BERMUDA MONETARY AUTHORITY

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BANKING, TRUST & INVESTMENT DEPARTMENT

GUIDANCE NOTES

LARGE EXPOSURE RETURN

December 2011

LARGE EXPOSURES RETURN

I GUIDANCE NOTES

The following notes and definitions apply specifically to the Large Exposure Return. The instructions generally set out the minimum information to be reported in respect of a reporting institution's large exposures to individual counterparties. The Authority may, however, require (under section 38 (4) of the Banks & Deposit Companies Act 1999) additional information to be reported by the reporting institution either regularly or in respect of certain reporting dates only. Such additional information will be agreed in writing with the institutions concerned.

II THE REPORTING FORM

Exposures should be reported in BD$000's.

Exposures (as defined above) to individual counterparties should be reported in each category of counterparty in descending order by size.

Capital base for the purpose of these returns is as notified to the reporting institution by the Authority and should be entered on the cover of the Large Exposure Return.

Exposures are defined *gross* of specific provisions made for bad and doubtful debts. Such provisions should however be reported in the appropriate column.

Exposures should be reported gross of write-offs which have occurred since the last reporting date. These should be reported in the same column as specific provisions for bad and doubtful debts.

PART 1

Exposures to individual non-bank counterparties and groups of closely related non-bank counterparties

List the 20 largest exposures and any other exposure which exceeds 10% of the reporting institution's capital base. List the commitment to lend if larger than the exposure.

Exposures to individual counterparties which constitute "a group of closely related counterparties" should be reported as one exposure.

Include exposures to international organisations (including multilateral development banks and the Bank for International Settlements (BIS)).

Exposures to individual non-bank counterparties and groups of closely related counterparties which are connected to the reporting institution should be highlighted by insertion of an asterisk (*).

PART 2
Exposures to Banks

List the 20 largest exposures and any other exposures which exceed 10% of the reporting institution's capital base. Identify separately any non-marketable elements of these exposures with a remaining maturity in excess of 1 year. List the commitment to lend if larger than the exposure.

Multilateral development banks should be reported in Part 1.

Exposures to an overseas bank which the Authority has agreed may be considered as an exposure to the central government should be reported in Part 3 only.

PART 3

Exposures to Zone A central governments and central banks

List all exposures which exceed 10% of the reporting institution's capital base.

Exposures to local authorities, states, other public sector bodies, central banks, and other state owned banks which it has been agreed with the Bermuda Monetary Authority (the Authority) may be treated as an exposure to a Zone A central government should also be reported here.

Exposures to Zone B central governments and central banks

List all exposures which exceed 10% of the reporting institution's capital base.

Exposures to local authorities, states, other public sector bodies, central banks, and other stated owned banks which it has been agreed with the Authority should be treated as an exposure to a central government of an overseas country should also be reported here.

III DEFINITIONS

(a) an exposure
(b) the amount at risk
(c) a counterparty
(d) identity of a counterparty

a) AN EXPOSURE

An exposure for the purpose of reporting large exposures is the amount at risk (see section b) below) arising from the aggregate of the reporting institution's:

(i) claims on a counterparty including actual claims, 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 institution has committed itself to provide, and claims which the institution has committed itself to purchase or underwrite:

(ii) 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 institution has committed itself to provide; and

(iii) assets, and those assets which the institution has committed itself to purchase or underwrite, whose value depends wholly or mainly on a counterparty performing his obligations, or whose value otherwise depends on that counterparty's financial soundness but which do not represent a claim on the counterparty.

Exposures entered into by an institution as a trustee are excluded from the scope of the large exposures return.

