

# First wave of new banking regulation: The revised large exposure regime

**The large exposure regime is a key aspect of regulation of the financial industry. It is in place to ensure that banks and other regulated entities diversify their exposures in order to limit the impact of a failure of a counterparty or group of counterparties on an institution.**

The global financial crisis highlighted the need for a stronger supervision in this field which the EU met by issuing the directive 2009/111/EC. To start this article will provide an overview of the regulatory frameworks/guidelines on European level and its transposition into national law. The second part will deal with changes resulting from the new regulation and in particular the new definition of connected clients. Finally, the third part will cover challenges banks will face while implementing the new regulation.

In September 2009, the European Parliament and the European Council adopted a directive amending the Capital Requirements Directive ("CRD"; Directive 2006/49/EC) which is referred to as "CRD 2". This directive (2009/111/EC) has been published in the Official Journal of the European Union on November 17, 2009 and has to be transposed into Member States' law by October, 31st 2010 for application as from December 31st, 2010. In December 2009, the Committee of European Banking Supervisors (CEBS) published guidelines as it felt that there was a need for further guidance. The guideline covers two specific aspects. The focus of the first part is the definition of 'connected clients', in particular, 'control' and 'economic interconnections'; the second part deals with the treatment of schemes with exposures to underlying assets for large exposure purposes.

The transposition of the new directive into Luxembourg law has to be done by the means of a new Circular amending Circulars CSSF 06/273 and CSSF 08/381. In April 2010, the CSSF issued the Circular 10/450 and Circular 10/451 which informs the financial industry about the new rules applicable to interbank exposures as of December 31st, 2010 and advises the industry to prepare for these new requirements.

This chapter will answer the question: What are the main changes the financial industry will have to cope with? Additionally, it will focus on the extended definition of connected clients.

**Limits:** The limits which a client or group of connected clients should not trespass have been revised, the higher of the absolute limit set at 150 million EUR (only applicable to interbank exposures) and the relative limit set at 25% of own funds prevails: For institutions with own funds less than 150 million EUR the limit is set at 100% of its own funds for interbank exposures. Any other exposure type is limited to 25% of the credit institutions own funds. For institutions with own funds above 600 million EUR the limit is set at 25% of its own funds. Institution with own funds between 150 and 600 million EUR should stay within the upper absolute and relative limits for interbank exposures.

**Interbank exposures:** Currently, interbank exposures are treated with risk weights ranging from 0% to 50% depending on their maturity. By the end of the year, interbank exposures will have to be treated with a 100% risk weight, except for intra-group exposures and exposures, which are due the following business day and are not in a major currency like USD.

**Underlying assets:** The new directive also introduces new rules for the treatment of exposures to schemes with underlying assets. The exposures can be treated with the full or partial look through approach which means that all/known underlying assets are identified to determine the existence of a group of connected clients. Should an institution be able to ensure that the underlying assets of the scheme are not part of a client or group of connected client, then the structure-based approach allows an institution to treat these schemes as separate unconnected clients. In the case of unknown underlying assets, all unknown underlying exposures and schemes are considered to belong to one separate group of connected clients. **Connected clients:** The definition of connected clients has been widened by the new directive. The definition of a group of connected clients is set in Article 4(45 b) of Directive 2006/48/EC and has been amended as follows: "Two or more natural or legal persons between whom there is no relationship of control as described in point (a) but who are to be regarded as

constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, in particular funding or repayment difficulties, the other or all of the others would also be likely to encounter funding or repayment difficulties."

Under this definition the EU decided to specify that financial problems arising from funding or repayment difficulties and leading to funding difficulties for other clients should be taken into account when defining a group of connected clients. On a conceptual level, this new requirement is a paradigm for the regulatory trend of linking two different types of risks: the credit risk of the institution and in that case the liquidity risk of its client(s). A group of connected clients has to be created if there is a control relationship according to Article 4(9) of Directive 2006/48/EC. Control may also exist when less than half of the voting rights are owned. In that case indicators of control, such as the power to decide on crucial transactions give an indication as to whether a control relationship exists or not. The control definition does not apply to entities directly owned by the central government which receive a 0% risk weight

A group of clients can also be interconnected economically. CEBS gives guidance on how to evaluate economic interconnection and clearly states that this type of interconnection needs to be differentiated from the geographic and sectorial concentration risks which Basel II Pillar II deals with. The concept of economic interconnection aims at determining if there exists a relationship of economic dependence between clients where the financial difficulties of one client will affect the ability of repayment of other(s) client(s).

This may be the case if there is for example a financial dependency or a dependence on one or several large customers. An economic interconnection may also exist through a main source of funding. This is the case when entities are dependent on the same funding source which cannot easily be replaced and where the funding problems of one entity may spread to the other(s). As we have seen in this section, the need to group connected clients can arise from 2 different concepts: Interconnections arising through control and interconnections arising through econo-

mic interconnection. A linkage between the two concepts may be put in place but this is not mandatory as it would lead to complex grouping requirements. One of the key challenges when implementing the new regulation will be to comply with the new definition of connected clients. This new definition will have both qualitative as well as quantitative impacts on the large exposure report: The groups of connected clients which have been formed until now, have to be extended to clients who are connected economically and, as a consequence, the quantitative limits for groups of connected clients may be reached sooner than in the past.

Furthermore, this new definition will also have process-related and technical implications. Information which will help to identify economically connected clients will need to be gathered. This includes publicly available information but also information concerning legal or natural persons connected to the client. An exhaustive list of the information to be taken into account cannot be provided. Also an automated procedure cannot be put in place because in order to detect economic interconnection an individual analysis and judgement is needed. An in depth analysis including appropriate documentation should be carried out particularly for material exposures, those that exceed 2% of own funds. All the internal processes affected by this change such as the credit granting process will need to be reviewed and the internal procedures will need to be updated in order to reflect the new changes. Technically the systems such as the counterparty database will need to be updated by adding new fields and functions for storing the information concerning clients who are economically interconnected.

As shown using the example of the new definition of connected clients, the changes due to directive 2009/111/EC which will soon be implemented in a Circular are substantial and require the financial industry to act pro-actively and anticipate the changes to come in order to be ready for the end of year reporting.