

PS12/21

Financial Services Authority

Large Exposure Regime – Groups of Connected Clients and Connected Counterparties

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This Policy Statement reports on the main issues arising from Consultation Paper 12/1 (*Large Exposure Regime – Groups of connected clients and connected counterparties*) and publishes final rules.

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Copies of this Policy Statement are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

Abbreviations used in this paper

ABCP	Asset Backed Commercial Paper
CRD	Capital Requirement Directive
CLO	Collateralised Loan Obligations
CMBS	Commercial Mortgage Backed Security
CP	Commercial paper
CEBS	Committee of European Banking Supervisors (now the European Banking Authority)
CB	Covered Bond
GCC	Group of connected clients
LE	Large exposure
LAPA	Liquidity asset purchase agreement
RMBS	Residential Mortgage Backed Security
SPE	Special Purpose Entity
SPV	Special Purpose Vehicle

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Overview

Background

- 1.1 We published a Consultation Paper in January 2012 to propose rule changes to our handbook definition of connected counterparties and the basis for aggregating exposures to connected counterparties when applying large exposure (LE) limits. We also proposed new guidance on the treatment of LE to structured finance vehicles, building on the Committee of European Banking Supervisors (CEBS) guidelines on the implementation of the revised LE regime published in December 2009.¹ Finally we proposed a change to the handbook guidance in BIPRU 10.6.33G on the institutional exemption.
- 1.2 Having considered feedback from industry, we intend to implement the proposals subject to some amendments to the guidance that are outlined in Chapter 2.

Who should read this Policy Statement?

- 1.3 The LE regime applies to all banks, building societies and all BIPRU firms, and will be of particular interest to these firms and their advisers.

Responses received

- 1.4 We received nine responses from industry and we outline a summary of all responses in Chapter 2. We are grateful to all respondents for their time and effort in providing comments.

¹ See www.eba.europa.eu/documents/Publications/Standards---Guidelines/2009/Large-exposures_all/Guidelines-on-Large-exposures_connected-clients-an.aspx

Next steps

- 1.5 In the Consultation Paper we stated that we expect the final rule changes to come into immediate effect without the use of transitional arrangements when we publish the Policy Statement. This is because the rule changes reflected in this statement will effectively be a relaxation of existing rules. However, we do understand that firms might need to discuss practical matters about the guidance on the treatment of LE to structured finance vehicles and we encourage firms to engage with their supervisory relationship managers to discuss reasonable timeframes to full compliance.

2

Outcome from consultation

- 2.1 We received nine responses from industry and we have considered the areas where industry has expressed concern.

Implementation date

- 2.2 A large majority of respondents expressed concern over the implementation date without transitional arrangements. As outlined in Chapter 1, we do not see the need for transitional arrangements for these handbook changes. However, we do understand that firms might need to discuss arrangements for implementing the guidance for the treatment of exposures to structured finance vehicles. We therefore suggest that all affected firms engage with their supervisory relationship managers immediately.

Diagrams and decision trees

- 2.3 In the guidance for the treatment of exposures to structured finance vehicles, we proposed to include diagrams and decision trees to help firms decide whether to treat these structures as part of a group of connected clients. These decision trees were based on typical structures and, as such, could not be expected to capture the variety of features that may be found in all structured finance transactions. However, since most respondents found these either unhelpful or confusing, we have decided to delete the diagrams and decision trees from our final guidance. Please refer to Chapter 3.

Changes to the handbook

- 2.4 Respondents agreed with deleting the definition of connected counterparties in BIPRU 10.3.8R but two respondents questioned the timing of this change in light of CRD IV. We consider that these handbook changes are consistent with CRD IV legislative proposals for LEs. In any event,

the current connected counterparties approach has a wider application than required by the CRD definition of group of connected clients and we do not see the need for delaying these changes.

- 2.5 The changes proposed in CP12/1 will not affect the LE treatment of counterparties that are members of a firm's core UK group or non-core LE group.
- 2.6 Firms will still be required to complete Part 2 of the FSA 008 (the details of connected counterparties at the reporting date) but the guidance will be amended to reflect that this section of the report will now apply to counterparties falling within BIPRU 10.10A.1R. This means there will be no changes to how firms are currently reporting exposures in FSA008, even though there will be no requirement to meet the 25% LE limit on an aggregate basis for counterparties falling within BIPRU 10.10A.1R. Given that the Guidelines on Common Reporting (COREP) are due to be implemented, we did not consider it feasible to make any amendments to the current reporting forms.

ABCP conduits as group of connected clients

- 2.7 The industry has outlined its opposition to the presumptions that Asset Backed Commercial Paper (ABCP) conduits should be treated as a group of connected clients in a number of discussions with us, and we have considered all the responses and the reasons that firms put forward for disagreeing with our presumption.
- 2.8 The LE regime applies a non-risk sensitive regulatory backstop to a firm's exposures to a counterparty or a group of connected clients. A number of respondents felt that the Consultation Paper seemed to address systemic liquidity problems rather than the concentration risk of connected borrowers failing. Therefore, we would like to be clear that the LE regime is designed to address unforeseen event risk and is not intended to overlap or replace the liquidity or credit risk regimes. Applying a back stop limit that is non-risk sensitive is designed to reduce the likelihood that financial difficulties in one counterparty or a group of connected clients could cause or exacerbate financial difficulties in the regulated firm, or could lead to the failure of the regulated firm.
- 2.9 A number of respondents looked at the look-through approach and questioned whether we were ignoring the second part of the CEBS guidelines, which deals with the treatment of exposures to schemes with underlying assets. The CEBS guidelines make it clear that, for exposures where there is a scheme and an exposure to underlying assets, an institution will assess the scheme, its underlying exposures, or both. For that purpose, an institution will evaluate the economic substance and the risk inherent in the structure of the transaction.² It is important to note that the evaluation of risk inherent in the structures does not just refer to credit risk, but to all risks that could possibly affect the institution; this includes liquidity risk, market risk, etc.

