in Section 30.40(2), the additional collateral may include substitution assets (cash or short term liquid and secure assets held in substitution of the primary assets to top up the cover pool for management purposes) and derivatives entered into for the purposes of hedging the risks arising in the covered bond programme.

30.41 In order to calculate the required maximum loan-to-value ratio for residential real estate and commercial real estate referred to in Section 30.40, the operational requirements included in the advanced modeling approach within the capital adequacy framework that applies regarding the objective market value of collateral and the frequent revaluation must be used. The conditions set out in Section 30.40 must be satisfied at the inception of the covered bond and throughout its remaining maturity.

Collective investment undertakings, securitisation vehicles and other structures

30.42 Banking corporations must consider exposures even when a structure lies between the banking corporation and the exposures, that is, even when the banking corporation invests

in structures through an entity which itself has exposures to assets (hereafter referred to as the "underlying assets"). Banking corporations must assign the exposure amount, ie the amount invested in a particular structure, to specific counterparties following the approach described below. Such structures include funds, securitisations and other structures with underlying assets.

- 30.43** A banking corporation may assign the exposure amount to the structure itself, defined as a distinct counterparty, if it can demonstrate that the banking corporation's exposure amount to each underlying asset of the structure is smaller than 0.25 percent of its Tier 1 capital, considering only those exposures to underlying assets that result from the investment in the structure itself and using the exposure value calculated according to Sections 30.49 and 30.50.¹⁵ In this case, a bank is not required to look through the structure to identify the underlying assets.
- 30.44** A banking corporation must look through the structure to identify those underlying assets for which the underlying exposure value is equal to or above 0.25 percent of its Tier 1 capital. In this case, the counterparty corresponding to each of the underlying assets must be identified so that these underlying exposures can be added to any other direct or indirect exposure to the same counterparty. The banking corporation's exposure amount to the underlying assets that are below 0.25 percent of the banking corporation's Tier 1 capital may be assigned to the structure itself (i.e., partial look-through is permitted).
- 30.45** If a banking corporation is unable to identify the underlying assets of a structure:
- (1) where the total amount of its exposure does not exceed 0.25 percent of its Tier 1 capital, the banking corporation must assign the total exposure amount of its investment to the structure;
 - (2) otherwise, it must assign this total exposure amount to the "unknown" counterparty.
- 30.46** The banking corporation must aggregate all unknown exposures as if they related to a single counterparty (the unknown client), to which the large exposure limit would apply.
- 30.47** When the look-through approach (LTA) is not required according to Section 30.43, a banking corporation must nevertheless be able to demonstrate that regulatory arbitrage considerations have not influenced the decision whether to look through or not – e.g., that the banking corporation has not circumvented the large exposure limit by investing in several individually immaterial transactions with identical underlying assets.
- 30.48** If the LTA need not be applied, a banking corporation's exposure to the structure must be the nominal amount it invests in the structure.

¹⁵ By definition, this required test will be passed if the bank's whole investment in a structure is below 0.25% of its Tier 1 capital.

- 30.49** When the LTA is required according to the paragraphs above, the exposure value assigned to a counterparty is equal to the pro rata share that the banking corporation holds in the structure multiplied by the value of the underlying asset in the structure. Thus, a banking corporation holding a 1 percent share of a structure that invests in 20 assets each with a value of 5 must assign an exposure of 0.05 to each of the counterparties. An exposure to a counterparty must be added to any other direct or indirect exposures the bank has to that counterparty.
- 30.50** When the LTA is required according to the paragraphs above, the exposure value to a counterparty is measured for each tranche within the structure, assuming a pro rata distribution of losses amongst investors in a single tranche. To compute the exposure value to the underlying asset, a banking corporation must:
- (1) first, consider the lower of the value of the tranche in which the banking corporation invests and the nominal value of each underlying asset included in the underlying portfolio of assets
 - (2) second, apply the pro rata share of the banking corporation's investment in the tranche to the value determined in the first step above.
- 30.51** Banking corporations must identify third parties that may constitute an additional risk factor inherent in a structure itself rather than in the underlying assets. Such a third party could be a risk factor for more than one structure that a banking corporation invests in. Examples of roles played by third parties include originator, fund manager, liquidity provider and credit protection provider.
- 30.52** The identification of an additional risk factor has two implications.
- (1) The first implication is that banking corporations must connect their investments in those structures with a common risk factor to form a group of connected counterparties. In such cases, the manager would be regarded as a distinct counterparty so that the sum of a banking corporation's investments in all of the funds managed by this manager would be subject to the large exposure limit, with the exposure value being the total value of the different investments. But in other cases, the identity of the manager may not comprise an additional risk factor - for example, if the legal framework governing the regulation of particular funds requires separation between the legal entity that manages the fund and the legal entity that has custody of the fund's assets. In the case of structured finance products, the liquidity provider or sponsor of short-term programmes (asset-backed commercial paper [ABCP] conduits and structured investment vehicle [SIV]) may warrant consideration as an additional risk factor (with the exposure value being the amount invested). Similarly, in synthetic deals, the protection providers (sellers of protection by means of CDS/guarantees) may be an additional source of risk and a common factor for interconnecting different structures (in this case, the exposure value would correspond to the percentage value of the underlying portfolio).
 - (2) The second implication is that banking corporations may add their investments in a set of structures associated with a third party that constitutes a common risk factor to

