BERMUDA MONETARY AUTHORITY

CONSULTATION PAPER

PROPOSED REVISIONS TO THE LARGE EXPOSURE FRAMEWORK FOR BANKS

CONTENTS

I. INTRODUCTION

1. The Bermuda Monetary Authority (BMA or Authority) is committed to ensuring that its regulatory framework for banking is aligned with international standards whilst ensuring that it remains appropriate for the local banking sector so that banks can continue to operate prudently, competitively and sustainably.

2. In April 2014, the Basel Committee on Banking Supervision (Basel) published its standard on "Supervisory framework for measuring and controlling large exposures" (Basel LE framework). The standard aims to limit the maximum loss that a bank faces in the event of a sudden counterparty failure and complements the risk-based capital standard to safeguard a bank's solvency.

3. The need for banks to measure and limit the size of large exposures in relation to their capital has long been recognised by Basel, and the Authority has consistently applied these international requirements. In a similar vein, the Core Principles for Effective Banking Supervision (Core Principle 19) require that local laws and bank regulations set prudent limits on large exposures to a single borrower or a closely related group of borrowers.

4. A large exposures framework complements the Authority'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. 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. For this reason, the Authority agrees that the existing risk-based capital framework is not sufficient to fully mitigate the micro-prudential risk from exposures that are large compared to a bank's capital resources.

5. As part of the Basel III reforms, Basel issued new standards, *Supervisory framework for measuring and controlling large exposures,* which became effective in 2019.[1] These new standards were incorporated into the *Basel III: A global regulatory framework for more resilient banks and banking systems* document thereafter. The rationale behind these revisions is based on lessons learned from the 2008 financial crisis. It became clear that banks did not always consistently measure, aggregate and control exposures to single counterparties or groups of connected counterparties across their books and operations.

[1] Basel LE framework: 2014

6. The revised large exposure policy will replace current large exposure guidance within *The Management and Control of Credit Risks and the Implementation of the Statutory Provisions for Large Exposures* (2007 Guidance).[2]

7. The Authority proposes to adopt the revised Basel LE framework whilst also retaining various elements of the 2007 Guidance as detailed in the following paragraphs.

8. Industry and other stakeholders are invited to provide feedback to the proposals outlined in this paper and in its various attachments, by emailing their comments to banking@bma.bm by close of business on 31 March 2022.

II. SCOPE OF APPLICATION

9. The current Large Exposure (LE) framework is applied to a bank on an unconsolidated and consolidated basis.

10. The Basel LE framework maintains this requirement as it is noted that the large exposures framework is constructed to serve as a backstop and complement to the risk-based capital standards. As a consequence, it must apply at the same level as the risk-based capital requirements, which are required to be applied at every tier within a banking group.

III. LARGE EXPOSURE MONITORING AND CONTROL FRAMEWORK

11. The Authority expects a bank to implement adequate monitoring and control frameworks for large exposures. Paragraph 33 of the Authority's 2007 guidance details the need for a bank to monitor carefully their overall 'clustering' position, which means the total of their exposures (excluding short-term inter-bank exposures) in excess of 10% of the large exposure capital base (LECB) as part of their efforts to ensure proper diversification of their risks.

12. As is required currently under paragraph 34 of the Authority's 2007 Guidance, the Authority recognises that reporting on large exposures, may on occasion, raise particularly sensitive issues of client confidentiality in certain jurisdictions. However, the Authority would not expect institutions to face problems over obtaining the data necessary to monitor and control their large exposures effectively. Where such a concern arises, the Authority must be notified immediately.

13. The Authority expects a bank to maintain an appropriate LE monitoring and control framework designed to ensure that counterparty exposures do not breach the 25% LECB threshold, as well as pre-approved exceptions above this limit.

[2] 2007 Guidance

14. The Authority expects a bank to periodically review large exposure limits against single counterparty exposures to ensure that actual exposures remain within either Authority pre-approved limits or internal exposure limits set by the bank.

15. As part of the Basel LE framework, and for prudent management of large exposures, it is expected that management information concerning large exposures is provided to the board of directors on at least a semi-annual basis, whilst any breaches of large exposure limits be reported to the board of directors at the next scheduled board meeting or immediately; dependent on the severity of the breach(es) in question.

