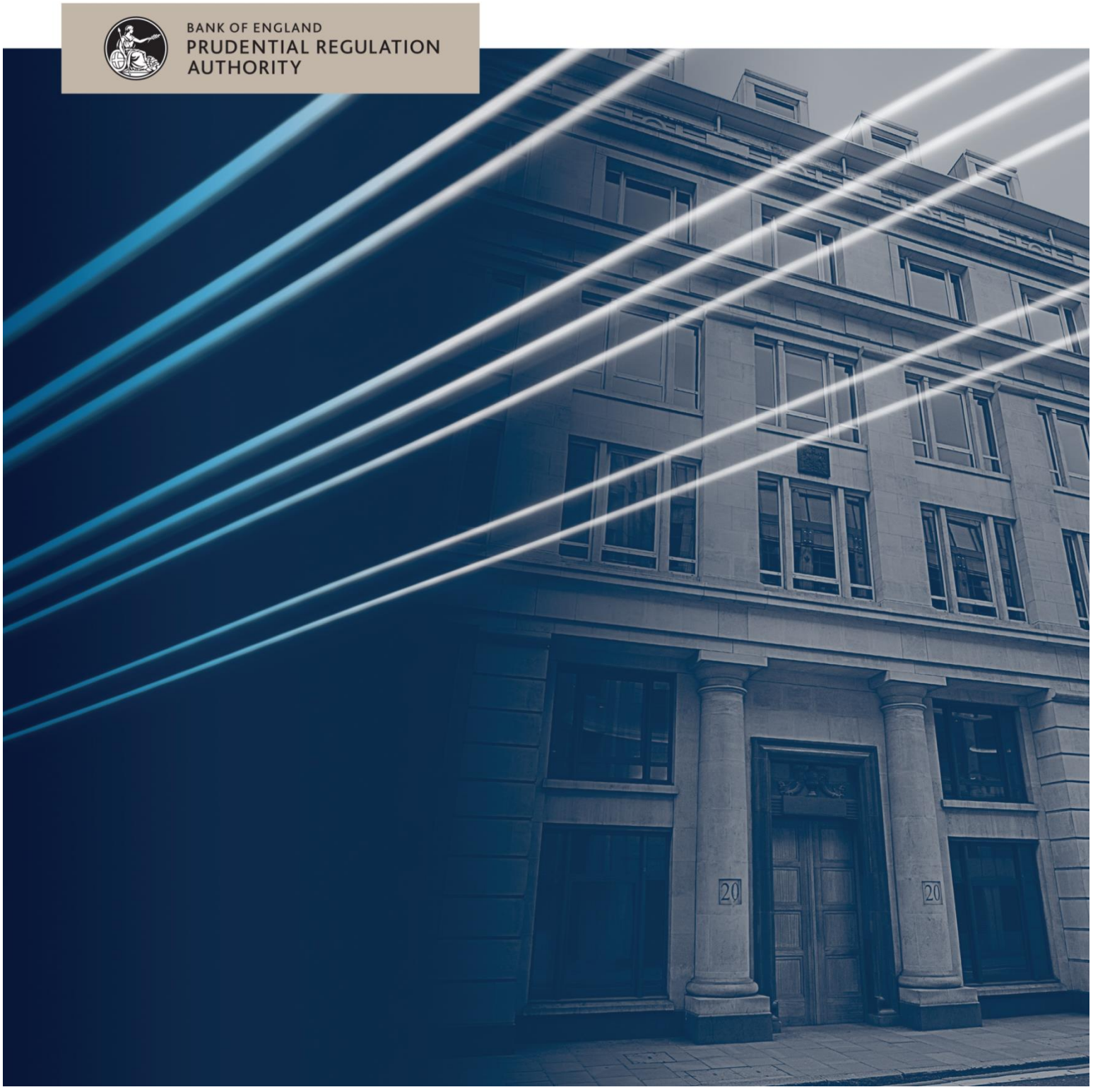
Supervisory Statement | SS16/13

Large exposures

December 2013

(Updated July 2016)



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

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1 Introduction

Update: On 7 July 2016, this supervisory statement was updated following publication of Policy Statement (PS) 20/16 'The implementation of ring-fencing: prudential requirements, intragroup arrangements and use of financial market infrastructures' which included final ring-fencing rules and Supervisory Statement (SS) 8/16 'Ring-fenced bodies (RFBs)'. Specifically, paragraph 1.3 has been updated to take into account SS8/16, paragraph 2.4 has been updated to take into account the PRA's objectives with respect to RFBs, and paragraph 3.10 has been added to set out expectations for an RFB, or any other PRA-authorised person that is a member of a group containing an RFB, wishing to apply for permission to apply a 0% risk weight to certain exposures under CRR Article 113(6).

