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News Bulletin

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The Basel Committee Proposes to Double Down on Counterparty Exposure Limits

On March 26, the Basel Committee on Banking Supervision ("Basel Committee") published a Consultative Document in which it proposes a revised supervisory framework for measuring and controlling large counterparty exposures ("Proposal," or "Exposure Framework") of systemically important financial institutions ("SIFIs"). Comments on the Proposal are due by June 28, 2013.

Key Elements of the Proposed Exposure Framework

Highlights of the Proposal include:

Applicability. The Exposure Framework would apply to all "internationally active banks" that are subject to the Basel Committee risk-based capital accord. Covered banks would be expected to apply the Exposure Framework on a consolidated basis.

Counterparties. For purposes of the Exposure Framework, a single counterparty would include a group of "connected counterparties" with "mutual relationships or dependencies" based on control or economic interdependence, with specific guidelines for measuring these elements.

Large Exposures. The Proposal would define a "large exposure" as 5 percent or more of a covered bank's "eligible capital," and all covered banking organizations would be required to report all their large exposures to their supervisory agencies.

Large Exposure Limits. The Basel Committee proposes an initial exposure limit of 25 percent of common equity Tier 1 capital, whereas 1991 guidance issued by the Basel Committee established a limit of 25 percent of total regulatory capital.[1] This limit may be subject to a downward adjustment, however, pending the results of a quantitative impact study that the Basel Committee proposes to undertake in the near term.

Definition and Measurement of Exposures. The Proposal is based on the proposition that any exposure that attracts risk-based capital should be subject to the Exposure Framework. In turn, the Basel Committee provisionally has determined that banking organizations should not use an internal models approach to calculate their exposure limits. The Exposure Framework would capture on-balance sheet banking book assets, "traditional" off-balance sheet banking book commitments (with a 100% credit conversion factor), trading book positions, options positions in the trading book, and counterparty credit risk in derivatives, securities financing and long settlement transactions. Banking organizations would be permitted to apply credit risk mitigation techniques as provided in the Basel Committee's "standardized approach" risk-based capital rules, with a modified

[1] Basel Committee, *Measuring and Controlling Large Credit Exposures* (January 1991) ("1991 Guidance").

(hybrid) approach for the treatment of financial collateral under the "comprehensive approach" for financial collateral.

Treatment of Selected Exposures. Sovereign, central bank and public sector entity exposures would be excluded from the Exposure Framework, whereas interbank exposures would be included.

Collective Entity Exposures. For exposures arising through investments in collective investment schemes, securitizations and other investment vehicles, the Basel Committee proposes a relatively elaborate look-through approach ("LTA") whereby the banking organization in substance would identify and measure its exposures to a covered entity's underlying assets, with a *de minimis* granularity threshold (the largest underlying assets in a vehicle exposure could not exceed 1 percent of the transaction). In addition, the LTA would require banking organizations to assess possible additional risks that do not relate to a structure's underlying assets, but rather to the structure's specific features and to any third parties linked to the structure.

Central Counterparty ("CCP") Exposures. The Basel Committee currently is uncertain how to apply the Exposure Framework to CCP exposures. The Proposal states that two options under consideration are (i) applying a modified quantitative limit under the Exposure Framework to all CCP exposures, or (ii) requiring banking organizations to report *qualified CCP* exposures but not applying any hard limits to such exposures.

Large Exposures of Global Systemically Important Banks ("G-SIBs"). In addition, the Basel Committee proposes a "hard" exposure sublimit for G-SIBs[2] of between 10 and 15 percent of common equity Tier 1 capital for an exposure with a single G-SIB counterparty. The Basel Committee, however, encourages member jurisdictions to consider stricter limits to exposures at the domestic SIFI level ("domestic systemically important banks" or "D-SIBs").

Transitional Arrangements. The Basel Committee calls for full implementation of the Exposure Framework by January 1, 2019, the same date on which the transition to the Basel Committee's G-SIB framework would be complete.