² CRR Article 379, paragraph 7

- 2.10** It is our position that, to properly evaluate the economic substance and risks inherent in a structure, it is important to assess both the scheme and the underlying exposures.
- 2.11** Many respondents wanted to know why we were publishing this before EBA binding technical standards due by 1 January 2014.³ It is important to note that the treatment of exposures to structured finance vehicles has been a contentious and much debated issue before the implementation of the changes to the large exposures regime in 2010. We met with the industry and affected firms on numerous occasions before publishing the proposals by the EC and CP12/01 and expressed our concerns around the economic risks within the specified structures. Due to the size of the affected structures and the likelihood of a single risk existing with the structures identified in the guidance, we feel that delaying the implementation of our guidance may affect our ability to meet our statutory objectives of market confidence and financial stability.
- 2.12** Our concern with ABCP structures and how they should be treated for LE purposes are not linked to a systemic failure in the ABCP market itself, hence why we do not require the connection of all exposures to all ABCP conduits. Our concern has always been the reliance that investors in the commercial paper (CP) of ABCP conduits place on the financial strength of their sponsor.
- 2.13** An ABCP investor's first recourse is the ability of a conduit to issue a new commercial paper and, failing to do so, the sponsoring bank (assuming it is the backstop liquidity provider to the conduit, as is typically the case). Only if both these liquidity mechanisms fail will an investor become exposed to the underlying assets. The unforeseen event risk that we are hoping to address is if a sponsoring bank experiences liquidity or financial problems and, due to the short-term nature of commercial paper, investors withdraw from conduits that are sponsored by the said bank. This situation does not require increased risk in the ABCP market as a whole, but just an increased risk to conduits that are sponsored by a given bank that might be experiencing financial difficulties. This could leave the sponsoring bank vulnerable to funding all liquidity obligations to conduits in a short space of time, when the bank is already experiencing financial difficulties. The LE regime will limit this single risk to 25% of the sponsoring bank's capital resources if banks treat the conduits as a group of connected clients due to their connection to the firm itself.
- 2.14** Given 2.13, the credit quality of the underlying assets within the conduits are a secondary concern when assessing LEs and, although we take note of the fact that multi-seller ABCP conduits performed better during the ABCP market failure of 2007, we have to stress that we are committed to ensuring compliance with the LE regime and not merely addressing inadequacies that led to the 2007 market crash.

³ CRR Article 379, paragraph 8 b

Cost benefit analysis

- 2.15** CP12/1 estimated the cost of alternative funding sources and described the benefits of the proposed large exposure regime. These considered the market effects assuming a sizable and immediate reduction in ABCP conduits under a variety of options available to firms to comply with the guidance in a worst case scenario. In reality, firms using ABCP conduits have a number of options available besides outright reduction in exposure:
- a) demonstrate that some conduits do not represent a single risk;
 - b) reduce lending to some degree;
 - c) replace ABCP funding with alternative forms of securitization or funding; and
 - d) a mixture of all of the above.
- 2.16** Over the past year, some firms have gradually reduced exposures to ABCP conduits making any further adjustment more easily within reach. A review of Q2 2012 regulatory return data suggests that the majority of the major sponsors are within the limits, even when counting all ABCP conduits as a single risk. This suggests that the transition costs with the new guidance may be nominal. As we mentioned in paragraph 2.2, firms are encouraged to discuss arrangements for implementing the guidance with their supervisory relationship managers to mitigate any unintended impacts on lending. We remain confident that the benefits of reducing the large exposures to banks outweigh the cost of reducing and replacing commercial paper funding.
- 2.17** Also, where firms are able to demonstrate with sufficient justification why certain conduits do not represent a single risk with other conduits, such conduits will not be presumed to fall within a single group of connected clients (as outlined in Chapter 3). This reduces the risk that the availability of conduit funding contracts fall to a level that cannot support the assets that do not have access to alternative funding sources (such as the term securitisation market), or would have substantially higher funding costs in such alternative funding markets. We believe that there are significant benefits (as set out in CP12/1) from firms considering the types of risk involved in each conduit, ensuring that risks are not concentrated and allowing genuine cases of differentiated risk to be accounted as separate exposures.

3

Guidance for the treatment of structured finance vehicles

Changes to the proposed guidance

- 3.1 Our guidance remains unchanged apart from the removal of decision trees and diagrams, as most respondents found these to be unhelpful.

Guidance on application of the group of connected clients definition to structured finance vehicles

A. Group of connected client considerations

1. A revised large exposures regime is included in the amended Capital Requirements Directive (CRD 2). To ensure harmonised implementation of the revised regime, CEBS published guidelines⁴ which focus on the CRD 2 definition of group of connected clients (GCC) and, in particular, on what constitutes control and economic interconnection for the purposes of that definition.
2. The CRD 2 definition of a GCC and the CEBS guidelines refer to interconnections arising from control and economic dependency between two or more entities to which a reporting firm has exposures. The purpose behind consideration of such interconnections is to determine if it is appropriate to aggregate the exposures to two or more entities because these entities constitute a single risk.
3. This guidance considers application of both the control limb and the economic interconnection limb of the GCC definition to structured finance vehicles.