1.1 This supervisory statement is aimed at firms to which CRD IV applies.

1.2 This statement outlines the Prudential Regulation Authority's (PRA's) expectations in relation to large exposures requirements within the CRR. It covers:

- Applications to include undertakings within a core UK group (CRR Article 113(6)) and non-core large exposure group (CRR 400(2)(c)).

- Sovereign large exposures exemptions (CRR Article 400(2)(g or h)) and exposures to trustees.

1.3 This statement should be read in conjunction with the specified CRR articles, the requirements in the Large Exposures Part of the PRA Rulebook and the high-level expectations outlined in The PRA's approach to banking supervision.[1] For RFBs, as defined in the Financial Services and Markets Act (FSMA), section 142A, or any other PRA-authorised person that is a member of a group containing an RFB, this statement should be read alongside the PRA's Supervisory Statement 8/16 Ring-fenced bodies (RFBs).[2]

2 CRR Article 113(6): core UK group applications

2.1 CRR Article 113(6) permits a firm, subject to conditions, to apply a 0% risk weight for exposures to certain entities within its consolidation group. CRR Article 400(1)(f) then requires that exposures that would be assigned a 0% risk weight under CRR Article 113(6) are fully exempted from the large exposures limit stipulated in CRR Article 395(1).

Application process

2.2 Firms wishing to apply a 0% risk weight to relevant exposures should make a formal application to the PRA, through which they should seek to demonstrate how the conditions set out in CRR Article 113(6)(a)–(e) are met.

2.3 The PRA will assess individual applications against CRR Article 113(6) on a case-by-case basis. The PRA will only approve applications where the conditions stipulated in CRR Article 113(6) are met.

2.4 Firms should note that the PRA will still make a wider judgement whether it is appropriate to grant this treatment even where the conditions in CRR Article 113(6) are met. Where an

1 www.bankofengland.co.uk/publications/Pages/other/pra/supervisoryapproach.aspx.
2 PRA Supervisory Statement 8/16 'Ring-fenced bodies', July 2016, available at: www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss816.aspx.

application is made by an RFB, or any other PRA-authorised person that is a member of a group containing an RFB, this judgement will include an assessment of the impact of the proposed treatment on the PRA's general safety and soundness objective in relation to ring-fencing.[1]

2.5 It is the PRA's intention to continue to apply a high level of scrutiny to applications under CRR Article 113(6).

Application of criteria

2.6 In relation to CRR Article 113(6)(d), the PRA will consider the condition to have been satisfied if:

- the relevant counterparty is incorporated in the United Kingdom; or
- it is an undertaking of a type that falls within the scope of the Council Regulation of 29 May 2000 on insolvency proceedings (Regulation 1346/2000/EC); and
- it is established in the United Kingdom other than by incorporation; and
- the firm can demonstrate that the counterparty's centre of main interests is situated in the United Kingdom.

2.7 In relation to CRR Article 113(6)(e), the PRA will consider the following non-exhaustive list of factors when assessing whether this condition has been met:

- the speed with which funds can be transferred or liabilities repaid to the firm and the simplicity of the method for the transfer or repayment. As part of our overall assessment, we would consider one of the indicators to achieving prompt transfer as being ownership of 100% of the subsidiary undertaking;
- whether there are any interests other than those of the firm in the undertaking, and what impact those other interests may have on the firm's control over the undertaking and the ability of the firm to require a transfer of funds or repayment of liabilities;
- whether there are any tax disadvantages for the firm or the undertaking as a result of the transfer of funds or repayment of liabilities;
- whether the purpose of the undertaking prejudices the prompt transfer of funds or repayment of liabilities;
- whether the legal structure of the undertaking prejudices the prompt transfer of funds or repayment of liabilities;
- whether the contractual relationships of the undertaking with the firm and other third parties prejudices the prompt transfer of funds or repayment of liabilities; and
- whether past and proposed flows of funds between the undertaking and the firm demonstrate the ability to make prompt transfer of funds or repayment of liabilities.