Ramifications and Implications

The Exposure Framework, which is intended to replace the Basel Committee's 1991 guidance, is in part the product of the Basel Committee's "lessons learned" from the financial crisis, including the failure of banking organizations to measure and control single counterparty exposures during the crisis, as well as the systemic impact of such exposures and their contributions to financial instability. The Basel Committee notes that the Exposure Framework would act as a backstop to the Basel Committee's risk-based capital requirements and would supplement the existing risk-based capital framework by "protecting banks from substantive losses caused by the sudden default of a counterparty or group of connected counterparties."

Single counterparty exposure limits in substance are nothing more—and nothing less—than a variation of single borrower limits to which banks in many countries long have been subject. The imposition of exposure limits at the holding company (enterprise) level, however, creates new challenges and complications for affected banking organizations. U.S. banks that are subject to the SIFI requirements of the Dodd-Frank Act already are discovering to their general dismay that these limits may have a significant impact on their financial exposures and balance sheet management activities. In addition, the process of identifying, calculating and aggregating multiple exposures across a range of banking and nonbanking businesses will present operational and compliance issues. Further, the Exposure Framework's proposed treatment of CCP exposures, depending on which route the Basel Committee ultimately takes, could be problematic in light of the fact that there is a relatively high concentration of clearing activities among a relatively small number of CCPs, a trend that the Dodd-Frank Act and other

[2] *See*, Basel Committee, *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement: Rules Text* (November 2011).

international developments (*e.g.*, the European Market Infrastructure Regulation, or EMIR) have helped to accelerate.

Banking organizations that are subject to SIFI regulation and supervision in the U.S., the UK and other jurisdictions—and which generally would be treated as D-SIBs under the Basel Committee's G-SIB framework—are well-advised to take note of the Proposal, because it will have a cascading impact in member jurisdictions. The financial and business consequences of the single counterparty exposure limits for SIFIs have been the subject of active debate in the U.S. and elsewhere, but the Basel Committee's Proposal is a strong indication that the Basel Committee is committed to this course of action and expects its members to act accordingly in implementing the Exposure Framework. In this regard, the Basel Committee is encouraging member jurisdiction to consider the application of these requirements, in some form, to its D-SIB banking organizations. In the U.S., for example, this would generally include those banks that are subject to SIFI regulation under section 165 of the Dodd-Frank Act. Similarly, in the UK, the Proposal could act as a further catalyst for the implementation of the Vickers Commission recommendations for facilitating more competition in the domestic UK banking market.

While the proposed Exposure Framework is based on, and is intended to supplement, the Basel Committee's risk-based capital accord, the Exposure Framework departs in several significant respects from the risk-based capital requirements applicable to banking and trading book exposures. These departures are particularly evident in the Exposure Framework's treatment of off-balance sheet commitments, credit risk mitigation, trading book exposures and securities financing exposures, which are subject to specified limitations and/or calculations that would not apply under the risk-based capital rules. Moreover, the Basel Committee notably is proposing single counterparty exposure limits as a more stringent percentage of *Tier 1 equity capital*, in contrast to, for example, the Dodd-Frank Act and most bank single borrower rules that measure these limits as a percentage of *total capital*.

The Basel Committee also seeks to use the Exposure Framework to capture banking organization exposures to classes of financial intermediaries other than banks, in particular financial entities doing business in the "shadow" banking system. To this end, the Exposure Framework includes provisions that are designed to capture exposures to bank-like activities conducted by non-banks that are "of concern to supervisors" by requiring banking organizations to separately identify and limit large exposures to collective investment entities, securitization structures and funds through application of the LTA.

In sum, there is much in the Proposal that will be of interest, and perhaps concern, to affected banking organizations. The Basel Committee appears open to industry input on its Proposal, at least with respect to some of its individual requirements, even if the Basel Committee is committed to this overall approach. Interested banking organizations therefore should take the time to study and comment on the Proposal.

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