IV. DEFINITION OF LARGE EXPOSURE CAPITAL BASE

16. The 2007 Guidance defines the LECB as the sum of allowable Tier 1 and Tier 2 capital, less any deductions. The LECB for each institution is confirmed by the Authority in writing, at least annually, which must be used as the basis for large exposure reporting until such time as the Authority confirms a change. However, the LECB could be revised prior to these annual submissions in the event that a bank's capital resources significantly change during the interim period.

17. The Basel LE framework narrows the LECB definition to Tier 1 capital only.

18. The Authority proposes to revise the LECB definition from Tier 1 and Tier 2 capital to Tier 1 capital only as proposed by Basel.

V. DEFINITION OF LARGE EXPOSURE

19. The definition of large exposure will remain unchanged and will be consistent with the definition in paragraph 23 of the 2007 Guidance.

20. A bank must consider exposures to any counterparty apart from the counterparties outlined in section XII of this document.

21. The Basel LE framework maintains the 10% LECB threshold and the 25% pre-approval limit requirement. The Authority will maintain its current LE definition as 10% or greater than the approved LECB.

VI. DEFINITION OF EXPOSURE VALUE

22. Banks must consider both on-and-off-balance sheet exposures included in either the banking or trading book and instruments with counterparty credit risk under the risk-based capital framework.

23. An exposure 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]

[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.

24. For banking book on-balance sheet non-derivative exposures, these can be measured at either the accounting value of the exposure (net of specific provisions and value adjustments) or on a gross exposure basis.

25. For banking book and trading book OTC derivatives (and any other instrument with counterparty credit risk), the exposure value must be the exposure at default according to the standardised approach for counterparty credit risk.

26. Off-balance sheet items will be converted into credit exposure equivalents through the use of credit conversion factors (CCFs) by applying the CCFs set out for the standardised approach for credit risk for risk-based capital requirements, with a floor of 10%. The Basel issued CCFs can be found in Appendix I.

VII. LARGE EXPOSURE REPORTING

27. The Authority proposes to maintain the current reporting and prior approval requirements for large exposures.

28. Section 38 of the Banks and Deposit Companies Act 1999 (Act) places specific reporting obligations on banks for large exposures. The Authority requires institutions to calculate, monitor and report these concentration risks on a 'worst case' basis.

29. Moreover, banks are required to seek the Authority's prior approval whenever they propose to enter into a transaction or transactions to any one person, which would expose them in aggregate to incurring losses equal or in excess of 25% of their available capital resources. Other than where certain specific types of exposures are concerned, the Authority gives consent to exposures in excess of 25% of capital only in exceptional circumstances and where the risk of loss can be demonstrated as being extremely small.

VIII. NOTIFICATION OF LE BREACHES

30. The Authority will maintain the current reporting requirements for a bank in relation to a breach of approved large exposure limits as outlined in paragraph 31 of the 2007 Guidance.

IX. LOWER RISK EXPOSURES

31. The Authority proposes to maintain the current discretion to approve individual exposures in excess of 25% of their LECB when deemed to involve much lower than normal credit risk as outlined in paragraph 25 of the 2007 Guidance.

32. The Authority will also continue to consider other individual large exposures if it can be demonstrated that the risk of loss is small. Banks are expected to provide sufficient due diligence along with a large exposure approval request to justify individual exposure requests that are in excess of 25% of eligible capital. These requests must be made prior to entering into the exposure and submitted in a timely manner to ensure sufficient time for the Authority to review.

X. DEFINITION OF CONNECTED COUNTERPARTIES

33. Connected counterparties include exposures to a group of counterparties with specific relationships or dependencies such that, if one of the counterparties were to fail, there is the likelihood that the other counterparties would as well. A group of this sort, referred to in this framework as a group of connected counterparties, must be treated as a single counterparty. This definition represents no change to the current connected counterparty definition as outlined in paragraph 28 of the Authority's 2007 Guidance.

34. However, the Basel LE framework provides more granular details on how to determine if counterparties are connected via the following:

    a. Control relationship: one of the counterparties, directly or indirectly, has control over the other(s)
    b. 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

35. For assessing connectedness based on the control relationship, the Authority further proposes that banks identify control relationships based on the criteria outlined in paragraphs 23 to 25 of the Basel LE framework.

36. For assessing connectedness based on economic dependence, the Authority further proposes that banks identify economically interdependent counterparties based on the criteria outlined in paragraph 26 of the Basel LE framework.

37. A bank may be required to aggregate any of its exposures where the Authority believes that these exposures constitute a common risk.

