

# BANKING GUIDANCE NOTE (BGN 4.2)

## Large Exposures

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Financial Supervision Commission Barrantee Oaseirys

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## Part I – Banks incorporated in the Isle of Man

### **1. Rationale/Introduction**

- 1.1 Excessive exposure to a single customer/counterparty or to a group of closely related customers/counterparties is a significant risk incurred by banks.
- 1.2 Where excessive concentrations exist, it is important that a bank fully understands the resultant risks and that these are in line with the bank's strategic appetite for risk and mitigated as far as possible.
- 1.3 The Commission's approach to Large Exposures is based on Principle 9 of the Basel Core Principles for Effective Banking Supervision. This states that "Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers".
- 1.4 The Commission requires a bank to comply with certain explicit ("hard") limits in relation to large exposures. These compare the size of the exposures to a single customer/counterparty (or a group of closely related customers/counterparties) to the bank's capital base, and are designed to ensure that the bank has sufficient capital in the event of failure/default by a customer/counterparty (or group of closely related customers/counterparties).

### **2. Main Features of the Commission's Approach**

- 2.1 Any exposure that is 10% or more of a bank's *Large Exposures Capital Base* ("LECB") is defined as a large exposure.
- 2.2 The LECB should be calculated as the sum of allowable Tier 1 and Tier 2 capital, less appropriate deductions, and in accordance with the previous year's audited financial statements. It should be agreed on an annual basis with the Commission when the audited annual statements are submitted. A pro forma for the calculation of the LECB is in *Appendix 2*.

Where there is an alteration to the LECB during the year, as a result of the payment of a dividend or some other event, or if a bank wants to include interim (audited) profits as part of the LECB, a revised pro forma calculation should be sent to the Commission for agreement. Please refer to section 8 of the General Notes to Assist Completion of forms in BGN 2.2 (Banking Guidance Note – Banking Returns) for further detail.

- 2.3 A bank should be able to monitor its exposures on a daily basis. It must not incur an exposure to an individual customer/counterparty or group of closely

related customers/counterparties that exceeds 25% of its LECB except in extremely limited circumstances where the exposure falls within the definition of an *exempt exposure*.

- 2.4 A bank should notify the Commission of all new large exposures by the submission of a Large Exposures Card (*See Appendix 3*) when the exposure is incurred and on the SR-2B form to be submitted quarterly. An updated Large Exposures Card should be submitted whenever there is a change in the facility and at least annually when there has been no change.
- 2.5 A bank must limit the total of its large exposures, other than its exempt exposures, to individual customers/counterparties or groups of closely related customers/counterparties to a maximum of 800% of its LECB. Any breach must be notified immediately to the Commission. A bank must notify the Commission in advance before the total of its large exposures, excluding exempt exposures, exceeds 300% of its LECB. If the Commission does not agree with the bank exceeding the 300% limit it may issue a recommendation/direction.
- 2.6 A bank is required to provide the Commission with a statement of its large exposures policy. The Commission will not prescribe exactly the format of the policy statement although it must address the treatment of country, sectoral and counterparty risk (See Section 7). The policy statement must be reviewed annually by the Board and significant changes to this should be pre notified and discussed with the Commission. A copy of the amended policy statement should be provided to the Commission within 21 business days of the change being made and with the changes highlighted.

### **3. Definition of Exposure**

- 3.1 An exposure is the maximum loss a bank might suffer if a customer/counterparty or a group of closely related customers/counterparties fails to meet its obligations, or the maximum loss that might be experienced as a result of the bank realising assets or off-balance sheet positions.
- 3.2 A bank should calculate an exposure as the gross amount at risk arising from:
  - (a) claims on a customer/counterparty or group of closely related customers/counterparties including actual and potential claims that would arise from the drawing down in full of undrawn advised facilities (revocable or irrevocable, conditional or unconditional) that the bank has committed itself to provide, and claims that the bank has committed itself to purchase or underwrite. Typically these will be in the form of:
    - Loans, advances, overdrafts
    - Finance leases, less deferred tax
    - Discounted bills held outright

- Bonds, acceptances, promissory notes, loan stocks & other paper held outright
- Margin held with investment exchanges, clearing houses or other customers/counterparties
- OTC futures (including forwards), options, swaps & similar contracts on interest rates, foreign currencies, equities, securities & commodities
- Claims arising in the course of settlement of marketable securities and investments
- Claims arising in the case of forward sales and purchases of marketable securities and investments that either settle on a date beyond the market norm for that instrument or where the payment due is deferred until some future date
- Any commitment with a certain or uncertain drawdown entered into by the bank. This includes amounts outstanding under:
  - Repos and Reverse Repos
  - Forward asset purchase agreement
  - Buy back agreement
  - Forward deposit placed (i.e. where a credit institution contracts to make a deposit with another party on a future date at a pre-determined rate)
  - Unpaid part of partly paid shares
- Any other claims arising from similar transactions entered into by the bank.

**Exclusions** are as follows:-

- Claims and other assets already deducted from capital base for capital adequacy and large exposures purposes
- Where a marketable security or investment is traded, claims on a customer/counterparty arising during settlement where settlement by both parties takes place no later than 5 working days after the contractual settlement date
- Customer/counterparty risk on futures & options contracts where the contracts are traded on an exchange and are subject to daily margining requirements. However, except where contracts relate to a broadly based cash settled index, issuer risk on any underlying bonds/equities should be included, the value of the contracts depending on the issuer's financial soundness.