⁴ See www.eba.europa.eu/documents/Publications/Standards---Guidelines/2009/Large-exposures_all/Guidelines-on-Large-exposures_connected-clients-an.aspx

Control

4. The CEBS guidelines consider what constitutes control for the purposes of the definition of GCC. Where a control relationship exists, there is a presumption of single risk.
5. The CEBS guidelines note that firms must rely on the CRD definition of control, which is taken from the accounting definition. The relevant indicators of control for accounting purposes, in the context of structured finance vehicles may include SIC 12 (International accounting standards) or FRS 5 (UK GAAP).
6. Concepts that are relevant in assessing accounting control in the context of structured finance vehicles (e.g. ‘auto-pilot execution’ of actions in accordance with a prescribed and documented procedure) focus primarily on the retention of risks and benefits by the sponsor firm and do not specifically address if the sponsor and the structured finance vehicle constitute a single risk. Firms should therefore use this guidance in their assessment of single risk with structured finance vehicles. While the guidance that follows typically refers to firms acting in a capacity as ‘sponsor’ of a structured finance vehicle, the considerations raised are equally applicable where firms act either as sponsor or as originator of such transactions, and the usage of ‘sponsor’ and ‘sponsoring’ below is intended to capture both types of involvement in structured finance vehicles.
7. Firms may challenge the presumption of single risk that arises as a result of a relationship of control through a sufficiently justified analysis that situations exist where one of the two entities would survive while the other experiences existence threatening difficulties.

Economic interconnectedness

8. The economic interconnectedness limb of the GCC definition refers to single risk as a result of funding or repayment difficulties being experienced by one entity resulting in the other(s) being likely to encounter similar difficulties. Once again the aim behind this assessment is to establish if the entities constitute a single risk.

Single risk

9. The CEBS guidelines focus on the strong presumption of single risk between entities arising from either a control or economic interconnection relationship.
10. Firms may demonstrate, with sufficient justification, why a single risk does not exist for the specific vehicle(s) being considered.
11. The primary focus of this guidance is the treatment of different structured finance vehicle(s) in the GCC context, building on specific discussion of certain such vehicles in the CEBS guidelines.
12. The CEBS guidelines highlight the need to distinguish between issues related to a single funding market and those relating to the interaction between a vehicle and a sponsor, such

that sponsored vehicles should not be aggregated as a GCC simply because of common funding from a single investor base, e.g. ABCP or ABS investors.

Direction of causality of financial distress

13. In the context of economic interconnection, the CEBS guidelines highlight that the GCC definition is appropriate for use with entities that may be connected:
- 1) between themselves but not to the reporting firm; and
 - 2) to the reporting firm itself.
14. The CEBS guidelines highlight that an economic interconnection may exist as a result of either a one-way or two-way economic dependency. Firms should therefore identify the direction of causality of financial distress (i.e. vehicle to firm, firm to vehicle or vehicle to vehicle (via the firm)) as part of their GCC assessment. This assessment of different directions of contagion transmission will help determine the type of connection for the purposes of identifying a GCC.

B. Connected Client status of firm own sponsored structured finance special purpose entities (SPEs)

15. GCC considerations in the CEBS guidelines focus on connections between entities that are not necessarily connected with the reporting institution. As the focus of this guidance is specifically on exposures that firms have to sponsored SPEs, firms should first assess whether such a vehicle is a connected client of the firm and then should consider if this connected client constitutes a single risk with other counterparties. If so, the vehicle should be grouped with those other counterparties and deemed a GCC.
16. In assessing single risk firms need to consider the direction of causality of financial distress. This means that firm needs to assess whether financial contagion occurs in one direction or two.

Directional links dependent on degree of overlap in common scenarios

Vehicle types

Type A: Connected Client by Control	Type B: Connected Client by Interconnection
Type C: Connected Client by Interconnection – Firm to Vehicle Causality of Distress	Type D: Connected Client by Interconnection – Vehicle to Firm Causality of Distress

17. As outlined in the CEBS guidelines, firms should have in place established processes to determine when exposures to different entities represent a single risk. We expects firms to

be able to use analysis already carried out as part of the internal approvals⁵ process to identify scenarios in which individual vehicles face funding difficulties and to what degree these overlap with scenarios where:

- 1) the firm itself would face financial difficulties (in determining a connected client relationship); and
- 2) any other vehicles would also face financial difficulties (in determining a GCC relationship).

Scenarios of financial distress

18. In addition to other considerations, we would anticipate that firms would consider scenarios for vehicles that include:

- 1) the credit performance of the assets and asset-liability mismatch/liquidity⁶ considerations in the underlying portfolio of a vehicle;
- 2) the tenor of outstanding debt and related frequency of debt refinancing needs;
- 3) the reliance on successful debt refinancing, including the provision of contingent support (credit, liquidity or otherwise) from another entity (including the sponsor, originator or any other third party; this could include consideration of factors affecting the rating of the vehicle or bonds issued by it);
- 4) any deterioration in market sentiment in, or the performance of, any part of the portfolio of assets funded by the vehicle which could ultimately result in unavailability of replacement funding;
- 5) the structural features of the vehicle's constitution which may exacerbate deterioration in investor appetite for replacement debt; and
- 6) operational failures, e.g. servicer failure, collections fraud, etc.

19. Having compiled a set of scenarios for each individual vehicle, firms should seek to assess the degree of overlap that occurs between these different sets. As the CEBS guidelines clarify that common concentrations of industrial sector, geography or funding base should not result in counterparties being connected, firms may exclude these factors from their assessment of common scenarios.

⁵ Including among other things credit approval submissions, new business approval processes, franchise and reputational risk process.

⁶ The longer term nature of assets relative to the notes/paper issued to finance them, could mean that self-liquidation of assets to repay the liabilities of a vehicle is not feasible.