38. The Basel LE framework acknowledges there may be circumstances where some of these criteria do not automatically imply an economic dependence that results in two or more counterparties being connected. In instances where a bank undertakes disaggregation of connected counterparties, it is expected that the bank document the rationale for doing so. Such information should include but is not limited to highlighting where a counterparty, despite being economically closely related to another counterparty, may overcome financial difficulties or a default of the latter by finding alternative business partners or funding sources within an appropriate time period.

XI. RELATED PARTIES

39. The Authority proposes to maintain the current treatment of related party exposure as outlined in paragraph 8 of the 2007 Guidance.

XII. TREATMENT OF SPECIFIC EXPOSURE TYPES

40. The Basel LE framework exempts certain counterparty types from the large exposure framework as outlined in paragraphs 40 to 49 below. Notwithstanding these exemptions, a bank is required to continue to report its top 20 exposures within the quarterly PIR large exposure template.

Sovereign Exposures

41. The 2007 Guidance requires a bank to include all sovereign exposures in their large exposure calculation (i.e., exposures ≥10% of their approved LECB). However, the 2007 Guidance permits sovereign exposures to exceed the 25% LECB pre-approval threshold in the case of *Zone A* sovereign counterparties.

42. The Basel LE framework exempts exposures to sovereigns and their central banks. This exemption also applies to public sector entities treated as sovereigns, including quangos and any other pubic body guaranteed. In addition, any portion of an exposure guaranteed by or secured by financial instruments issued by sovereigns would also be excluded.

43. As the economic and financial circumstances of these sovereigns have changed since 2007, the Authority recommends that Zone A only includes sovereigns that retain a credit rating classification between *high grade* and *prime*. This translates to a minimum rating of A- to AAA based on S&P and Fitch rating scales and A3 to Aaa for Moody's.[4]

44. The Authority proposes to permit exposures to "Zone A" sovereigns to be excluded from large exposure calculations. Any proposed exposures to sovereigns not included in Zone A will require pre-approval from the Authority for exposures ≥25%, with these to be included in large exposure calculations (i.e., exposures ≥10% of their approved LECB).

Public Sector Entities (PSEs) Exposures

45. Under the Basel LE framework, the exemption for sovereign exposures is extended to include exposures to PSEs that are treated as sovereigns under the risk-based banking capital framework.

46. Any portion of an exposure guaranteed by or secured by financial instruments issued by sovereigns would 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.

47. The Authority proposes to adopt the PSE exemptions as per the Basel LE framework if the counterparty is a PSE of a Zone A sovereign listing and retains an explicit guarantee from their relevant sovereign.

Interbank Exposures

48. The 2007 Guidance does not exempt any interbank exposures from LE calculations.

[4] See Appendix II for Zone A sovereign external credit ratings

49. The Basel LE framework exempts intraday interbank exposures to avoid disturbing the payment and settlement processes.

50. The Authority proposes to adopt the Basel LE framework's exemption of intraday interbank exposures from a bank's LE calculations.

Covered Bonds

51. The Basel LE framework sets out preferential treatment for the exposure measurement of covered bonds that meet certain eligibility criteria, which must be satisfied at the inception of the covered bond and throughout its remaining maturity. The Authority is proposing to exclude preferential treatment as a national discretion. We will expect a bank to look through to the counterparty issuing the cover bond. If the issuing institution meets the requirements of the other specific treatment, then those would apply. Otherwise, standard large exposure treatments for any other type of counterparty must be applied.

Collective Investment Undertakings, Securitisation Vehicles and Other Structures

52. The Basel LE framework states:

"Banks must consider exposures even when a structure lies between the bank and the exposures, that is, even when the bank invests in structures through an entity which itself has exposures to assets (hereafter referred to as the "underlying assets"). Banks must assign the exposure amount (i.e., 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.[5]"

53. The Authority proposes to adopt the new framework for collective investment undertakings, securitisation vehicles and other structures as outlined in paragraphs 72 to 83 of the Basel LE framework.

XIII. ELIGIBLE CREDIT RISK MITIGATION TECHNIQUES

54. 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 protection and financial collateral that qualify as eligible financial collateral under the standardised approach for risk-based capital requirement purposes.

55. The Basel LE framework outlines eligible CRM techniques for the following:

    a. treatment of maturity mismatches;
    b. on-balance sheet netting;
    c. recognition of CRM techniques in reduction of original exposures; and
    d. recognition of exposures to CRM providers.