- (b) contingent liabilities arising in the normal course of business, and those contingent liabilities that would arise from the drawing down in full of undrawn advised facilities (whether revocable or irrevocable, conditional or unconditional) that the bank has committed itself to provide. This includes amounts outstanding under:-

- Direct credit substitutes (including guarantees, stand by letters of credit serving as financial guarantees, bills accepted but not held by the bank, per aval endorsements and equivalent endorsements)
- Claims sold with recourse where credit remains with the bank
- Transaction related contingent items not having the character of direct credit substitutes (including performance bonds, bid bonds, warranties, standby letter of credit relating to particular transactions, retention money guarantees, import and export excise duty bonds, VAT bonds)
- Undrawn documentary letters of credit issued or confirmed
- Those arising from similar transactions entered into by the bank.

**Exclusions** are as follows:-

- Indemnities for lost share certificates and export/import carnets
  - Bill endorsements on bills already endorsed by another credit institution
  - Contingent liabilities resulting from injuries, damage or loss suffered by third parties and caused by goods where the bank acts as lessor, mortgagee or owner of goods under a hire-purchase agreement.
- (c) Assets, including assets that the bank has committed itself to purchase or underwrite, whose value depends wholly or mainly on a customer/counterparty performing its obligations, or whose value otherwise depends on that customer/counterparty's financial soundness but that do not represent a claim on the customer/counterparty. This includes equities, equity warrants and options that do not represent a claim on the issuer but whose value depends, principally, on the issuer's financial soundness.

### 3.3 *Accrued interest*

For an exposure well below the 25% limit, the accrued interest element need not be reported. Where, however, the exposure is close to the 25% limit, the bank should be able to demonstrate that the 25% limit would not be breached if accrued interest were included.

### 3.4 *Bad debt provisions*

An exposure reported at book value should be gross of specific/individual provisions for bad and doubtful debts. Similarly, where an exposure is marked to market the valuation is gross of any provisions. However, for monitoring against limits, a specific/individual provision made against a loan should be set off against the gross amount of the exposure.

### 3.5 *Guaranteed exposures*

Where a third party has provided an explicit unconditional irrevocable guarantee, the bank may be permitted to report the exposure as being to the guarantor. In this case, such situations should be addressed in the bank's large exposures policy statement. The Commission expects the bank to apply its credit approval procedures to the guarantor and to the terms of the guarantee.

### 3.6 *Netting*

It is important to note that a bank should not calculate the size of its exposure to a customer/counterparty by netting its various claims and obligations relating to that customer/counterparty unless there is a legally enforceable contract which provides a right of set-off and this has been agreed in writing with the Commission.

## 4. **Definition of Customers/Counterparties**

4.1 A customer/counterparty is any party on which a bank, directly or indirectly, has a claim.

4.2 An individual customer/counterparty comprises natural and legal persons and includes government, local authorities, public sector entities, individual trusts, corporations, unincorporated businesses (whether sole traders or partnerships) and non profit making bodies.

### 4.3 *Identity of a customer/counterparty*

The identity of a customer/counterparty will generally be one of the following:

- (a) The borrower (customer)
- (b) The person whose obligations the bank is guaranteeing (where the bank is providing such a guarantee)
- (c) In the case of a derivatives contract, the party with whom the contract was made or
- (d) In the case of a security held, the issuer of the security. There are a number of non-straightforward cases:
  - i) Where bills are held by a bank that have been accepted by another credit institution, the claim should be reported as on that other credit institution

- ii) Where per aval endorsements on bills are held by a bank, the claim should be reported as a claim of over one year's maturity on the avalising credit institution
- iii) Where a bank is funding the activities of a company that trades on an exchange (whether for that company's own account or on behalf of clients), the full amount of such funding should be reported as an exposure to that company unless an alternative reporting method has been agreed with the Commission in writing, and
- iv) If a third party has provided an explicit unconditional irrevocable guarantee, a bank may report the exposure as being to the guarantor if its large exposures policy statement includes a section on guaranteed exposures to that effect.

#### 4.4 *A group of closely related customers/counterparties*

A group of closely related customers/counterparties exists either where:

- (a) Unless it can be shown otherwise, two or more individual customers/counterparties constitute a single risk because one of them has, directly or indirectly, control over the other(s) or
- (b) Individual customers/counterparties are related in such a way that the financial soundness of any of them may affect the financial soundness of the other(s) or the same factors may affect the financial soundness of both or all of them. Relationships between individual customers/counterparties that might give rise to common risks include group undertakings, companies whose ultimate owner is the same and that do not have a formal structure, companies having common directors or management and customers/counterparties linked by cross guarantees.

#### 4.5 *Connected customers/counterparties*

Exposures to companies or persons connected to the bank, its managers, directors or controllers require special care to ensure that a proper credit risk assessment is undertaken. This is due to possible contagion and the risk that the consideration of proposed loans to customers/counterparties connected to the bank may be obscured by subjective considerations. Such exposures may be justified only when there is a clear commercial advantage for the lending bank and when they are negotiated and agreed on an arm's length basis.

##### 4.5.1 Factors to take into account when considering whether an exposure has been agreed on an arm's length basis are:

- (a) The extent to which shareholders can influence a bank's operations, for example, through voting rights

- (b) The management role of shareholders where they are also, for example, directors, and
- (c) Whether the loan would be subject to the bank's usual monitoring and recovery procedures if repayment difficulties emerged.