Establishing single risk

20. Firms should seek to ensure that commonality of other factors is considered. These should include the:
- 1) Commonality of borrowers and/or sellers (i.e. exposures to a particular borrower or seller of assets, in a vehicle where the firm also has exposures to the same or related borrower/seller on its own balance sheet); and
 - 2) Consequences of common ratings triggers related to the provision of ancillary support facilities within the structured finance market, which may also occur within the provision of similar ancillary support facilities being provided by the firm to other non-sponsored structured finance SPE or to any other third parties.

C. Process for aggregation of exposures to Connected Client that are structured finance vehicles

21. When it comes to capturing scenarios where the firm experiences financial distress, it is appropriate to consider only those scenarios which result in one or more vehicles also encountering financial difficulties, along with the firm. This should allow firms to focus on the commonality of scenarios where both or more than two sponsored vehicles encounter financial distress as a result of constituting ‘single risk’ with the firm.

D. Vehicle-type specific conclusions

The conclusions reached in this section are based on typical features within common structures. Where a firm has an exposure to a structure that has atypical features, firms are encouraged to engage with their supervisory relationship managers.

D1. ABCP Conduits*Structural features*

22. There are a number of primary features of an ABCP conduit that lead us to conclude that they are connected:
- 1) a variety of liquidity support mechanisms including, but not exhaustively:
 - a) liquidity facilities;
 - b) liquidity asset purchase agreement (LAPA);
 - c) asset repurchase agreements;
 - d) total return swaps;
 - e) letters of credit; and
 - f) desk commitments to purchase ABCP issued.

- 2) credit support mechanisms:
 - a) program wide credit enhancements.
- 3) common funding sources – i.e. where the firm is the sponsor, via the provision of a LAPA or some other contingent liquidity support, and acts as the lender of last resort to the conduits.

Behavioural interactions

23. During the recent crisis period 2007 to 2010, firms provided non-contractual support to their sponsored conduits. Firms committed to repurchase assets from the conduits where investors objected to the inclusion of those assets, even though those assets did not necessarily affect the view of the Credit Rating Agencies (CRAs) on the rating of the ABCP issued. More recent history showed investor sentiment against the securitisation/ABS market, where any element of ABS held in conduits (or even the inability of the sponsor to demonstrate what proportion of the assets was represented by ABS) resulted in the swift deterioration of investor appetite.
24. As demonstrated during the last two to three years, conduits which had some liquidity support mechanisms provided by the sponsor firm, were likely to partially draw on these when they experienced financial difficulties. Therefore the presumption is that these vehicles are likely to be a connected client. In the case of third-party asset conduits it may be possible that firms can demonstrate that any exercise of liquidity to purchase the assets of a particular seller/contributor to a multi-seller conduit was offset by the seller/contributor either providing funding to the sponsor firm or having purchased the assets from the sponsor firm for them to be refinanced elsewhere.
25. In the case that reliance is placed on the ability of a seller/contributor to provide replacement funding for assets within a third-party asset conduit, as referred to above, firms should be satisfied with a high degree of confidence that all (and not only some) of the assets may be refinanced and that a sufficient tangible incentive (contractual or economic) exists for the seller/originator to engage in the event of the vehicle sponsor having to provide liquidity support.

Conclusion

26. ABCP conduit structures are to be considered a connected client with the sponsor firm and, for the purposes of GCC reporting, all conduits will be presumed to fall within a single GCC unless firms are able to demonstrate with sufficient justification why certain conduits may not represent single risk with other conduits.

D2. Residential Mortgage Backed Security (RMBS) Master Trusts

Structural features

27. The key structural features of RMBS master trusts that indicate the vehicles could be considered connected clients include:
- 1) the existence of call options and put options on the bonds which ultimately put the burden on repaying the bonds back with the sponsor firm which, in the absence of availability of replacement rollover financing in the RMBS market, may involve the sponsor buying either the replacement bonds or the injection of cash in return for an increase in the seller share;
 - 2) liquidity reserve top-up requirements – certain transactions have requirements to top up the liquidity reserves by the sponsor firm in addition to trapping cash flowing from the assets in the portfolio of the master trust; and
 - 3) ‘Seller Share’ requirements – the need to maintain a minimum seller share by either selling additional mortgages to the trust or by not taking principal receipts from maturing mortgages.
28. On the other hand, the following structural features are indicators that master trust structures do not need further support from the sponsor. The structure and ratings of the bonds reflect the ability of the assets to be serviced and administered for as full a repayment as possible of the bonds, including:
- 1) principal deficiency ledgers;
 - 2) replenishment of issuer and/or funding reserves by cash flows arising from the assets in the master trust (other than when a new issuer is introduced to the master trust); and
 - 3) the self-administering and self-liquidating nature of the assets as reflected in:
 - a) the legal maturity of the bonds being set at approximately two years after the longest dated mortgages; and
 - b) priority of payment directions allowing allocation of asset cash flows to repay the bond liabilities through time.
29. At the legal maturity of the trust, the risk of the trust experiencing difficulties in repaying any such liabilities is mitigated by (and ultimately reflected in the rating of the bonds):
- 1) the setting of legal maturity dates at sufficient time after the contractual maturity of the longest mortgage assets (plus the time delay for potential legal proceedings to be settled); and
 - 2) the comparatively small proportion of assets expected to be outstanding at or about the legal maturity date of the longest dated liability.