other exposures (such as a loan) it has to that third party. Whether the exposures to such structures must be added to any other exposures to the third party would again depend on a case-by-case consideration of the specific features of the structure and on the role of the third party. In the example of the fund manager, adding together the exposures may not be necessary because potentially fraudulent behaviour may not necessarily affect the repayment of a loan. The assessment may be different where the risk to the value of investments underlying the structures arises in the event of a third-party default. For example, in the case of a credit protection provider, the source of the additional risk for the banking corporation investing in a structure is the default of the credit protection provider. The banking corporation must add the investment in the structure to the direct exposures to the credit protection provider since both exposures might crystallise into losses in the event that the protection provider defaults (ignoring the covered part of the exposures may lead to the undesirable situation of a high concentration risk exposure to issuers of collateral or providers of credit protection).

30.53 It is conceivable that a banking corporation may consider multiple third parties to be potential drivers of additional risk. In this case, the banking corporation must assign the exposure resulting from the investment in the relevant structures to each of the third parties.

30.54 The requirement set out in Section 30.48 to recognise a structural risk inherent in the structure instead of the risk stemming from the underlying exposures is independent of whatever the general assessment of additional risks concludes.

Exposures to central counterparties

30.55 Banking corporations' exposures to qualifying central counterparties (QCCPs)¹⁶ related to clearing activities are exempted from this Directive. However, these exposures are subject to the regulatory reporting requirements as defined in Reporting to Banking Supervision Directive no. 810D.

30.56 In the case of non-QCCPs, banking corporations must measure their exposure as a sum of both the clearing exposures described in Section 30.58 and the non-clearing exposures described in Section 30.60, and must respect the general large exposure limit of 15 percent of the Tier 1 capital.

¹⁶ The definition of QCCP for large exposures purposes is the same as that used for risk-based capital requirement purposes. A QCCP is an entity that is licensed to operate as a central counterparty (CCP) (including a license granted by way of confirming an exemption), and is permitted by the appropriate regulator/overseer to operate as such with respect to the products offered. This is subject to the provision that the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the Committee on Payment and Financial Infrastructure and International Organization of Securities Commissions' Principles for Financial Market Infrastructures.

30.57 The concept of connected counterparties described in Sections 10.9—10.18 does not apply in the context of exposure to central counterparties (CCPs) that are specifically related to clearing activities.

30.58 Banking corporations must identify exposures to a CCP related to clearing activities and sum together these exposures. Exposures related to clearing activities are listed in the table below together with the exposure value to be used:

Table 1 **Exposures related to clearing activities**

Exposure type	Exposure value
Trade exposures	The exposure value of trade exposures must be calculated using the exposure measures prescribed in other parts of this framework for the respective type of exposures (e.g., using the SA-CCR for derivative exposures).
Segregated initial margin	The exposure value is zero. ¹⁵
Nonsegregated initial margin posted	The exposure value is the nominal amount of initial margin posted
Prefunded default fund	Nominal amount of the funded contribution. ¹⁷
Unfunded default fund	The exposure value is zero. ¹⁸
Equity stakes	The exposure value is the nominal amount. ¹⁹

30.59 Regarding exposures subject to clearing services (the banking corporation acting as a clearing member or being a client of a clearing member), the banking corporation must determine the counterparty to which exposures must be assigned by applying the provisions of the risk-based capital requirements.²⁰

30.60 Other types of exposures that are not directly related to clearing services provided by the CCP, such as funding facilities, credit facilities, guarantees etc., must be measured according to the rules set out in this chapter of this framework, as for any other type of

¹⁷ When the initial margin (IM) posted is bankruptcy-remote from the CCP – in the sense that it is segregated from the CCP’s own accounts, e.g., when the IM is held by a third-party custodian – this amount cannot be lost by the bank if the CCP defaults; therefore, the IM posted by the banking corporation can be exempted from the large exposure limit.

¹⁸ There may be a need to update the exposure value for prefunded transfers to the risk fund, if it also occurs for qualified and not only for unqualified central counterparties.

¹⁹ If equity holdings are deducted from the capital level on which the large exposure limitation is based, then these exposures must be deducted from the definition of the exposure to a central counterparty (CCP).

²⁰ See Directives 203 and 203A.

counterparty. These exposures will be added together and be subjected to the large exposure limit.

40. Not adopted.

Commencement and transition provisions

- (a) This Directive shall commence on January 1, 2026 (hereinafter, “the commencement date”; although a banking corporation may implement this Directive before the commencement date, provided that it has implemented all the requirements of the directive in full.
- (b) If a breach from the large exposure limit is created in respect of an existing exposure, as a result of this Directive going into effect, the amount of the breach shall be reduced in equal quarterly amounts within two years from the commencement date.
- (c) Notwithstanding the provisions of Subsection (a) above, a banking corporation may implement the provisions of Section 30.44 above, with a threshold that exceeds 0.5 percent of Tier 1 Capital of the banking corporation instead of 0.25 percent, until January 1, 2027.

Updates

Circular 06 no.	Version	Details	Date
2811	1	Original Circular	February 3, 2025