A Year of Challenge for the Banking Industry

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The Bank for International Settlements and Large Exposures

Global Risk Update Editor in-Chief Dennis Cox looks at some of the seemingly innocuous issues raised by the recently published BCBS284.

BCBS 284 published by the Basel Committee on Banking Supervision (BCBS) in April 2014 addressed the topic of large exposures. This paper does include significant detail regarding how a large exposure should be calculated. As with all regulations promulgated by the Bank for International Settlements (BIS) this paper will still need to be locally implemented.

The Issue that is being Addressed

The BIS state that “the Core Principles for Effective Banking Supervision (Core Principle 19) require that local laws and bank regulations set prudent limits on large exposures to a single borrower or a closely related group of borrowers.” But neither the 1994 guidance nor the Core Principles set out how banks should measure and aggregate their exposures to a single counterparty, nor do they explain which factors should be taken into account when considering whether separate legal entities form a group of connected counterparties. This has resulted in a considerable variation of practice across the globe.”

There has been some guidance on the importance of large exposures presented within other papers addressing stress testing and scenario modelling, but there is no doubt that some of the issues have not been completely addressed. The question is which are dealt with here and in addition which are dealt with effectively.

In making the case for the requirement for this paper, the BIS state that a “large exposures framework complements the Committee’s risk-based capital standard because the latter is not designed specifically to protect banks from large losses resulting from the sudden default of a single counterparty. In particular, the minimum capital requirements (Pillar 1) of the Basel risk-based capital framework implicitly assume that a bank holds infinitely granular portfolios, it no form of concentration risk is considered in calculating capital requirements. Contrary to this assumption, idiosyncratic risk due to large exposures to individual counterparties may be present in banks’ portfolios.

Although a supervisory review process (Pillar 2) concentration risk adjustment could be made to mitigate this risk, these adjustments are neither harmonised across jurisdictions, nor designed to protect a bank against very large losses from a single counterparty default. For this reason, the Committee has concluded that the existing risk-based capital framework is not sufficient to fully mitigate the microprudential risk from exposures that are large compared to a bank’s capital resources.

That framework needs to be supplemented with a simple large exposures framework that protects banks from traumatic losses caused by the sudden default of an individual counterparty or group of connected counterparties. To serve as a backstop to risk-based capital requirements, the large exposures framework should be designed so that the maximum possible loss a bank could incur if a single counterparty or group of connected counterparties were to suddenly fail would not endanger the bank’s survival as a going concern.”

There are a number of issues that arise from such a framework. Under Basel 2 credit risk is calibrated at a 99.9% confidence on a one year value at risk (VaR). This was intended to deal with 999 out of 1,000 losses which would surely include the sudden default on a single counterparty regardless of size. To suggest, as the preamble to this paper appears to do, that such a loss is not caught within that calibration is taking loss expectation out to perhaps a fifth standard deviation, which is actually a little radical.

As we know there is no concentration risk calibration in the Basel 2 credit risk calculation and it has been relegated to a Pillar 2 charge. Indeed this is a significant element of the Pillar 2 charge implemented in many countries. There is also the stress testing framework and the recovery and resolution planning framework to supplement work in these areas. Clearly anything that adds to understanding is logical, but it must be clearly designed to ensure that it does not duplicate other extant rules and regulations. If a single counterparty failure were to endanger the survival of a firm it would of course have been addressed in stress testing, the living will and the recovery and resolution plan.

What Concentration Risk is Being Addressed?

The large exposure paper does significantly restrict itself in what it is seeking to achieve and in many ways I consider this to be unhelpful. They state that “The Committee recognises that the risk from large exposures to single counterparties or groups of connected counterparties is not the only type of concentration risk that could undermine a bank’s resilience. Other types include both sectoral and geographical concentrations of asset exposures, reliance on concentrated funding sources, and also a significant net short position in securities, because the bank may incur severe losses if the price of these securities increases. The Committee has decided to focus this framework on losses incurred due to default of a single counterparty or a group of connected counterparties and not to take into account any other type of concentration risk. Similarly, intragroup exposures have not been included in the scope of this framework, although they could be considered as another source of concentration risk that might potentially endanger banks’ survival.”

As we shall see when looking at a few of the requirements there is a basic illogicity to this which undermines the rationale for this paper. If a single counterparty is to fail it fails for a reason. This reason could be complete incompetence by the management team or some other form of own goal, but in such cases the business is generally sound and continues albeit under different management. Generally in such cases the creditors do not receive a haircut.
and business continues as usual.