Behavioural interactions

30. Master Trust sponsors have endeavoured to ensure that RMBS bonds with a step-up and call feature have been called even during the crisis period between 2007 and 2010, despite:
- 1) the unavailability of replacement funding from the RMBS investor base;
 - 2) the low levels of step-up coupon required on bonds relative to the margins required for the small levels of primary market RMBS issuance, as well as in comparison to unsecured funding levels for most sponsors; and
 - 3) what some firms have told us about the impact of deciding not to call a bond, i.e. the failure to call a bond by a sponsor would likely result in the sponsor bank being frozen out from the wholesale funding markets for a sufficiently long period of time such that it could impact the on-going liquidity and solvency position of the firm.
31. The CEBS guidelines refer to entities experiencing financial difficulties, such as funding and/or repayment difficulties. The guidelines are silent on the point in time when such financial difficulties should be assessed, albeit that reference is provided to examples from the ABCP market, which refer to the incidence of financial difficulty coinciding with the legal maturity of the outstanding ABCP but the assessment of funding difficulties in the context of a vehicle that has a 'step-up and call option' structure, in advance of the legal maturity date of liabilities, is not specifically addressed.
32. In the case of RMBS master trusts, which are structured with a step-up and call option available to the issuing vehicles, together with bonds that have a long dated legal final maturity, it is not immediately obvious which of the two dates should be considered to assess whether financial difficulties are encountered. Firms are encouraged to consider their engagement with investors in establishing expectations about the effective repayment date, and whether there is sufficient expectation by investors and the market that bonds will in fact be repaid on the step-up and call date. If this is the case, we would consider there to be a strong indication that a firm to vehicle causality should be established.
33. While the optional nature of repayment may not constitute a firm commitment to repay, firms should consider if the nurturing of a tacit expectation of repayment on the call date is akin to the grounds on which ABCP investors purchase bonds, i.e. with the full expectation that if their maturing CP is not replaced with market issued CP, the liquidity support provided by the sponsor as a back-stop would be available. In these cases, firms should consider if investors in RMBS master trusts have purchased bonds as a result of continual signalling that on the step-up date, if the RMBS market is not willing to refinance the bonds to be called, the sponsor firm will act to provide financing to the master trust issuer so it can repay the bonds.
34. In the absence of CEBS guidance on whether funding and/or repayment difficulties at the step-up and call date should be captured, for the purposes of connected client status, we are willing to accept proposals (where supported by evidence) that the assessment of funding and/or repayment difficulties should be on the legal final maturity date of the bonds.

35. Given the above, to arrive at conclusions on whether the RMBS master trusts are connected clients, firm should consider:
- 1) statements made by the sponsor to RMBS investors about their intentions to call the bonds on their call option date;
 - 2) their ability, as the sponsor, to be able to find the quantity of replacement funding required to exercise the call, in the event of the RMBS investor base evaporating;
 - 3) the form in which the repayment occurs, e.g. the call by the issuer funded by the sponsor receiving an increase in the bonds held or in the seller share of the vehicle, (thus increasing its exposure to the vehicle); and
 - 4) how market expectations regarding the intent and/or ability of the master trust to call bonds is reflected in the market's pricing of the bonds, i.e. pricing in the expectation that bonds will be called or extended beyond the call date.

Connected Client determination

36. Sponsor firms are asked to ensure that appropriate consideration is given to historical behaviour for supporting investors in the trust and any anticipated future support.
37. In addition to the softer considerations around call-date versus legal maturity date repayment expectations, sponsors should also ensure their analysis incorporates consideration of:
- 1) liquidity facilities (if provided);
 - 2) actions taken by the firms to provide non-contractual top up of reserves (or other forms of credit enhancement) in the master trust; and
 - 3) contractual requirements on the firm to top up reserves (or other forms of credit enhancement) within the RMBS Master Trust.
38. This paragraph summarises circumstances in which RMBS master trust vehicles are likely not to be considered connected clients.
- 1) A master trust does not encounter financial difficulties, and thus require funding from the sponsor, on the step-up and call date if it has not been able to exercise the optional call due to:
 - a) the self-liquidating nature of the asset portfolio, which enables it to repay its liabilities by the legal maturity date;
 - b) investors recognising and accepting that bonds may not be repaid on the step-up and call date, as they will receive a contractual increase in the coupon payable after the call date in compensation; and
 - c) outstanding bonds being repaid in accordance with priorities of payment as outlined at the outset of the transaction.

- 2) To establish a connected client relationship, the economic interconnection limb of the definition of a GCC requires that the financial distress of one entity is likely to result in the financial distress of the other(s). Because of its legal construct (i.e. self-administering and self-liquidating), if an RMBS master trust would only encounter financial distress in very remote circumstances, this would result in it not being considered a connected client with the sponsor firm, or for inclusion within a GCC with any other vehicle of the sponsor firm.
 - 3) If the master trust has not benefited from (and does not currently benefit from) liquidity facilities or reserve replenishments (or increases in other forms of credit enhancement) being provided by the sponsor firm either contractually or non-contractually in times of distress (e.g. other than at the time of a new issuance from the master trust).
 - 4) The assets and liabilities of the master trust vehicle are reported on the regulatory balance sheet.
39. A firm's exposures to the RMBS master trust, such as seller share interests, subordinated loans, swap lines etc, should be considered against the 25% (of the LE capital base) limit for exposures to entities that are not in the core UK group nor in the non-core group.

D3. Credit card Master Trusts

Structural features

40. Credit card master trusts typically have a great deal of excess spread generated from the assets such that the need for support by the sponsor is minimal.
41. Any reserves required in the master trust are typically replenished through the trapping of the excess spread flowing from the assets.
42. Credit card assets typically have a short dated maturity and therefore asset portfolios generally tend to self-liquidate in a short time frame allowing trust liabilities to be repaid on or before their legal maturity date, and thereby the master trust does not encounter financial difficulties.