1 See section 2B of FSMA.

2.8 When demonstrating how CRR Article 113(6)(e) is met, the PRA considers that in the case of a counterparty which is not a firm, the formal application should include a legally binding agreement between the firm and the counterparty. This agreement will be to promptly, on demand by the firm, increase the firm's eligible capital by an amount required to ensure that the firm complies with the provisions contained in CRR Part Two (Own funds) and any other requirements relating to eligible capital or concentration risk imposed on a firm by or under the regulatory system.

2.9 For the purpose of demonstrating compliance with CRR Article 113(6)(e), the PRA considers that the agreement to increase the firm's eligible capital may be limited to eligible capital available to the undertaking. It may reasonably exclude such amount of eligible capital that, if transferred to the firm, would cause the undertaking to become balance sheet insolvent, in the manner contemplated in section 123(2) of the Insolvency Act 1986.

2.10 The PRA does not expect a firm to which this section applies to use any member of its core UK group (which is not a firm) to route lending, or to have exposures to any third party in excess of the limits stipulated in Article 395(1).

3 CRR Article 400(2)(c) — non-core large exposures group exemptions (trading book and non-trading book)

3.1 CRR 400(2)(c) permits the PRA to fully or partially exempt exposures incurred by a firm to certain intra-group undertakings from the large exposures limit stipulated in CRR Article 395(1). The PRA will consider exempting non-trading book and trading book exposures to intra-group undertakings that meet specified conditions (set out in the large exposures rules). Guidance in respect of these conditions is outlined below. Firms should note however that under CRR Article 400(2)(c) intra-group exposures that do not meet the criteria in Article 400(2)(c) are to be treated as exposures to a third party.

3.2 The PRA expects that members of a non-core large exposures group meet the conditions set out in CRR Article 113(6) except for the condition to be established in the United Kingdom — CRR Article 113(6)(d).

Non-core large exposures group non-trading book exemption

3.3 The PRA's rules fully exempt from the large exposures limit any non-trading book exposures from a firm to members of its non-core large exposures group, provided that the total such exposures are no greater than 100% of the firm's eligible capital. If the firm has a core UK group permission then the same can apply provided that the total such exposures are no greater than 100% of the core UK group's eligible capital.

Non-core large exposures group trading book exemption

3.4 A firm can also apply for a non-core large exposures group trading book exemption. The calculation of how much trading book exposures are exempt depends on whether the firm has a core UK group permission and the size of non-trading book exposures of the firm (or the firm and its core UK group) to the non-core large exposures group. The PRA rules provide for the calculation of this exemption as follows:

- If a firm does not have a core UK group permission, its trading book exposure allocation (amount of trading book exposures it can exempt under the non-core large exposures group trading book exemption) is the difference between the size of the firm's eligible capital and the amount of non-trading book exposures it has to the members of the non-core large exposures group.

- If a firm has a core UK group permission, its trading book exposure allocation is the product of:

(i) its proportion of the core UK group's trading book exposures to the non-core large exposures group; and

(ii) the difference between the core UK group's total eligible capital and the core UK group's total non-trading book exposures to the non-core large exposures group.

3.5 Any trading book exposures of a firm to its non-core large exposures group above the firm's trading book exposure allocation will be subject to the CRR large exposures regime (Part Four). This includes the ability to have trading book exposures that exceed the 25% limit provided the conditions in CRR Article 395 are met, including the additional own funds requirement in CRR Article 395(5)(b).

3.6 In addition to outlining how to calculate the size of the trading book exemption at any point in time, the PRA rules also specify that firms must allocate exposures to its trading book exposure allocation in order of ascending risk requirements. Therefore, a firm should first allocate the trading book exposures with the lowest risk requirements to its trading book exposure allocation. Once no further trading book exposures can be allocated within the firm's trading book exposure allocation, any remaining trading book exposures are subject to the CRR large exposure regime.

