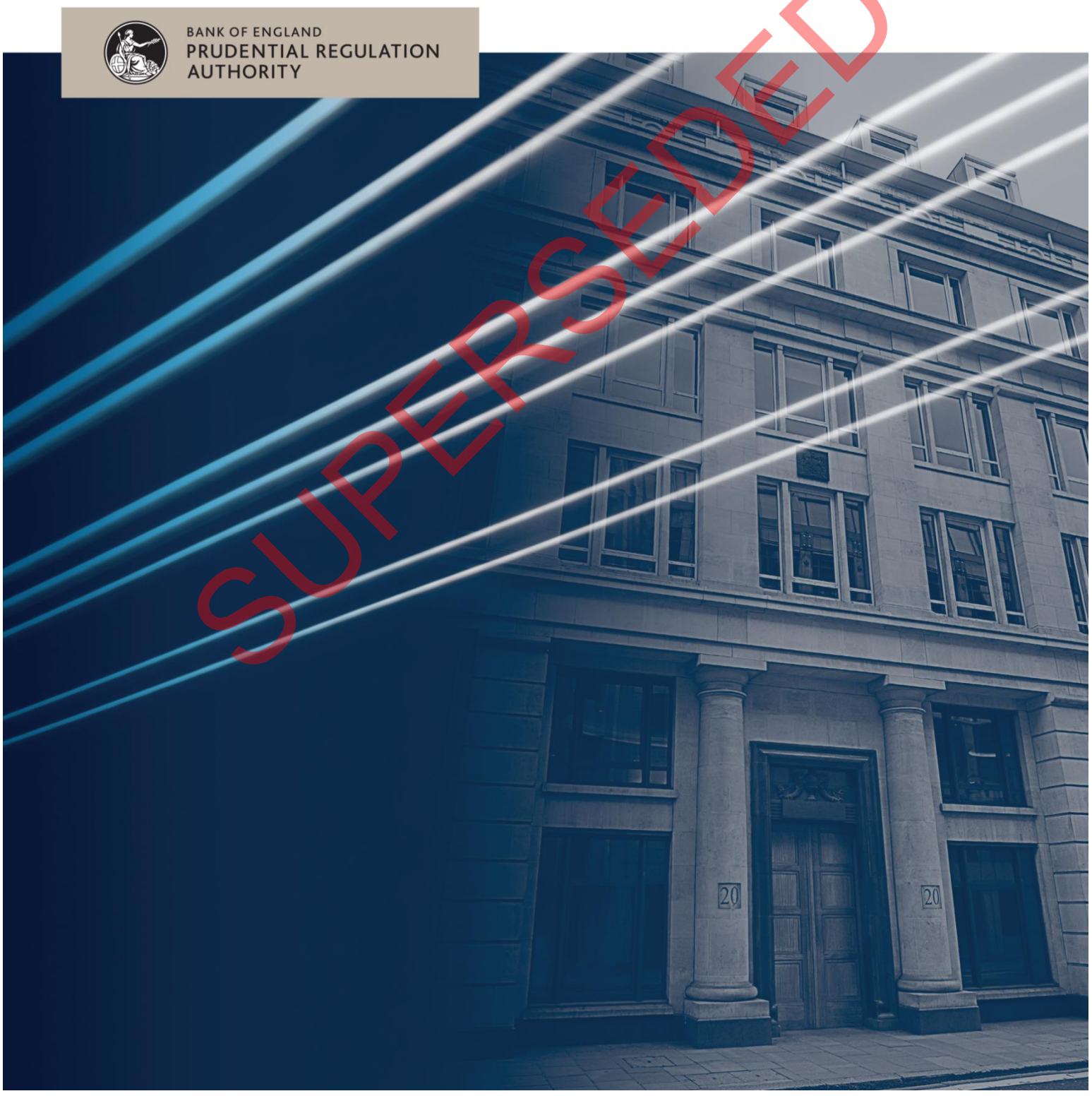
Supervisory Statement | SS16/13

Large Exposures

June 2018

(Updating July 2016)



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Supervisory Statement | SS16/13

Large Exposures

June 2018

Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

Contents

1 Introduction

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)).
- Exemption of exposures that support resolution (CRR Article 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. In making that judgement, the PRA will consider whether group entities are strongly incentivised to support each other. The PRA will also consider whether the treatment is consistent with the overall business model of the firm and furthers the PRA's safety and soundness objective. Where an 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.[3]

1 www.bankofengland.co.uk/prudential-regulation/supervision.
2 July 2016: www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss816.aspx.
3 See section 2B of FSMA.

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

2.5A In relation to CRR Article 113(6)(c), the PRA will consider the following non-exhaustive list of factors when assessing whether the condition is met:

- regular and transparent mechanisms for communication are established within the consolidated group to enable the senior management, business lines, the risk management function and other control functions to share and access information about risk measurement, analysis and monitoring;

- internal procedures and information systems are integrated, consistent and reliable throughout the consolidated group so that all sources of risk can be identified, measured and monitored on a consolidated basis and also, to the extent necessary, separately by entity, business line and portfolio; and

- key risk information is regularly reported to the central risk management function of the consolidated group to enable centralised evaluation, measurement and control of risk across the relevant group entities.

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.

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).