Claims include amounts outstanding in the form of:-

(a) loans, including those denominated in gold, silver and other precious metals;

(b) advances (including overdrafts) including those denominated in gold, silver and other precious metals;

(c) the net investment in finance leases;

(d) discounted bills held;

(e) bonds, acceptances, promissory notes, loans stocks and other paper held;

(f) margin deposits with futures, options, commodities and other investment exchanges and their clearing houses and brokers;

(g) interest rate contracts, including single currency interest rate swaps, basis swaps, forward rate agreements and products with similar characteristics, interest rate futures, interest rate options purchased (including caps, collars and floors purchased as stand-alone contracts) and similar instruments;

(h) bond futures and bond options purchased;

(i) foreign exchange rate contracts (of over 14 days original maturity) including cross currency swaps, cross currency interest rate swaps, outright forward foreign exchange contracts; currency futures, currency options purchased and similar instruments;

(j) equity options purchased and equity futures, and futures, swaps and similar instruments involving physical commodities; and

(k) those claims arising from similar transactions entered into by the reporting institutions.

Claims exclude those arising from, or in the form of:-

(a) claims and other assets which have been deducted from the reporting institution's capital base in determining the capital base for the purpose of reporting large exposures. Such deductions will generally include the reporting institution's investments in its subsidiary and associate companies, and certain connected loans of a capital nature;

(b) claims arising in the course of settlement of a foreign exchange transaction on a counterparty where the reporting institution has settled its side of the transaction but has not received the countervalue, for a period of up to 2 working days after payment was made. After this period such claims will constitute an exposure;

(c) in the case where an asset is traded, claims on the counterparty to the transaction which occur whilst the transaction is in the course of settlement. Such claims arise after the reporting institution has completed its part of the transaction (i.e. paid over cash or delivered securities etc) but before the counterparty has settled (*Amounts which have not been settled within* ***5 working days*** *after the due date should, however, be reported as an exposure*);

(d) in the case where an asset is traded, where neither party has settled, up to 15 working days; thereafter the replacement cost of the transaction should be reported as an exposure;

(e) claims, and commodities and other physical assets sold forward (other than claims resulting from foreign exchange and interest rate contracts) should not be reported as giving rise to an exposure to the contracted counterparty; and

(f) futures and options should not be reported where the contracts concerned are traded on exchanges subject to daily margining requirements.

Commitments to purchase claims include amounts outstanding under:-

(a) sale and repurchase agreements;

(b) forward asset purchase agreements;

(c) buy back agreements;

(d) forward deposits placed;

(e) unpaid part of partly-paid shares; and

(f) any other commitment with a certain drawdown entered into by the reporting institution.

Contingent liabilities include amounts outstanding under:-

(a) direct credit substitutes (including guarantees, standby letters of credit serving as financial guarantees, bills accepted by the reporting institution but not held by it, 'per aval' endorsements and other endorsements with equivalent effect);

(b) claims sold with recourse, where the credit risk remains with the reporting institution;

(c) transaction related contingents not having the character of direct credit substitutes (including tender and performance bonds, bid bonds, warranties, standby letters of credit related to particular transactions; retention money guarantees, import and export excise duty bonds;

(d) undrawn documentary letters of credit issued or confirmed; and

(e) those arising from similar transactions entered into by the reporting institution.

Contingent liabilities exclude those arising from, or in the form of:

(a) indemnities in respect of lost share certificates and import/export carnets;

(b) bill endorsements on bills already endorsed by another bank; and

(c) where the reporting institution acts as lessor, mortgagee, or owner of goods under a hire-purchase agreement, exclude those contingent liabilities which may result from injuries, damage or loss suffered by third parties and caused by the goods.

Facilities include overdraft, standby, revolving, underwriting, and multiple option facilities and similar facilities provided by the reporting institution. It may be the practice for an institution or group to advise sub-limits within an overall facility limit for different types of business or to be advised by different branches or subsidiaries of the institution. These sub-limits may total more than the overall facility limit. In such cases, the exposure should be taken as the overall facility limit rather than the aggregate of the sub-limits.

Assets include, principally, equities, equity warrants and options which do not represent a claim on the issuer but whose value depends, inter alia, on the issuer's financial soundness.

b) THE AMOUNT AT RISK

The amount at risk should, with certain exceptions detailed below (or otherwise advised to the reporting institution), be reported as the book value of the reporting institution's actual or potential claims, contingent liabilities or assets.