[5] Paragraph 72 of the Basel LE framework

56. The Authority proposes to adopt the revised CRM techniques as outlined in paragraphs 36 to 43 of the Basel LE framework.

XIV. TRADING BOOK POSITIONS – CALCULATION OF EXPOSURES

57. Banks must aggregate any exposures to a single counterparty arising in the trading book to any other exposures to that counterparty within their banking book.

58. The Basel LE framework details the following requirements for the calculation of exposure values of trading book positions:

    a. scope of large exposure limits in the trading book; and
    b. calculation of exposure value for trading book positions.

59. The Authority proposes to adopt the trading book position exposure value calculations as outlined in paragraphs 44 to 50 of the Basel LE framework.

XV. OFFSETTING LONG AND SHORT POSITIONS IN THE TRADING BOOK

60. The Basel LE framework details the treatment for offsetting long and short positions in the trading book, which includes:

    a. offsetting between long and short positions in the same issue;
    b. offsetting between long and short positions in different issues;
    c. offsetting short positions in the trading book against long positions in the banking book; and
    d. net short positions after offsetting.

61. The Authority proposes to adopt the offsetting methods for trading book positions as outlined in paragraphs 51 to 59 of the Basel LE framework.

XVI. EXPOSURES TO CENTRAL COUNTERPARTIES

62. Exposures to qualifying central counterparties (QCCPs) related to clearing activities are exempted from the large exposure framework.

63. For non-QCCPs, banks must measure their exposure as a sum of both the clearing exposures and must respect the general large exposure limit of 25% of the LECB and be reported if in excess of 10% of LECB.

64. The concept of connected counterparties described in section X above does not apply in the context of exposures to CCPs that are specifically related to clearing activities.

Calculation of Exposures Related to Clearing Activities

65. Banks 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:

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.
Non-segregated initial margin	The exposure value is the nominal amount of the initial margin posted.
Pre-funded default fund contributions	Nominal amount of the funded contribution.
Unfunded default fund contributions	The exposure value is zero.
Equity stakes	The exposure value is the nominal amount

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

Other exposures

67. 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 previous paragraphs of this consultation paper, as for any other type of counterparty. These exposures will be added together and be subjected to the large exposure limit.

XVII. IMPLEMENTATION TIMELINE

68. The Authority is seeking to implement the revisions to the LE framework in the quarter-end 30 June 2022.

APPENDIX I – CREDIT CONVERSION FACTORS

Off-balance Sheet Exposure	**Credit Conversion Factor**
UCCs	10%
Commitments, except UCCs	40%
NIFs and RUFs, and certain transaction-related contingent items	50%
ST self-liquidating trade letters of credit arising from the movement of goods	20%
Direct credit substitutes and other off-balance sheet exposures	100%

APPENDIX II – PROPOSED EXTERNAL CREDIT RATING SCALES FOR SOVEREIGN EXPOSURES

Grade	**S&P**	**Fitch**	**Moody's**	**Pre-Approval**	**Included in LE Calculations**
Prime	AAA	AAA	Aaa	No	No
High grade	AA+	AA+	Aa1	No	No
	AA	AA	Aa2	No	No
	AA-	AA-	Aa3	No	No
Upper medium grade	A+	A+	A1	Yes	Yes
	A	A	A2	Yes	Yes
	A-	A-	A3	Yes	Yes
Lower medium grade	BBB+	BBB+	Baa1	Yes	Yes
	BBB	BBB	Baa2	Yes	Yes
	BBB-	BBB-	Baa3	Yes	Yes
Non-investment grade: speculative	BB+	BB+	Ba1	Yes	Yes
	BB	BB	Ba2	Yes	Yes
	BB-	BB-	Ba3	Yes	Yes
Highly speculative	B+	B+	B1	Yes	Yes
	B	B	B2	Yes	Yes
	B-	B-	B3	Yes	Yes
Substantial risk	CCC+	CCC+	Caa1	Yes	Yes
	CCC	CCC	Caa2	Yes	Yes
	CCC-	CCC-	Caa3	Yes	Yes
Extremely speculative	CC	CC	Ca	Yes	Yes
Default imminent	C	C		Yes	Yes
In default	RD	DDD	C	Yes	Yes
	SD	DD	/	Yes	Yes
	D	D	/	Yes	Yes