4.5.2 Staff loans other than to managers, controllers or directors are not normally treated as connected.

4.5.3 Parties connected to a bank comprise:

- (a) Group undertakings

Group undertakings include subsidiaries and related companies.

A 'related company' in relation to a bank or the parent of a bank, means a body corporate (other than a subsidiary undertaking) in which the bank or parent undertaking holds a qualifying capital interest.

A qualifying capital interest means an interest in relevant shares of the body corporate that the bank or the parent undertaking holds on a long-term basis for the purpose of securing a contribution to its own activities by the exercise of control or influence arising from that interest.

Relevant shares means shares comprised in the equity share capital of the body corporate of a class carrying rights to vote in all circumstances at general meetings of that body.

A holding of 20% or more of nominal value of the relevant shares of a body corporate should be presumed to be a qualifying interest unless the contrary is shown.

- (b) Associated Companies
- (c) Directors, controllers and their associates (as defined in the Banking Act 1998)
- (d) Non-group companies with which the bank's directors and controllers are associated. A director (including an alternate director) and / or controller of a bank is deemed to be associated with another company in the following circumstances:
  - (i) he holds the position of director in his own right, or
  - (ii) as a result of a loan granted by the bank to a company and which is not made on an arm's length basis, or

- (iii) as a result of a financial interest taken by the bank in that company, or
- (iv) by virtue of a professional interest unconnected with the bank, or
- (v) he and/or his associates together hold 20% or more of the equity share capital of that company.

4.5.4 Exposures to companies or persons connected to a bank may be deducted from the bank's capital base if they are of the nature of a capital investment or are made other than on an arm's length basis.

4.6 ***Lending to investment trusts, unit trusts, OEICs and venture funds managed within banking groups***

Where a bank has exposures to funds managed within the same banking group or exposures to several different funds managed within the same third party group, it must examine each case carefully to assess whether the funds need to be treated as related or connected exposures (respectively).

4.6.1 The following points should be considered when assessing whether an exposure to the fund should be treated as a connected exposure, or whether exposure to several different funds within the same third party group should be treated as a related exposure:

- (a) Whether the beneficial owners of the fund, i.e. the shareholders, are connected to the bank and/or related to other funds managed within its group
- (b) The degree of independence of control of the fund, for example, the composition of the fund's board and its relation to the bank and/or other funds
- (c) Whether the fund is subject to any other relevant statutory or regulatory requirements controlling independence and quality of management and systems and controls, and whether, as far as can reasonably be ascertained from publicly available information, it is meeting these requirements to the satisfaction of the relevant regulatory bodies
- (d) Whether the fund has an audit committee and is subject to internal and external audit
- (e) Whether the loan is made on an arm's length basis
- (f) Whether the bank has the necessary systems and controls to monitor the above criteria on an on-going basis.

- 4.6.2 Even where a bank can satisfy itself that such funds do not need to be treated as either a connected customer/counterparty or as a related exposure, there remains some aggregate risk.

For example, where a bank lends to several funds within its own group or within a third party group, there remains the risk that a run on fund A will prompt runs on funds B and C where all three are managed within the same group, thereby conceivably precipitating problems for the bank.

- 4.6.3 A bank should include within its large exposures policy statement its limits for:

- (a) The aggregate of lending to funds within the same banking group
- (b) The aggregate of lending to two or more funds within a third party group.

## 5. The 25% Limit & Exempt Exposures

### 5.1 *The 25% limit*

A bank must not enter into an exposure in excess of 25% of its LECB except in limited circumstances where the exposure falls within the definition of an “exempt exposure”.

- 5.2 A bank should only have a total exposure to an individual customer/counterparty or to a group of closely related customers/counterparties that exceeds 25% of the LECB if the exposure or those parts of the exposure that exceed the 25% limit are exempt from the limit.

### 5.3 *Exempt exposures*

Exposures may be considered exempt in the following cases:-

- 5.3.1 *Exposures of one year or less to Zone A credit institutions* (excluding multilateral development banks) not connected to the bank provided the placing(s) is/are not subject to any form or charge or pledge. This applies to the situation where such exposures are part of the normal activities of the bank for example, treasury, funding and other cash management. The bank is not required to pre-notify the Commission if such exposures exceed the 25% limit.

- 5.3.2 *Exposures to or guaranteed by central governments and central banks from Zone A countries.* This may also include an exposure guaranteed by a Zone A country’s export credit agency (or equivalent) provided the Commission has notified the bank that it is satisfied that the bank has sufficient expertise and systems in place to ensure that the terms of the guarantee are met fully. If the bank proposes to exceed the 25% limit, the Commission should be

given prior notification in writing of at least 2 business days. If the Commission does not agree with the proposed course of action, it may issue a recommendation/direction.

5.3.3 ***Exposures to Zone B central governments*** if they are denominated in local currency and funded by liabilities in the same currency. If the bank proposes to exceed the 25% limit, the Commission should be give prior notification in writing of at least 2 business days. If the Commission does not agree with the proposed course of action, it may issue a recommendation/direction.