Unless otherwise agreed by the Authority, exposures should be calculated in accordance with generally accepted accounting practice. In certain cases the reporting institution may wish to adopt an alternative accounting practice. Such cases should be discussed with the Authority in order to determine whether reports can be accepted on that basis. The accounting practice adopted for the reporting of exposures should unless otherwise stated below be consistent with that used for the calculation of the reporting institution's capital base.

Bad debt provisions

The book value should be reported gross of provisions for bad and doubtful debts and net of write-offs. Calculation of exposures against large exposures limits should be made using exposures net of specific provisions and write-offs. Write-offs made since the last reporting date, which relate to exposures on the form, should be reported on a separate sheet and attached to the Form.

Currencies other than Bermuda dollars

Unless otherwise stated claims in currencies other than Bermuda dollars should be converted into the Bermuda dollar equivalent at the closing middle market spot rate for the date of the report.

Loans, advances etc. denominated in gold, silver and other precious metals

Claims in this form should be translated into the Bermuda dollar equivalent at the closing spot price for the day of the report.

Interest and dividends

The value of outstanding claims should include interest and dividends due but not yet received if such amounts are reflected in the reporting institution's capital base. Reporting on any other basis should be first discussed with the Authority. (Unearned finance charges should be excluded).

Offsets

In reporting large exposures, credit balances should not be offset against debit balances. However, where a facility limit advised to a *single* counterparty is in the form of the net amount on the counterparty's accounts with the reporting institution the net amount should be reported as the exposure providing:-

(i) the facility limit is not exceeded; and
(ii) there is a formal agreement with the customer that debit balances on accounts with the reporting institution may be offset against credit balances on other accounts and a legal right of set-off exists.

Back-to-backs allowed to be netted out of other statistical reports made to the Authority should <u>not</u> be netted out in calculating the size of an exposure.

Securities

In the case where an institution deals in securities the exposure (to the issuer of the security) should be calculated as the *net long position* (taking into account repos as well as other forward transactions) for a particular security. Where the reporting institution has written or purchased a put option, the amount (valued at the exercise price) should be included in the calculation of the institution's position in that security. No exposure to the counterparty to the transaction is reportable unless the settlement of the transaction is more than 5 working days overdue. A long position in one security issue should not be offset by a short position in another security issue made by the same issuer (except as set out below). A net short position does not give rise to an exposure covered by this return. Securities lent by the reporting institution should be included in the calculation of its exposure to the issuer(s) of the securities. Securities borrowed should not be reported as an exposure by the borrower.

Netting of long and short positions will be permitted for securities issued by central governments and central banks, but only if the following criteria are all met:

(i) the long and short positions are in securities issued by the same central government of bank;

(ii) the long and short positions are in securities denominated in the same currency; and

(iii) the long and short positions are in fixed rate securities within the same maturity time band (i.e. both are one year or less or over one year). Similarly, index-linked securities may only be offset against each other if they are within the same maturity time band. Floating rate securities of any maturity can be offset against each other but no netting of floating rate securities against fixed rate or index-linked securities is permitted.

Syndicated loans/Sub-participations

Where the reporting institution acts as manager or co-manager of a loan financed by more than one institution the other participating institution's share of the loan should not be reported as an exposure by the reporting institution. The participating institution, however, must have made a deposit with the manager covering its full share of the loan, and there should be no recourse to the manager by the participating institution should the borrower fail to repay. A participating institution should report its exposure as an exposure to the ultimate borrower.

For exposures relating to interest rate contracts and foreign exchange rate contracts the amount at risk for the reporting of large exposures is deemed to be less than the nominal exposure. These exposures should be reported and aggregated with other exposures to the same counterparty. Similar treatment may be extended to underwriting commitments only on the basis of specific agreement with the Authority.