2.11 The PRA will typically expect to receive the following information and documents in support of an application:

- an up-to-date organisation chart of the fully consolidated entities in the group, specifying, in relation to each entity, whether the entity is an institution, financial institution or an ancillary services undertaking as those terms are defined in the CRR;

- a description of the risk management policies and controls of the counterparty;

- written policies describing group company risk measurement, evaluation and control procedures in the areas of credit risk, market risk, liquidity risk and operational risk and a description of how these policies are applied by each entity;

- a description of the process that ensures a prompt transfer of own funds and the repayment of liabilities; and

- a statement signed by representatives and approved by the management body of each of the parent undertaking and the relevant group entities attesting that there are no material practical or legal impediments to the transfer of funds or repayment of liabilities between group entities and the firm. This applies to all entities that do not need to provide a legally binding agreement as set out in paragraph 2.8.

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 and in CRR Article 400(3)). 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).

3.2A For the purposes of assessing whether the condition in CRR Article 113(6)(e) is met, the PRA will consider the specific measures or restrictions, current or foreseen, that a regulator in other jurisdictions has placed or may place on the proposed member of the Non-Core Large Exposures Group (NCLEG) and whether such measures constitute a material impediment. The PRA expect firms to provide a description of any such specific measures or restrictions such as restrictions on dividend payment. The firm should confirm to the PRA that, insofar as it is aware, no such measures or restrictions are in place or foreseeable.

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.

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 amount of trading book exposures that may be exempted will depend on a firm's trading book exposure allocation as defined in the PRA rules.

3.5 Any trading book exposures of a firm to its non-core large exposures group above the firm's trading book exposure allocation must be considered together with total exposures incurred by a firm to members of its group that are not included in a Core UK Group (CUG) permission, an NCLEG non-trading permission or an NCLEG trading book permission, and will be subject to the CRR large exposures regime (Part Four). This includes the ability to have trading book exposures that exceed the limits laid down in CRR Article 395 provided the conditions in this article 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 exposures 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 group non-trading book exemption, and/or non-core large exposures group trading book 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).

3.8A For the purpose of assessing whether any remaining concentration risk can be addressed by other equally effective means for the purposes of CRR Article 400(3)(b), the PRA will consider the following non-exhaustive list of factors, including whether the:

- firm has robust processes, procedures and controls, at individual level and at consolidated level, where relevant, to ensure that use of the exemption would not result in concentration risk that runs counter to its risk strategy and the principles of sound internal group risk management;
- concentration risk arising has been or will be clearly identified in the internal capital adequacy assessment process (ICAAP) of the firm and will be actively managed. The arrangements, processes and mechanisms to manage the concentration risk will be assessed in the supervisory review and evaluation process (SREP).

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. In making that judgement, the PRA will consider whether group entities are strongly incentivised to support each other. The PRA will also consider whether the treatment is consistent with the overall business model of the firm and furthers the PRA's safety and soundness objective.

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]

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

1 See section 2B of FSMA.

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.

- 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.

6 CRR Article 400(2)(c) - Resolution exemption

6.1 Firms that exclude exposures pursuant to the resolution exemption in the Large Exposures Part of the PRA Rulebook should notify the PRA if those exposures are not included in MREL reporting templates as specified in Supervisory Statement (SS) 19/13 'Resolution planning'.[1]

6.2 When assessing whether exposures are resolution exposures as defined in the Large Exposures Part of the PRA Rulebook, a firm should give due consideration to whether resolution liabilities have been recognised by relevant resolution authorities. This could have an impact on whether resolution liabilities ensure that losses can be absorbed and passed from the firm to its resolution authority.

6.3 Firms may wish to contact their supervisor where they have exposures to liabilities that are recognised by the relevant resolution authorities but do not meet the criteria in the PRA rules to qualify for a resolution exemption.

1 June 2018: www.bankofengland.co.uk/prudential-regulation/publication/2013/resolution-planning-ss.

Annex – Updates to SS16/13

This annex details changes made to this Supervisory Statement (SS) following its initial publication in December 2013 following Policy Statement (PS) 7/13 'Strengthening capital standards: Implementing CRD IV, feedback and final rules'.[1]

2018

29 June 2018

Following publication of PS 14/18 'Changes to the PRA's Large Exposures Framework',[2] the following changes were made:

- Paragraph 1.2 was updated to include reference to the resolution exemption.
- Paragraphs 2.4, 2.5A, 2.11, 3.1, 3.2A, 3.5, 3.8, 3.8A, 3.9 was updated to provide additional guidance to firms on Core UK group (CUG) and Non-core large exposures group (NCLEG) permissions.
- Paragraphs 3.3 and 3.4 was updated to reflect changes to simplify the intragroup large exposures framework.
- Section 6 was added to set out the PRA's expectations on the resolution exemption.

This SS also includes changes from 7 July 2016, see details below. These take effect from Tuesday 1 January 2019.

2016

7 July 2016

Following publication of PS20/16 'The implementation of ring-fencing: prudential requirements, intragroup arrangements and use of financial market infrastructures'[3] which included final ring-fencing rules and SS8/16 'Ring-fenced bodies (RFBs)',[4] the following changes were made:

- Paragraph 1.3 was updated to take into account SS8/16.
- Paragraph 2.4 was updated to take into account the PRA's objectives with respect to RFBs.
- Paragraph 3.10 was 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).

These updated expectations take effect from 1 January 2019.

1 December 2013: www.bankofengland.co.uk/prudential-regulation/publication/2013/strengthening-capital-standards-implementing-crd-4.
2 June 2018: www.bankofengland.co.uk/prudential-regulation/publication/2017/changes-to-the-pras-large-exposures-framework.
3 July 2016: https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-implementation-of-ring-fencing-prudential-requirements-intragroup-arrangements
4 December 2017: www.bankofengland.co.uk/prudential-regulation/publication/2016/ring-fenced-bodies-ss.