Behavioural interactions

43. While excess spread generated from the asset pool is typically sufficient to meet the requirements of the bonds, in the recent past it has been observed that sponsors have sold additional assets, in accordance with their rights during the revolving phase of the trust, at a discounted value in order to provide additional credit enhancement for the outstanding bonds. This supportive behaviour where risk is effectively transferred from the vehicle to the sponsor, is an indicator for establishing a connected client status, on the grounds that the sponsor firm would continue to provide this type of support as and when required by the vehicle. However, to date, this kind of support has been limited.

44. Recently, subordinated note tranches have been introduced, and have been subscribed to by the sponsor. This has essentially served as a credit support mechanism by the sponsor akin to taking credit risk that would otherwise have been borne by credit card ABS investors.

Conclusion

45. Typical credit card master trusts are not expected to be captured for connected client purposes as the short dated nature of credit card assets allows for scenarios of the master trust encountering financial difficulty being averted by the ability of assets to speedily repay associated bond liabilities on or prior to the legal maturity date.
46. While there is evidence that certain sponsors have provided non-contractual support to ensure that their credit card master trust vehicles continue to be available for funding, it appears that the occurrence of such activities has been limited (but such activity could lead to a determination that the vehicle is a connected client).

D4. Covered Bond LLPs

Structural features

47. Covered Bond LLPs (CB LLP) have several features and characteristics that support the conclusion that the LLPs are not connected:
- 1) The CB LLP does not encounter financial difficulties as a result of the firm experiencing financial difficulties; since the LLP is created to provide a guarantee, backed by a portfolio of assets, to holders of covered bonds issued by the firm and specifically designed with the objective of surviving the bankruptcy of the firm. Therefore, by definition, these LLPs do not constitute a single risk with the firm.
 - 2) Exposures of a firm to the CB LLP are not subordinated to any material extent, other than if the firm does not perform in its commitments to the covered bondholders.
 - 3) The (frequently long) legal maturity date of the bonds allows the LLP to be self-administering and self-liquidating to ensure that financial repayment difficulties are not encountered if the bank were to encounter financial difficulties. As such, the commitments would be met at or before the legal maturity of the bonds guaranteed by the vehicle.

Behavioural interactions

48. Sponsor firms provide credit enhancement through over-collateralisation, and the mechanics surrounding how this collateral is handled post the default of a sponsor firm may raise connectedness considerations. While this is a requirement for obtaining a credit rating, excessive over-collateralisation leads to unnecessary encumbrance on the bank's assets in the event of the firm becoming insolvent. It is recognised that sponsor firms may choose to provide collateral in excess to the required over-collateralisation levels for

reasons of operational convenience, in order to mitigate the possibility of inadvertent breaches of required over-collateralisation. However, firms should look to ensure that the excess of any over-collateralisation over the required levels does not raise undue encumbrance concerns.

Conclusion

49. A typical CB LLP is not considered to be a connected client with sponsor firms and may therefore not need to be considered in a GCC context with any other parties.

D5. Stand-alone RMBS

Structural features

50. As in the considerations of RMBS master trusts above, there are key structural features of stand-alone RMBS SPVs that indicate that these vehicles may be considered connected clients.
- 1) The existence of call options and put options on the bonds which ultimately result in the burden on repaying the bonds being with the sponsor, which in the absence of availability of replacement rollover financing in the RMBS market, may involve buying the outstanding assets back on to the balance sheet.
 - 2) Liquidity reserve top up requirements – certain transactions have requirements to top up the liquidity reserves by the sponsor and not by trapping cash flowing from the assets in the portfolio of the stand alone RMBS.
51. Firms need to be comfortable with expectations of the investor base and the firm's own communication about intentions to call or not prior to legal final maturity.

Behavioural interactions

52. Due to the similarities of certain structural features with RMBS master trusts, the behavioural interactions between Sponsor firms and RMBS vehicles are also similar to those likely to be observed with the master trust vehicles. Therefore firms need to review the behavioural interactions section for RMBS master trusts and apply these considerations to the connectedness of stand alone RMBS.

Connected Client determination

53. Sponsor firms are asked to ensure that appropriate consideration is given to historical behaviour for supporting investors in the trust and any anticipated future support.
54. In addition to the softer considerations around call-date versus legal maturity date repayment expectations, sponsors should also ensure their analysis incorporates consideration of:
- 1) liquidity facilities (if provided);

- 2) actions taken by the firms to provide non-contractual top up of reserves (or other forms of credit enhancement); and
- 3) contractual requirements on the firm to top-up reserves (or other forms of credit enhancement) within the RMBS vehicle.

Conclusion

55. This paragraph summarises circumstances in which stand-alone RMBS vehicles are likely to not be considered connected clients.
- 1) A vehicle does not encounter financial difficulties on the step-up and call date if it has not been able to exercise the optional call due to:
 - a) the self-liquidating nature of the asset portfolio to repay rated liabilities by the legal maturity date;
 - b) investors recognising and accepting that bonds may not be repaid on the step-up and call date, as they will receive a contractual compensating increase in the coupon payable after the call date; and
 - c) outstanding bonds are repaid in accordance with priorities of payment as outlined at the outset of the transaction.
 - 2) The vehicle has not benefited from (and does not currently benefit from) liquidity facilities nor reserve replenishments (nor increases in other forms of credit enhancement) being provided by the sponsor either contractually or non-contractually in times of distress.
 - 3) The assets and liabilities of the vehicle are reported on the regulatory balance sheet.