5.3.4 ***Exposures secured either by cash (including CDs issued by the lending bank held by the lender) or Zone A central government or central bank securities.*** If the bank proposes to exceed the 25% limit the Commission should be given prior notification in writing of at least 2 business days. If the Commission does not agree with the proposed course of action, it may issue a recommendation/direction. The following points must be considered:

- (a) A single such exposure will be limited to a maximum of 100% of LECB
- (b) While the Commission takes such security into account when considering the acceptability of a bank's exposure up to 25% of LECB, the presence of security on its own generally is not considered by the Commission to be an acceptable reason for an exposure to exceed 25%
- (c) The exposure is only exempt to the proportion that is fully covered by the cash or securities and where the bank has a full right of set-off over the cash/and or Zone A central government or central bank securities
- (d) In both cases, the exposure may be fully or partially collateralised and the lender's legal title should be fully protected. There should also be an appropriate margin to cover possible currency fluctuation if the collateral is in a different currency to the exposure; in the case of securities, the margin should also cover any fall in their market value from the start of the loan
- (e) In both cases, a bank should take legal advice in all relevant jurisdictions, generally from an external legal advisor
- (f) A similar treatment may be applied in the case of certain exposures that are partially guaranteed (e.g. by Export Credit Guaranteed Department), where the element of the exposure that is guaranteed can be viewed as an exposure to the guarantor.

5.3.5 ***Exposures arising from underwriting*** provided certain criteria are met. If a bank proposes to exceed the 25% limit, the Commission should be given at least 2 business day's prior notification in writing. If the Commission does not agree with the proposed course of action, it may issue a recommendation/direction.

### 5.3.6 *Exposures to other group companies*

In certain cases the Commission may agree that it is appropriate for a bank to have (an) exposure(s) over 25% of LECB to another credit institution within the same group. In all cases before entering into the initial arrangement, the bank should give the Commission prior notification in writing of at least 2 business days. If the Commission does not agree with the proposed course of action, it may issue a recommendation/direction.

This may apply to the following situations:-

- (a) Another credit institution in the group is managing surplus liquidity across the group
- (b) Another credit institution in the group takes on a treasury role on behalf of the group
- (c) The bank takes on a treasury role on behalf of its group.

### 5.3.7 *Exposures with parental guarantees*

A bank may undertake exposures of any maturity in excess of 25% of LECB to unconnected customers/counterparties if there is a suitable guarantee in place. The bank should give the Commission at least 2 business days' prior notification in writing if they wish to enter into such exposures. If the Commission does not agree with the proposed course of action, it may issue a recommendation/direction. The following conditions must be met:-

- (a) The bank's group is subject to regulation of an equivalent standard to that of the Isle of Man
- (b) Its parent credit institution provides a suitable guarantee
- (c) The exposures are entered into within the terms of a policy agreed by the parent credit institution.
  - (i) The Commission may request written confirmation from the parent credit institution that the exposure is retained in the subsidiary's balance sheet at the parent credit institution's request in order to meet group objectives. The Commission may also need to be satisfied as to the nature of the exposure concerned
  - (ii) This policy recognises that there can often be a sound reason for certain commercial business to be booked in one part of a banking group, e.g. an on-going client relationship
  - (iii) A suitable guarantee is either a *parental guarantee* or a *capital maintenance agreement*

- (iv) Any guarantee arrangement should be legally enforceable by the subsidiary, since its purpose is to prevent the subsidiary bank's capital from becoming deficient if a loss is incurred on the exposure
- (v) It may be necessary to ask for evidence that the guarantee is enforceable, for example, an external legal opinion.
- (d) The parent credit institution should ensure that its Home Regulator is aware of, and has no objection to, what is proposed when such an exposure is being considered. The Commission may request a written confirmation from the Home Regulator, including confirmation that the group is subject to consolidated supervision.
- (e) In some instances the Commission may require the guarantor credit institution to deposit monies with the bank in support of the parental guarantee.
- (f) The Commission would not normally expect the aggregate of all exposures guaranteed by the parent to exceed 10% of the parent's regulatory capital base. The aggregate should never exceed 25% of the parent's regulatory capital base.
- (g) Only those capital maintenance agreements in which the guarantor credit institution gives an undertaking to ensure that the bank will not be in breach of its large exposures requirements will be acceptable.

### 5.3.8 *Exposures to overseas countries and economic sectors*

Exposures to overseas countries and economic sectors that exceed 25% of the LECB are not covered by the pre-notification requirements. However, where a proposed transaction will result in an exposure which represents a significant departure from the bank's large exposures policy statement, the Commission expects the proposed transaction to be notified in advance and discussed with the Commission.

The Commission may request information on such exposures and discuss with the bank as required.

## 6. Large Exposure Limits & Notification Requirements

- 6.1 A bank must report all exposures equalling or exceeding 10% of its LECB, including exempt exposures, on a quarterly basis on SR-2B. A bank should not adopt a policy that will lead to 10% being exceeded as a matter of course.
- 6.2 A bank should notify the Commission of all large exposures by the submission of a Large Exposures Card when the exposure is incurred and on

the SR-2B form to be submitted quarterly. An updated Large Exposure Card should be submitted whenever there is a change in the facility and at least annually when there has been no change.