What is more problematic is when there is a change in an industry or an economic reality that starts to question business models or undermines existing products. In such cases a failure of a single firm becomes the first of a series of corporate failures. Recently this has been clear in the High Street where there has been the failure of a number of prominent firms due to changing demographics and ways of working.

In such cases it is an economic issue which causes the failure and a true loss also is incurred, but the loss is of course more that the failure of the single firm. A blighted High Street causes all firms in the High Street to suffer – the loss of the anchor tenants is often key the on going success. Accordingly the concentration is not aligned just to the single firm, but is broader. Secondly the suppliers to the firm also suffer, as do their employees and the firms the employee use. This is the contagion effect of the failure. So the question is what is the point in producing new rules for the single exposure which to an significant extent already sit within other rules and expectations?

As we shall see there has been some attempt to deal with some of these matters, but the extent of coverage is perhaps questionable.

What is a Large Exposure?

In this paper this is defined as:

The sum of all exposure values of a bank to a counterparty or to a group of connected counterparties, if it is equal to or above 10% of the bank’s eligible capital base.

The requirement is that international active banks must report to their supervisor the exposure values before and after application of credit risk mitigation techniques. Banks must report to the supervisor:

(i) all exposures with values measured as equal to or above 10% of the bank’s eligible capital (ie meeting the definition of a large exposure),
(ii) all other exposures with values measured as specified without the effect of credit risk mitigation being taken into account equal to or above 10% of the bank’s eligible capital,
(iii) all the exempted exposures with values equal to or above 10% of the bank’s eligible capital,
(iv) their largest 20 exposures to counterparties measured and included in the scope of application, irrespective of the values of these exposures relative to the bank’s eligible capital base.

They then set a minimum large exposure by requiring that the sum of all the exposure values of a bank to a single counterparty or to a group of connected counterparties must not be higher than 25% of the bank’s available eligible capital base at all times. However, this figure is set at 15% for a G-SIB’s exposures to another G-SIB.

Connected Counterparty

What is a connected counterparty? This is also addressed in the paper, as follows:

The importance of connectedness is recognised by the BIS who state that:

“In some cases, a bank may have exposures to a group of counterparties with specific relationships or dependencies such that, were one of the counterparties to fail, all of the counterparties would very likely fail. A group of this sort, referred to in this framework as a group of connected counterparties, must be treated as a single counterparty. In this case, the sum of the bank’s exposures to all the individual entities included within a group of connected counterparties is subject to the large exposure limit and to the regulatory reporting requirements as specified above.”

This is of course exactly what you would expect. However with this style of regulation the details can be complex to deal with as we shall see. Two tests are initially provided to identify deemed connectivity. The standard states that:

“Two or more natural or legal persons shall be deemed a group of connected counterparties if at least one of the following criteria is satisfied.

(a) Control relationship: one of the counterparties, directly or indirectly, has control over the other(s);
(b) Economic interdependence: if one of the counterparties were to experience financial problems, in particular funding or repayment difficulties, the other(s), as a result, would also be likely to encounter funding or repayment difficulties.”

Direct control is deemed to exist if 50% of the voting rights are held, so Royal Bank of Scotland would be deemed to be controlled by the UK government under these rules. In other areas (significant influence, appointment of directors etc) the control rules broadly follow the existing IFRS accounting rules.

The inclusion of indirect control here is interesting and does place some additional obligations on firms. Given the nature of the reporting systems within many banks indirect controllers are identified in single entities but rarely across multiple entities. Accordingly there is probably a data collection requirement arising from the implementation of these rules.

Going back to the High Street example identified above. If an anchor tenant in a High Street has financial difficulties would this be sufficient to require the economic dependence test to be applied? The answer appears to be that this is not the case.