D6. Commercial Mortgage Backed Security (CMBS) issuing vehicles

Structural features

56. The structural features of CMBS issuing vehicles do not typically result in the vehicle as a whole being considered a connected client of the sponsor firm. While sponsor firms do have certain cure rights (e.g. in relation to remedying certain LTV breaches), these rights have been demonstrated to be exercised with strong consideration of the economic conditions related specifically to an injection of cash to cure the breach, as opposed to being motivated by the need to manage franchise or reputation effects that might cause the sponsor to have funding difficulties.

Behavioural interactions

57. Where a sponsor has on balance sheet exposures to a borrower, or to an entity related to the borrower (e.g. parent or sponsor entity) that is also a borrower in a securitised commercial mortgage (in a CMBS issuing vehicle sponsored by the reporting institution),

there may be a conflict of interest in how the securitised loan may be restructured if the borrower encounters financial difficulties. As a consequence it would be appropriate for securitised commercial mortgages (if exposure to the CMBS is retained) to be aggregated with on-balance sheet exposures to the same or related entities. The influence of the commonality of borrower(s) is heightened to the extent cross default provisions exist between the on-balance sheet and securitised exposures.

Connected Client considerations

58. The behavioural and structural features discussed should be incorporated into firm considerations as to the appropriate level of aggregation required between on-balance-sheet and securitised commercial mortgages (where exposure is retained).

Conclusion

59. Typical CMBS issuing vehicles are not likely to be considered connected clients of the sponsor firm, unless the sponsor has historically provided non-contractual support to their CMBS. However, firms should ensure connected client considerations are addressed in any new structures in the CMBS market.

D7. Collateralised Loan Obligations (CLO) issuing vehicles

Structural features

60. The structural features of CLOs do not typically result in the vehicle as a whole being considered a connected client of the sponsor firm. Sponsor firms have limited responsibility in terms of explicit support of the CLO, in which the main non-discretionary obligation of the sponsor is to remedy breaches of representations and warranties where the sponsor has originated the respective loans within the CLO portfolio. However, on a discretionary basis, the sponsor may decide to support the transaction in order to prevent breaches of contractual tests. Such actions could be carried out to protect the sponsor's own economic interest in the transaction (for example if they hold the equity tranche), or alternatively such actions may be motivated by the need to manage franchise or reputation effects that may occur as a result of failing to remedy the breaching of such tests.

Behavioural interactions

61. Where a sponsor has on balance sheet exposures to a borrower, or to an entity related to the borrower (e.g. parent or sponsor entity) that is also a borrower of a loan in the CLO sponsored by the reporting institution, possibilities arise for a conflict of interest in how the securitised loan may be restructured if the borrower encounters financial difficulties. As a consequence it would be appropriate for loans within the CLO (if exposure to the CLO is retained) to be aggregated with on-balance sheet exposures to the same or related entities.

In addition, the influence of the commonality of borrower(s) is heightened to the extent cross default provisions exist between the on-balance sheet and securitised exposures.

Connected Client consideration

62. The behavioural and structural features discussed should be incorporated into firm considerations, as to the appropriate level of aggregation required between loans that are on-balance-sheet and loans within the CLO portfolio (where exposure is retained). The aggregation exercise should be performed in cases where:
- 1) a default on a loan within the CLO could cause cross default in respect of on balance sheet facilities; and
 - 2) the firm has other facilities to the borrowers whose loans are in the CLO.

Conclusion

63. Typical CLO issuing vehicles are not likely to be considered connected clients of the sponsor firm, unless the sponsor has historically provided non-contractual support to their CLOs. However, firms should ensure connected client considerations are addressed in any new structures in the CLO market.

Annex 1

List of non-confidential respondents

Association of Financial Markets in Europe

Bank Leumi (UK) plc

Barclays Plc

British Bankers' Association

City of London Law Society

HSBC

Lloyds TSB

Nationwide Building Society

Travers Smith LLP

Appendix 1

Made rules (legal instrument)

**PRUDENTIAL SOURCEBOOK FOR BANKS, BUILDING SOCIETIES AND
INVESTMENT FIRMS (LARGE EXPOSURES) (AMENDMENT)
INSTRUMENT 2012**

Powers exercised

- A. The Financial Services Authority makes this instrument in the exercise of:
- (1) the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
 - (a) section 138 (General rule-making power);
 - (b) section 156 (General supplementary powers);
 - (c) section 157(1) (Guidance); and
 - (2) the other powers and related provisions listed in Schedule 4 (Powers exercised) to the General Provisions of the Handbook.
- B. The rule-making powers referred to above are specified for the purposes of section 153(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on 2 November 2012.

Amendments to the Handbook

- D. The Glossary of definitions is amended in accordance with Annex A to this instrument.
- E. The Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU) is amended in accordance with Annex B to this instrument.

Notes

- F. In Annex B to this instrument, the “notes” (indicated by “**Note:**”) are included for the convenience of readers but do not form part of the legislative text.

Citation

- G. This instrument may be cited as the Prudential Sourcebook for Banks, Building Societies and Investment Firms (Large Exposures) (Amendment) Instrument 2012.

By order of the Board
31 October 2012

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text.

Amend the following definitions as shown.