- 6.3 A bank must pre-notify the Commission of any exposure exceeding 25% of LECB before becoming committed to the transaction, apart from those as detailed in section 5.3.1. The Commission normally expects to be informed of any such plans at least 2 business days in advance to allow time for discussion of the issues involved; longer notice should be given if a bank believes that a case is likely to raise complex or difficult issues.
- 6.4 A bank should notify the Commission immediately of any breach of the 25% limit.
- 6.5 The limited circumstances in which a bank may exceed the 25% limit are set out in 5.3 above. As indicated above, in all instances except one, pre-notification is required.
- 6.6 If a bank has a number of large exposures and their aggregate, excluding exempt exposures, exceeds 100% of LECB, the Commission may consider whether the bank's risk asset ratio should be increased.

Factors the Commission will consider are

- Consistency with the bank's large exposures policy statement
  - The number of exposures, their individual size and nature
  - The characteristics of the bank including the nature of its business and the experience of its management.
- 6.7 Should a bank wish the aggregate of its large exposures, excluding exempt exposures, to exceed 300% of its LECB, it must provide the Commission with adequate prior notification in writing.
  - 6.8 A bank should limit the total of its large exposures, other than its exempt exposures, to individual customers/counterparties or to groups of closely related customers/counterparties to a maximum of 800% of its LECB. This is an explicit ("hard") limit and must not be breached.
  - 6.9 Any breach of the 800% limit should be notified immediately to the Commission.
  - 6.10 The Commission does not condone the practice of "top slicing".
    - 6.10.1 Top slicing is the practice:-
      - 6.10.1.1 By which a bank systematically collateralises only the element of its exposure that exceeds the 25% limit to bring it within the limit, or collateralises just more than the element of an exposure that equals or

exceeds 10% of the bank's large exposures capital base in order to bring the sum below the clustering limit; and/or

- 6.10.1.2 By which a bank systematically uses a parental guarantee for the element of its exposure that exceeds the 25% limit to bring it within the limit or uses a parental guarantee for the element of an exposure that equals or exceeds 10% of the bank's large exposures capital base in order to bring the sum below the clustering limit.
- 6.10.2 The Commission takes such activity into account when assessing a bank's individual capital ratio(s) accordingly.

## **7. Large Exposures Policy Statement**

- 7.1 The bank must provide the Commission with a copy of its large exposures policy statement ("the Statement"). The Statement must be reviewed at least annually by the Board and any significant changes should be provided to the Commission within 21 business days of the Board's approval of the changes.
- 7.2 The bank should confirm within four months of its year end that it has reviewed the Statement during the year and that the Statement has been assessed as being up to date and appropriate. This confirmation should be made via the Annual Compliance Certificate.
- 7.3 The Statement should take into account limits and exposures incurred under the bank's other risk management policies.
- 7.4 The detail contained in the Statement will depend on the type of bank and the nature of its business but it must address the following areas:

### **7.4.1 *Exposure limits***

- Exposure limits for different types of customers
- Exposure limits to be considered separately for exposures up to one year, exposures over one year and exposures to Zone A governments
- Policy towards related and connected exposures including intra-group exposures
- Clustering – the number and value of non-exempt large exposures that may exist at any one time
- Approach to lending to individual economic sectors
- Approach to sovereign lending
- Country exposure limits
- Economic sector exposure limits.

### **7.4.2 *Authorisation***

- Circumstances in which the above limits may be exceeded
- Approvals required for any breach of the limits

- Sanctioning limits for individuals
- Exposure approval procedures (evaluation of customer/counterparty, nature and extent of security for exposure, maturity of exposure, bank's expertise in this type of transaction, bank's relationship with customer/counterparty).

#### 7.4.3 *Security*

- Differentiation between secured and unsecured exposures, together with any definitions necessary on permissible forms of security.

#### 7.4.4 *Guarantees*

- Procedures for guarantees
- Credit approval process for exposure to a guarantor.

#### 7.4.5 *Monitoring & control*

- Procedures & systems for reviewing, monitoring and controlling exposures
- These should include the composition and terms of reference of the main credit committee, delegated authority and the nature and frequency of the bank's review and monitoring procedures, including exception reports
- Procedures should detail how the bank monitors its large exposures relative to the LECB and ensures that limits are not exceeded.

#### 7.4.6 *Regulatory reporting to the Commission*

- Allocation of responsibility for reporting large exposures and any breaches to the Commission.

### 8. **Measurement & Control**

A bank must implement the necessary control systems to enable it to monitor exposures on a daily basis and ensure adherence to its policy on large exposures.

### 9. **Additional Capital Requirements**

The Commission may require a bank to maintain higher risk asset ratios than would otherwise be the case when it considers it to be exposed to particular concentrations of risk. Where a bank's total non-exempt large exposures exceed 100% of its LECB, the Commission will consider if such measures are necessary.

## Part 2 – Banks operating in or from the Isle of Man which are incorporated outside the Isle of Man (“branches”)

### **1. Rationale/Introduction**

- 1.1 Excessive exposure to a single customer/counterparty or to a group of closely related customers/counterparties is a significant risk incurred by banks.
- 1.2 Where excessive concentrations exist, it is important that a bank fully understands the resultant risks and that these are in line with the bank’s strategic appetite for risk and mitigated as far as possible.
- 1.3 The Commission’s approach to Large Exposures is based on Principle 9 of the Basel Core Principles for Effective Banking Supervision. This states that “Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers”.

### **2. Main Features of the Commission’s Approach**

- 2.1 A branch is required to report as at each calendar quarter-end the ten largest exposures to credit and non-credit institutions relating to its operations on the Isle of Man. Such reporting should be on SR-2B and within 21 business days of the reporting date.
- 2.2 It is appreciated that Head Office will normally formulate a Large Exposures policy that will include the operations of the Isle of Man branch. It is, however, expected that the branch will have and comply with documented controls and procedures in accordance with that policy.