In establishing connectedness based on economic interdependence, the BIS require that banks must consider, at a minimum, the following qualitative criteria:

- Where 50% or more of one counterparty’s gross receipts or gross expenditures (on an annual basis) is derived from transactions with the other counterparty (eg the owner of a residential/commercial property and the tenant who pays a significant part of the rent),
- Where one counterparty has fully or partly guaranteed the exposure of the other counterparty, or is liable by other means, and the exposure is so significant that the guarantor is likely to default if a claim occurs,
- Where a significant part of one counterparty’s production/output is sold to another counterparty, which cannot easily be replaced by other customers,
- When the expected source of funds to repay each loan one counterparty makes to another is the same and the counterparty does not have another source of income from which the loan may be fully repaid,
- Where it is likely that the financial problems of one counterparty would cause difficulties for the other counterparties in terms of full and timely repayment of liabilities,
Where the insolvency or default of one counterparty is likely to be associated with the insolvency or default of the other(s).

When two or more counterparties rely on the same source for the majority of their funding and, in the event of the common provider’s default, an alternative provider cannot be found - in this case, the funding problems of one counterparty are likely to spread to another due to a one-way or two-way dependence on the same main funding source.

Now at last the true difficulty of these rules becomes clear. We all know what the BIS is trying to do, but in attempting to catch everything matters become quite complex. If we take a car showroom, for example, the product they sell could be totally dependent on the single car distributor. Does this mean that they are “derived” from transactions with the other counterparty? The examples provided do not make this clear. Accordingly under these rules my suspicion is that you are not required to link every car dealership with the car producer.

The loss of the single major customer is significant though. If the car manufacturer fails then many of their suppliers will fail. Do you have that data available? I would suspect not in a form that enables it to easily be obtained, so again a key element of data collection. But what about 50%? As a company if I lose a customer that accounts for 25% of my business then I would expect to have some problems. If I have lost 40% of my turnover, the question is whether or not I would survive. If I am running a business where my costs are essentially fixed but my income is variable the level of loss leading to failure is likely to be well below the 50%. However on the other side there is a contrarian argument.

If you have a major customer single it is often the case that the supplier is unable to supply their competitors. If the customer fails the market available to the other potential customers grow and they potentially also require supply. In such cases the supplier may not experience the full loss value of the customer collapse and may be able to replace one customer with another. This is not considered in these rules.

Given that supplier and customer information is not included in annual statutory accounts and instead is recorded in credit applications by relationship managers with little if any verification the concern is that this neglected area may become of greater significance. Then what of the secondary effects? If I lose my job then my cleaner and gardener lose their jobs. Are we linking the corporate failure to the personal failure and the impact on collateral values? The answer is not yet.

**Interbank Exposures**

We are not going to discuss the measurement and mitigation issues here, so reference should be made to the paper itself in this regard. Instead I am surprised by the following comment in the paper:

“To avoid disturbing the payment and settlement processes, interday interbank exposures are not subject to the large exposures framework, either for reporting purposes or for application of the large exposure limit. In stressed circumstances, supervisors may have to accept a breach of an interbank limit ex post, in order to help ensure stability in the interbank market.”

This is of course not sensible under any level. Banks are already required to have limits for such issues and there are separate papers produced on intraday monitoring. The exclude it here when probably it is most important is in my opinion naive. The requirement should have been to include the limit within the connected exposure, but instead they have left it out. To say that interbank limits can be moved under stress is also in my opinion running against everything that has been achieved in developing stress testing. Increasing connectivity under stress increases the risk of contagion. That is one of the key lessons from the recent crisis. Accordingly my hope is that regulators do take account of the suggestion made here and do not accept a breach of interbank limits under such a circumstance.

**Other Matters**

This paper is due to be implemented 1 January 2019 so there is time to sort out a few matters. For example Central counterparty exposures are not currently to be included but will be addressed in due course.

There is a long section looking at what are termed additional risks which refer to where a third party provider supports perhaps technically a range of products. This seems to be aimed at securitisation linkage potentially extending connectivity.

The scope could be broad as stated as follows:

“Banks must identify third parties that may constitute an additional risk factor inherent in a structure itself rather than in the underlying assets. Such a third party could be a risk factor for more than one structure that a bank invests in. Examples of roles played by third parties include originator, fund manager, liquidity provider and credit protection provider.”

Again this is another data requirement for banks to deal with since this is another area where data is not currently collated in the way envisaged.

**Conclusion**

As you can see this appears at first sight to be an innocuous paper. If you just looked at the heading you might have thought it was just changing some form of reporting, but as you can see there is much to do. The connectivity rules are changing and broadening and this does mean that more information is likely to be required than was previously the case. Worse than that is perhaps that the data that is recorded will not have currently been routinely verified by the bank and with new regulatory impetus I would suggest that greater care may be required in such areas.

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