3.7 The PRA has judged that this approach represents the most appropriate way to retain our current intra-group large exposures policy under the CRR. Although there is a degree of additional complexity in calculating the amount of intra-group exposures that can be exempted under our rules the PRA judges that the policy outcome will be broadly similar to that under the current regime. The impact of this approach on the total own funds requirement for excess intra-group trading book exposures will depend on specific firm circumstances.

Application process

3.8 In its review of a firm's non-core large exposures exemption application, the PRA expects to assess:

- compliance with the conditions set out in the large exposures rules; and

- how the counterparties to be included in the non-core large exposures group meet the conditions for the core UK group except CRR Article 113(6)(d).

3.9 Firms should note that the PRA will still make a wider judgement whether it is appropriate to grant this treatment even where the above conditions are met.

3.10 An RFB, or any other PRA-authorised person that is a member of a group containing an RFB, should note that the PRA will assess whether it remains appropriate to permit the treatment where the conditions as listed in paragraph 3.8 are met, including an assessment of the impact of the proposed treatment on the PRA's general safety and soundness objective in relation to ring-fencing.[1]

1 See section 2B of FSMA.

4 CRR Article 400(2)(g) and (h) — sovereign large exposures exemption

4.1 CRR Article 400(2)(g) and (h) allows the PRA to exempt exposures which constitute claims on central banks in the form of minimum reserves held at central banks and denominated in their national currencies, and claims on central governments in the form of statutory liquidity requirements held in government securities, which are denominated and funded in their national currencies.

Application process

4.2 A firm seeking a sovereign large exposures exemption should demonstrate in the application to the PRA how the conditions in the large exposures rules are met.

4.3 The PRA will assess individual sovereign large exposures exemption applications against the conditions set out in the large exposures rules.

4.4 Firms should note that the PRA will still make a wider judgement whether it is appropriate to grant this treatment even where the conditions set out in the large exposures rules are met.

Application of criteria

4.5 It is the PRA's intention to continue to apply a high level of scrutiny to applications in respect of CRR Article 400(2)(g) or (h).

4.6 As part of the process of applying for a sovereign large exposure exemption, the PRA will set out the amount of the exposures that may be exempted. In general, the PRA expects the likelihood of the firm's liabilities (that fund the particular exempt exposure) falling alongside a fall in that exposure in an event of default to form one of the key considerations in determining the total amount of such exempt exposures.

4.7 The PRA will expect the firm to demonstrate that, taking into account the aggregate of all exposures exempted under other sovereign large exposure exemptions granted to the firm, the exemption being sought would not result in an undue risk to the safety and soundness of the firm.

5 Exposures to trustees

5.1 This section clarifies the PRA's expectations on firms when considering exposures to counterparties which act as a trustee, custodian or general partner of an investment trust, unit trust, venture capital or other investment fund, pension fund or a similar fund.

5.2 If a firm has an exposure to a person ('A') when A is acting on his own behalf, and also an exposure to A when A acts in his capacity as trustee, custodian or general partner of an investment trust, unit trust, venture capital or other investment fund, pension fund or a similar fund (a 'fund'), the firm may treat the latter exposure as if it was to the fund. This treatment may be adopted unless such a treatment would be misleading.

5.3 When considering whether the treatment described is misleading, factors a firm should consider include:

- the degree of independence of control of the fund, including the relation of the fund's board and senior management to the firm or to other funds or to both;

- the terms on which the counterparty, when acting as trustee, is able to satisfy its obligation to the firm out of the fund of which it is trustee;

- whether the beneficial owners of the fund are connected to the firm, or related to other funds managed within the firm's group, or both; and

- for a counterparty that is connected to the firm itself, whether the exposure arises from a transaction entered into on an arm's length basis.

5.4 When a firm decides whether a transaction is at arm's length, the PRA expects the following factors to be taken into account:

- the extent to which the person to whom the firm has an exposure ('A') can influence the firm's operations, through for example the exercise of voting rights;

- the management role of A where A is also a director of the firm; and

- whether the exposure would be subject to the firm's usual monitoring and recovery procedures if repayment difficulties emerged.