### **3. Definition of Exposure**

- 3.1 An exposure is the maximum loss a bank might suffer if a customer/counterparty or a group of closely related customers/counterparties fails to meet its obligations, or the maximum loss that might be experienced as a result of the bank realising assets or off-balance sheet positions.
- 3.2 A bank should calculate an exposure as the gross amount at risk arising from:
  - (a) claims on a customer/counterparty or group of closely related customers/counterparties including actual and potential claims that would arise from the drawing down in full of undrawn advised facilities (revocable or irrevocable, conditional or unconditional) that the bank has committed itself to provide, and claims that the bank

has committed itself to purchase or underwrite. Typically these will be in the form of:

- Loans, advances, overdrafts
- Finance leases, less deferred tax
- Discounted bills held outright
- Bonds, acceptances, promissory notes, loan stocks & other paper held outright
- Margin held with investment exchanges, clearing houses or other customers/counterparties
- OTC futures (including forwards), options, swaps & similar contracts on interest rates, foreign currencies, equities, securities & commodities
- Claims arising in the course of settlement of marketable securities and investments
- Claims arising in the case of forward sales and purchases of marketable securities and investments that either settle on a date beyond the market norm for that instrument or where the payment due is deferred until some future date
- Any commitment with a certain or uncertain drawdown entered into by the bank. This includes amounts outstanding under:
  - Repos and Reverse Repos
  - Forward asset purchase agreement
  - Buy back agreement
  - Forward deposit placed (i.e. where a credit institution contracts to make a deposit with another party on a future date at a pre-determined rate)
  - Unpaid part of partly paid shares
- Any other claims arising from similar transactions entered into by the bank.

**Exclusions** are as follows:-

- Claims and other assets already deducted from capital base for capital adequacy and large exposures purposes
- Where a marketable security or investment is traded, claims on a customer/counterparty arising during settlement where settlement by both parties takes place no later than 5 working days after the contractual settlement date
- Customer/counterparty risk on futures & options contracts where the contracts are traded on an exchange and are subject to daily margining requirements. However, except where contracts relate to a broadly based cash settled index, issuer risk on any underlying bonds/equities should be included, the value of the contracts depending on the issuer's financial soundness.

(b) contingent liabilities arising in the normal course of business, and those contingent liabilities that would arise from the drawing down in full of undrawn advised facilities (whether revocable or irrevocable, conditional or unconditional) that the bank has committed itself to provide. This includes amounts outstanding under:-

- Direct credit substitutes (including guarantees, stand by letters of credit serving as financial guarantees, bills accepted but not held by the bank, per aval endorsements and equivalent endorsements)
- Claims sold with recourse where credit remains with the bank
- Transaction related contingent items not having the character of direct credit substitutes (including performance bonds, bid bonds, warranties, standby letter of credit relating to particular transactions, retention money guarantees, import and export excise duty bonds, VAT bonds)
- Undrawn documentary letters of credit issued or confirmed
- Those arising from similar transactions entered into by the bank.

**Exclusions** are as follows:-

- Indemnities for lost share certificates and export/import carnets
- Bill endorsements on bills already endorsed by another credit institution
- Contingent liabilities resulting from injuries, damage or loss suffered by third parties and caused by goods where the bank acts as lessor, mortgagee or owner of goods under a hire-purchase agreement.

(c) Assets, including assets that the bank has committed itself to purchase or underwrite, whose value depends wholly or mainly on a customer/counterparty performing its obligations, or whose value otherwise depends on that customer/counterparty's financial soundness but that do not represent a claim on the customer/counterparty. This includes equities, equity warrants and options that do not represent a claim on the issuer but whose value depends, principally, on the issuer's financial soundness.

### 3.3 *Guaranteed exposures*

Where a third party has provided an explicit unconditional irrevocable guarantee, the branch may be permitted to report the exposure as being to the guarantor. In this case, it is expected that such situations would be addressed in the bank's Large Exposures policy statement with which the branch is expected to comply. The Commission expects the branch to apply its credit approval procedures to the guarantor and to the terms of the guarantee.

### 3.4 *Netting*

The Commission would not expect the branch to calculate the size of its exposure to a customer/counterparty by netting its various claims and obligations relating to that customer/counterparty unless there is a legally enforceable contract which provides a right of set-off and this has been agreed in writing with the Commission. It is expected that the bank's Large Exposures policy (with which the branch should comply) would address such situations.

## 4. **Definition of Customers/Counterparties**

- 4.1 A customer/counterparty is any party on which a bank, directly or indirectly, has a claim.
- 4.2 An individual customer/counterparty comprises natural and legal persons and includes government, local authorities, public sector entities, individual trusts, corporations, unincorporated businesses (whether sole traders or partnerships) and non profit making bodies.