Interest rate contracts and foreign exchange rate contracts

The amount at risk is the credit equivalent amount of these items which can be arrived at by the replacement cost method. Reporting institutions should report on the same basis as for the capital adequacy calculation.

Interest rate related contracts: single currency interest rate swaps, basis swaps, forward rate agreements and products with similar characteristics, interest rate futures, interest rate options purchased (including caps, collars and floors purchased as stand-alone contracts) and similar instruments should be reported as interest rate related contracts. Bond futures and bond options purchased should also be included.

Foreign exchange rate related contracts: cross currency swaps, cross currency interest rate swaps, forward foreign exchange contracts, currency futures, currency options purchased and similar instruments should be reported as foreign exchange related contracts. Equity options purchased and equity futures should also be reported in this way as should futures, swaps, and similar instruments involving physical commodities.

Replacement cost

In order to calculate the credit equivalent amount of these instruments, an institution should add together:-

(a) the total replacement cost (obtained by 'marking-to-market') of all its contracts with a positive value; and

(b) an amount for potential future credit exposure which reflects the residual maturity of the contract, calculated as a percentage of notional principal amount according to the following matrix:

Residual maturity	**Interest rate contracts**	**Exchange rate contracts**
One year or less	0%	1.0%
Over one year	0.5%	5.0%

No potential exposure should be calculated for single currency interest rate basis swaps; the credit equivalent amount on these contracts should be evaluated solely on the basis of mark-to-market value.

In the case of interest rate or cross currency swaps arranged at off-market prices, the Authority requires special treatment for contracts which have been created in order to disguise a credit exposure to the counterparty.

Notional principal amount

For exchange rate contracts and bond futures and options, the notional principal amount should be taken as the amount of principal underlying the contract, as regards the asset (currency, equity, bond or commodity) being received by the reporting institution, translated into Bermuda dollars at the spot exchange rate on the reporting date.

For an amortising swap, i.e. one based on a steadily declining notional principal, the notional principal should be taken as that the amount outstanding at the reporting date.

For a swap based on a fluctuating level of principal, the notional principal should be taken as the maximum notional principal outstanding over the remaining life of the swap.

For amortising interest rate swaps with cash-flow mismatches in payments, the notional principal may differ between the two sides of the swap – the higher of the two should be used.

Where swaps are arranged at off-market rates, contracts may include an element of "disguised" credit exposure. In general, the Authority would consider a disguised credit exposure to be present where the contract either starts with a significantly positive mark-to-market, or because of an assumption of unchanged interest and exchange rates, is designed at some time in its life to have a significantly positive mark-to-market value.

The reporting institution should contact the Authority to agree on a suitable reporting treatment where it has such contracts.

For swaps involving physical commodities, the notional principal should relate to the total volume over the whole contract (not simply the volume per settlement period.)

For options purchased, the notional principal should be taken as the underlying principal on the option, using for currency options, the received currency at the spot rate on the reporting date.

Remaining maturity

The remaining maturity of a swap should be taken as the time until the final expiry of the swap. For FRAs and similar products, the remaining maturity should be taken as the time from the reporting date until the end of the period to which the interest rate underlying the contract relates e.g. for an FRA with three months until settlement based on a one year rate, the remaining maturity would be 15 months. Where settlement of an FRA takes place at the start of the period to which the interest rate underlying the contract relates, no account should be taken of the FRA following settlement, i.e. the FRA would no longer be reported; where settlement takes place at the end of this period, the FRA should continue to be reported until settlement takes place given that, even after the settlement amount is fixed, the contract will continue to have a mark-to-market value which will be subject to fluctuation.

For interest rate options, the remaining maturity should be taken as the time from the reporting date until the end of the period to which the interest rate underlying the option relates, i.e. in a similar way to FRAs.

For swaps with interim mark-to-market settlements, the remaining maturity should be taken as the time until final maturity, and not the time until the next interim settlement.

Replacement cost/mark-to-market amount

Reporting institutions should mark-to-market in a prudent and consistent manner. Where no readily observable market prices are available, reporting institutions should develop their own methodology for calculating market values, details of which should be made available to the Authority. The Authority will monitor the approaches adopted by institutions and will be concerned that such approaches should be broadly comparable across all institutions in line with best market and supervisory practice. The following general guidelines should be observed:

For swaps, forward rate agreements and products with similar characteristics, outright forward foreign exchange contracts and futures (if appropriate) the mark-to-market approach should be based on an estimation of the net present value of the future case flow of the contract, using interest rates based on current market rates and relevant to periods in which the cash-flows will arise (commonly for example, the rates from a derived yield curve for zero-coupon government bonds).

For options purchased, the mark-to-market approach should be based on a valuation of the option reflecting, inter alia, the amount by which the option is “in the money” (i.e.. the amount, if any, by which the rate at which the option can be exercised is more favourable than the current market rate when applied to the notional principal underlying the option), the time to expiry of the option, the volatility of the underlying exchange or interest rate, and (for currency options) the interest rate differential between the currencies. Typically such valuations will be based on a methodology involving a complex formula, and will value the option at an amount above its “in the money” value. Reporting institutions whose involvement in options is limited and who have not developed a suitable methodology may, with the written consent of the Authority value options at their “in the money” value.

Netting

Net amounts due in respect of foreign exchange and interest rate related transactions may be reported only if the net amount derived is pursuant to the application of a bilateral agreement (between two counterparties) based upon netting by novation. Netting by novation is where obligations between counterparties to deliver given amounts on a given date are automatically amalgamated with all other obligations to deliver the same currency on the same value date and netted. Such netting should have the effect of legally discharging performance of the original obligation and substituting the single net amount as the sole remaining obligation between the parties for the relevant value date.

Underwriting commitments

In the case of exposures arising from the underwriting of discrete issues of equities or bonds, reporting institutions may also seek agreement from the Authority to the use of credit equivalent amounts, thereby applying a discounting factor to the nominal exposures. Institutions seeking such concessionary treatment need to seek specific approval of the Authority for the discounting factors to be used.

c) A COUNTERPARTY

A counterparty is a borrower or customer of the reporting institution, or some other party to which the reporting institution is directly or indirectly exposed. Exposures to the following categories of counterparties should be reported separately:-

(i) exposures to an individual non-bank or group of closely related non-bank counterparties (including those connected to the reporting institution);

(ii) exposures to a bank (including those connected to the reporting institution);

(iii) exposures to Zone A and Zone B central governments and central banks.

An individual non-bank counterparty

An individual non-bank counterparty comprises natural and legal persons and includes individual trusts, corporations, unincorporated businesses (whether as sole traders or partnerships) and non-profit making bodies. This category *excludes* governments but *includes* local authorities and public sector bodies.

Closely related counterparties

A group of closely related counterparties exists where:-

(i) unless it can be shown otherwise, two or more individual counterparties constitute a single risk because one of them has, directly or indirectly, control over the other or others; or
(ii) individual counterparties are connected in such a way that the financial soundness of any of them may affect the financial soundness of the other or others or the same factors may affect the financial soundness of both or all of them.

In such cases the exposure to these individual counterparties should be aggregated and considered as a single exposure to a group of closely related counterparties.

It is not possible to give a comprehensive list of the different types of relationship between individual counterparties which it might be reasonable to consider as giving rise to common risk and therefore which constitutes for these purposes a group of closely related non-bank counterparties.

The following list is therefore indicative and not comprehensive:-

(a) Group companies. The definition used in this return of "group companies" in relation to a company covers:
 (i) its parent company and any co-subsidiaries of that parent;
 (ii) its subsidiaries; and
 (iii) other companies in which such companies hold 20% or more of the voting rights or ordinary share capital

(b) Companies whose ultimate owner (whether in whole or in significant part) is the same individual or individuals but which do not have a formal group structure;

(c) Companies having common directors or management; and

(d) Counterparties linked by cross guarantees.