### 4.3 *Identity of a customer/counterparty*

The identity of a customer/counterparty will generally be one of the following:

- (a) The borrower (customer)
- (b) The person whose obligations the bank is guaranteeing (where the bank is providing such a guarantee)
- (c) In the case of a derivatives contract, the party with whom the contract was made or
- (d) In the case of a security held, the issuer of the security. There are a number of non-straightforward cases:
  - (i) Where bills are held by a bank that have been accepted by another credit institution, the claim should be reported (if booked in the branch) as on that other credit institution;
  - (ii) Where per aval endorsements on bills are held by a bank, the claim should be reported (if booked in the branch) as a claim of over one year's maturity on the avalising credit institution;
  - (iii) Where a bank is funding the activities of a company that trades on an exchange (whether for that company's own account or on behalf of clients), the full amount of such funding should be reported (if booked in the branch) as an exposure to that

company unless an alternative reporting method has been agreed with the Commission in writing; and

- (iv) If a third party has provided an explicit unconditional irrevocable guarantee, a branch may report the exposure as being to the guarantor if the Large Exposures policy statement (with which the branch should comply) includes a section on guaranteed exposures to that effect.

#### 4.4 *A group of closely related customers/counterparties*

A group of closely related customers/counterparties exists either where:

- (a) Unless it can be shown otherwise, two or more individual customers/counterparties constitute a single risk because one of them has, directly or indirectly, control over the other(s) or
- (b) Individual customers/counterparties are related in such a way that the financial soundness of any of them may affect the financial soundness of the other(s) or the same factors may affect the financial soundness of both or all of them. Relationships between individual customers/counterparties that might give rise to common risks include group undertakings, companies whose ultimate owner is the same and that do not have a formal structure, companies having common directors or management and customers/counterparties linked by cross guarantees.

#### 4.5 *Connected customers/counterparties*

Exposures to companies or persons connected to the bank, its managers, directors or controllers require special care to ensure that a proper credit risk assessment is undertaken. This is due to possible contagion and the risk that the consideration of proposed loans to customers/counterparties connected to the bank may be obscured by subjective considerations. Such exposures may be justified only when there is a clear commercial advantage for the lending bank (in this case the branch) and when they are negotiated and agreed on an arm's length basis.

##### 4.5.1 Factors to take into account when considering whether an exposure has been agreed on an arm's length basis are:

- (a) The extent to which shareholders can influence a bank's operations, for example, through voting rights
- (b) The management role of shareholders where they are also, for example, directors, and
- (c) Whether the loan would be subject to the bank's usual monitoring and recovery procedures if repayment difficulties emerged.

4.5.2 Staff loans other than to managers, controllers or directors are not normally treated as connected.

4.5.3 Parties connected to a bank comprise:

(a) Group undertakings

Group undertakings include subsidiaries and related companies.

A 'related company' in relation to a bank or the parent of a bank, means a body corporate (other than a subsidiary undertaking) in which the bank or parent undertaking holds a qualifying capital interest.

A qualifying capital interest means an interest in relevant shares of the body corporate that the bank or the parent undertaking holds on a long-term basis for the purpose of securing a contribution to its own activities by the exercise of control or influence arising from that interest.

Relevant shares means shares comprised in the equity share capital of the body corporate of a class carrying rights to vote in all circumstances at general meetings of that body.

A holding of 20% or more of nominal value of the relevant shares of a body corporate should be presumed to be a qualifying interest unless the contrary is shown.

(b) Associated Companies

(c) Directors, controllers and their associates (as defined in the Banking Act 1998)

(d) Non-group companies with which the bank's directors and controllers are associated. A director (including an alternate director) and / or controller of a bank is deemed to be associated with another company in the following circumstances:

- (i) he holds the position of director in his own right, or
- (ii) as a result of a loan granted by the bank to a company and which is not made on an arm's length basis, or
- (iii) as a result of a financial interest taken by the bank in that company, or
- (iv) by virtue of a professional interest unconnected with the bank, or

- (v) he and/or his associates together hold 20% or more of the equity share capital of that company.

#### 4.6 *Lending to investment trusts, unit trusts, OEICs and venture funds managed within banking groups*

Where a bank has exposures (booked in the branch) to funds managed within the same banking group or exposures to several different funds managed within the same third party group, it must examine each case carefully to assess whether the funds need to be treated as related or connected exposures (respectively).

4.6.1 The following points should be considered when assessing whether an exposure to the fund should be treated as a connected exposure, or whether exposure to several different funds within the same third party group should be treated as a related exposure:

- (a) Whether the beneficial owners of the fund, i.e. the shareholders, are connected to the bank and/or related to other funds managed within its group
- (b) The degree of independence of control of the fund, for example, the composition of the fund's board and its relation to the bank and/or other funds
- (c) Whether the fund is subject to any other relevant statutory or regulatory requirements controlling independence and quality of management and systems and controls, and whether, as far as can reasonably be ascertained from publicly available information, it is meeting these requirements to the satisfaction of the relevant regulatory bodies
- (d) Whether the fund has an audit committee and is subject to internal and external audit
- (e) Whether the loan is made on an arm's length basis
- (f) Whether the bank has the necessary systems and controls to monitor the above criteria on an on-going basis.

4.6.2 Even where a bank can satisfy itself that such funds do not need to be treated as either a connected customer/counterparty or as a related exposure, there remains some aggregate risk.

For example, where a bank lends to several funds within its own group or within a third party group, there remains the risk that a run on fund A will prompt runs on funds B and C where all three are managed within the same group, thereby conceivably precipitating problems for the bank.

**5. Regulatory reporting to the Commission**

The branch should ensure that responsibility for reporting the ten largest exposures to credit and non-credit institutions to the Commission are clearly allocated.