Where there is doubt in a particular case as to whether a number of individual persons constitute a group of closely related non-bank counterparties or, notwithstanding that a relationship as identified above exists, it is considered that the counterparties do not share a 'common risk' the circumstances should be discussed with the Authority to determine how the exposure(s) should be reported. Exposures to a number of public sector bodies, or local authorities are deemed not to constitute a single exposure to "a group of closely related non-bank counterparties."

Zone A/Zone B countries

The term "Zone A" covers full members of the OECD and those countries which have concluded special lending arrangements with the IMF associated with the IMF's General Arrangements to Borrow, provided they have not rescheduled their external sovereign debt, to official private sector creditors in the previous 5 years. At present these countries comprise:

Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany (including any pre-reunification claims on East Germany), Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Portugal, Saudi Arabia, Spain, Sweden, Switzerland, Turkey, United Kingdom and United States.

Bermuda, Gibraltar, the Channel Islands and the Isle of Man should also be regarded as Zone A countries.

The reporting institution should discuss with the Deposit Taking Division the appropriate treatment of other dependencies of Zone A countries.

Zone B comprises all countries not in Zone A.

For the purposes of determining whether a bank is in Zone A or B, the place of incorporation is the relevant factor to be considered rather than location of branch. For example, a loan made to a branch located in a Zone A country of a Zone B incorporated bank should be classified as a loan to a Zone B bank.

A bank

"Banks" comprise institutions which are authorised as banks or equivalent deposit-taking bodies by the supervisory/regulatory authority in the country of incorporation. Exclude central banks, multilateral development banks and the Bank for International Settlements (BIS).

A central government

A central government comprises all departments, establishments and bodies of a central government located in its domestic territory performing government functions and the embassies, consulate and military establishments of the government located elsewhere.

A connected counterparty

Parties connected to the reporting institution comprise:

(i) group companies ;

(ii) associated companies as defined under standard accounting rules;

(iii) directors, controllers and their associates as defined in section 2 of the Banks and Deposit Companies Act 1999; and

(iv) non-group companies with which the reporting institution's directors and controllers are associated.

A director (including an alternate director) and controller of the reporting institution is deemed to be associated with another company whether registered or domiciled in Bermuda or overseas, if he holds the office of a director (or alternate director) with that company (whether in his own right, or as a result of a loan granted by, or financial interest taken by, the reporting institution to, or in, that company, or even by virtue of a professional interest unconnected with the reporting bank), or if he and/or his associates, as defined above, together hold 10% or more of the equity share capital of that company. For the purposes of the large exposures policy, an employee of the lending institution who is not a director but who is appointed by the lending bank to be a director of another company is also treated as a director of the lending institution.

d) IDENTITY OF A COUNTERPARTY

The identity of a counterparty will generally be the borrower (customer), the person guaranteed, in the case of a security held the issuer of a security or in the case of a derivatives contract the party with whom the contract was made. In some circumstances, it may be uncertain which of two counterparties is the primary obligor (for example on a bill where there is a claim on both the drawer and the acceptor). When in doubt, the reporting institution should *either* report the exposure twice as an exposure to each counterparty *or* ask the Authority for a ruling. However, in the case of:-

(i) bills held which have been accepted by a bank (other than the reporting institution) the claim should be reported as a claim on a bank;

(ii) per aval endorsements on the bills held by the reporting institution the claim should be reported as a claim of over one year maturity on the avalising bank; and

(iii) transactions where a third party has provided an explicit unconditional irrevocable guarantee, institutions may be permitted to report the exposure as being to the guarantor. As a condition for allowing institutions to report exposures in this way, the Authority will require institutions to include a section on guaranteed exposures in their large exposures policy statement. In particular the Authority would expect a consistent approach to be adopted in the reporting of such exposures. The Authority does not expect institutions to report exposures to guarantors without having first approved the credit risk of the guarantor and the type of the exposure under the institution's normal credit approval procedures.