**6. Measurement & Control**

6.1 A branch must implement the necessary control systems to enable it to monitor exposures on a daily basis and ensure adherence to the bank's policy on large exposures (with which the branch is expected to comply).

6.2 The branch's controls and procedures should ensure compliance with Isle of Man legislation and regulatory codes.

## Appendix I – Glossary

**“bank”** is the Isle of Man incorporated bank (part 1), or the head office, or otherwise as applicable, of the branch (part 2).

**“branch”** means a branch in the Isle of Man of a bank incorporated outside the Isle of Man.

**“capital maintenance agreement”** is a legally enforceable undertaking by the guarantor credit institution to provide a sufficient amount of capital of the appropriate kind to restore the Isle of Man subsidiary bank’s risk asset ratio to above its minimum target level if exposures covered by the agreement subsequently become non-performing.

**“credit institution”** is another bank or building society to which the bank has an exposure.

**“exempt exposure”** means those exposures which do not need to be included in calculating whether the aggregate of a bank’s exposures to a particular customer/counterparty is within the 25% limit;

**“large exposures capital base”** (“LECB”) is equivalent to Adjusted Capital Base as calculated on form SR-2A and is the sum of allowable Tier 1 and Tier 2 capital, less appropriate deductions. The calculation is performed annually and is usually based on the previous year’s audited financial statements and should be agreed with the Commission for the next financial year.

**“parental guarantee”** is a legally enforceable undertaking from the parent credit institution, or another credit institution in the group acceptable to the Commission. Where a parental guarantee is in place, the Commission recognises the risk transfer to the guarantor credit institution.

**“Zone A”** means full members of the Organisation for Economic Co-operation and Development (OECD) and those countries which have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the IMF’s General Agreement to Borrow, provided they have not rescheduled their external sovereign debt, to official or private sector creditors, in the previous five years.

This group of countries is extended automatically to include any new countries which join the OECD, provided they meet the rescheduling criterion, from the date of their submission.

The Isle of Man, Channel Islands, Gibraltar and Bermuda should also be regarded as being within Zone A.

*NB. A claim on the governments of the Isle of Man, Jersey, Guernsey, Gibraltar and Bermuda is considered to be equivalent to a claim on a Zone A public sector entity. It is not considered as a claim on a central government.*

**“Zone B”** means all countries that are not in Zone A.

**Appendix 2  
Pro Forma for Calculation of Large Exposures Capital Base**

**Section 1 - Tier 1 Capital**

	-	-
	<u>All currencies £'000</u>	<u>All currencies £'000</u>
-	-	-
Ordinary shares, amount paid up (net of holdings of own shares)		
Perpetual non-cumulative preference shares		
General reserves (including Tier 1 share premia)		
Minority interests (in tier 1 capital)		
<b>Tier 1 Capital Sub Total</b>		
<i>Less Deductions</i>		
Goodwill and other intangible assets		
Net unrealised losses on equities held in the available-for-sale financial assets category		
Deductions sub total		
<b>Total Tier 1 Capital</b>		

**Section 2 - Tier 2 Capital (must not exceed Tier 1 capital)**

-		
General/collective provisions (up to a maximum of 1.25% of total risk weighted assets)		
Fixed asset revaluation reserve		
Unsecured convertible undated (perpetual) subordinated debt		
Perpetual cumulative preference shares		
Minority interests (in tier 2 capital)		
<b>Upper Tier 2 Capital</b>	0	
Dated (term) preference shares		
Unsecured dated (term) subordinated loan stock (original minimum term to maturity of 5 years and one day - subject to amortisation) (must not exceed 50% of tier 1 capital)		
<b>Lower Tier 2 Capital</b>	0	
<b>Total Tier 2 Capital (must not exceed tier 1 capital)</b>	0	

**Section 3 - Total capital and reserves**

-		
<b>3.1 Total Tier 1 and Tier 2 Capital</b>	0	

**Section 4 - Adjusted Capital Base**

-		
Eligible Capital (total Tier 1 & Tier 2 capital as per above)		0
Investments in subsidiary and associated companies		
Investments in the capital of other credit institutions		
Other Deductions		
<i>Total Deductions</i>		0
<b>Large Exposures Capital Base ("LECB")</b>		0

FSC Large Exposure Card

Name of Licenceholder \_\_\_\_\_ Agreed LECB £ \_\_\_\_\_

Date Card Submitted \_\_\_\_\_ New / Renewal \_\_\_\_\_ Loan Ref \_\_\_\_\_

Facility £<sup>1</sup> \_\_\_\_\_ Limit £ \_\_\_\_\_ LTV \_\_\_\_ % Currency \_\_\_\_\_

Interest Rate \_\_\_\_\_ Current/Rolled \_\_\_\_\_ Related Party \_\_\_\_\_

Term of Facility \_\_\_\_\_

Source of Repayment \_\_\_\_\_

Other Loans to the Same Borrower: (Ref/Amount) \_\_\_\_\_

Customer \_\_\_\_\_

Beneficial Owner \_\_\_\_\_

Security \_\_\_\_\_

\_\_\_\_\_

Purpose of Loan \_\_\_\_\_

\_\_\_\_\_

Loan History \_\_\_\_\_

\_\_\_\_\_

<sup>1</sup> This should be the maximum amount that has been agreed in the sanctioning process. If in currency this should be converted to sterling for assessment of the LECB (If security is in a different currency to the exposure a suitable margin should be maintained)