<i>connected counterparty</i>	(for the purposes of <i>BIPRU 10</i> (Large exposures requirements) and in relation to a <i>firm</i>) has the meaning set out in <i>BIPRU 10.3.8R</i> (Connected counterparties), which is in summary a <i>person</i> to whom the <i>firm</i> has an <i>exposure</i> and who fulfils at least one of the conditions set out in <i>BIPRU 10.3.8R</i> .
<i>group of connected clients</i>	(in accordance with Article 4(45) of the <i>Banking Consolidation Directive</i> (Definitions)) one of the following: <ul style="list-style-type: none"> (a) two or more <i>persons</i> who, unless it is shown otherwise, constitute a single risk because one of them is the <i>parent undertaking</i>, direct or indirect, of the other or others; or (b) two or more <i>persons</i> between whom there is no relationship as set out in (a) but who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, in particular funding or repayment difficulties, the other or all of the others would be likely to encounter funding or repayment difficulties. <u>has the meaning given to it in <i>BIPRU 10.3.5R</i>.</u>
<i>individual counterparty CNCOM</i>	has the meaning in <i>BIPRU 10.10A.8R</i> (How to calculate the concentration risk capital component), which is in summary the sum of a <i>firm's individual CNCOMs</i> with respect to its <i>connected counterparties</i> <u>counterparties</u> falling within <i>BIPRU 10.10A.1R</i> .
<i>large exposure</i>	has the meaning set out in <i>BIPRU 10.5.1R</i> , which in summary is the <i>total exposure</i> of a <i>firm</i> to a <i>counterparty</i> , <i>connected counterparties</i> or a <i>group of connected clients</i> , whether in the <i>firm's non-trading book</i> or <i>trading book</i> or both, <u>and counterparties falling within <i>BIPRU 10.10A.1R</i> within the trading book</u> , which in aggregate equals or exceeds 10% of the <i>firm's capital resources</i> .
<i>total exposure</i>	(in relation to a <i>counterparty</i> or <i>group of connected clients</i> and a <i>person</i> or in relation to a <i>person</i> and its <i>connected counterparties</i> <u><i>counterparties</i></u> falling within <i>BIPRU 10.10A.1R</i>) all that <i>person's exposures</i> to that <i>counterparty</i> or <i>group of connected clients</i> or to that <i>person's</i> <i>connected counterparties</i> <u><i>counterparties</i></u> falling within <i>BIPRU 10.10A.1R</i> , or the total amount of those <i>exposures</i> .

Annex B

Amendments to the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU)

In this Annex, underlining indicates new text and striking through indicates deleted text.

10 Large exposures requirements

10.2 Identification of exposures and recognition of credit risk mitigation

...

The financial collateral comprehensive method

- 10.2.14 R A *firm* which uses the *financial collateral comprehensive method* (but not under the full IRB approach (see *BIPRU* 10.2.10R)) may calculate the value of its *exposures* to a *counterparty* or to a *group of connected clients* ~~or to connected counterparties~~ as being the fully-adjusted value of the *exposures* to the *counterparty* or *group of connected clients* ~~or connected counterparties~~ calculated in accordance with the *financial collateral comprehensive method* under *BIPRU* 5 (Credit risk mitigation) and, if relevant, *BIPRU* 4.10 (The IRB approach: Credit risk mitigation) taking into account the *credit risk mitigation*, volatility adjustments and any maturity mismatch (E*) in accordance with those *rules*.

[Note: *BCD* Article 114(1) first paragraph]

...

Firms using full IRB approach

- 10.2.19 R A *firm* that uses the full IRB approach (see *BIPRU* 10.2.10R) may recognise the effects described in (1) in calculating the value of its *exposures* to a *counterparty* or to a *group of connected clients* ~~or to connected counterparties~~ for the purposes of *BIPRU* 10.5 (Limits on exposures) if:

...

...

10.3 Identification of counterparties

...

Groups of connected clients

- 10.3.5 G ~~The Glossary defines a group of connected clients.~~ A group of connected
R clients means one of the following:

- (1) two or more *persons* who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly, has control over the other or others; or
- (2) two or more *persons* between whom there is no relationship of control as set out in (1) but who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, in particular funding or repayment difficulties, the other or all of the others would be likely to encounter funding or repayment difficulties.

[Note: Article 4(45) of the *Banking Consolidation Directive*]

- 10.3.5A R Control in this context means control as defined in Article 1 of the Seventh Council Directive 83/349/EEC (the *Seventh Company Law Directive*) or a similar relationship between any *person* and an *undertaking*.
- 10.3.5B G Where there is a relationship of control, there is a presumption of single risk unless shown otherwise.
- 10.3.6 G (1) In identifying a *group of connected clients*, a *firm* should consider both third party *clients* and *counterparties* that are, or may be, connected to the *firm* itself.
- (2) Relationships between individual *counterparties* or between the *firm* and a *counterparty* which might be considered to constitute a single risk for the purposes of the definition of *group of connected clients* include:
- (1) *undertakings* in the same *group*;
 (a)
- (2) *companies* whose ultimate owner (whether wholly or significantly) is the same individual or individuals, and which do not have a formal group structure;
 (b)
- (3) *companies* having common directors or management; ~~and~~
 (c)
- (4) *counterparties* linked by cross guarantees where the same *persons* significantly influence the *governing body* of each of the *undertakings*;
 (d)
- (e) where the *firm* has an *exposure* to an *undertaking* that was not incurred for the clear commercial advantage of the *firm* or the *firm's group* and which is not on an arm's length basis;
- (f) *counterparties* linked by cross guarantees;
- (g) where it is likely that the financial problems of one *counterparty* would cause difficulties for the other

counterparty or counterparties in terms of full and timely repayment of liabilities;

- (h) where 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, which may be the firm itself;
- (i) where counterparties rely on the firm for their main funding source, for example through explicit or implicit liquidity support or credit support; and
- (j) where the insolvency or default of one of them is likely to be associated with the insolvency or default of the other(s).

...

Connected counterparties

- 10.3.8 R (1) ~~Subject to (2), for the purposes of BIPRU 10, and in relation to a firm, a connected counterparty means another person ('P') to whom the firm has an exposure and who fulfils at least one of the following conditions:~~
- (a) ~~P is closely related to the firm; or~~
 - (b) ~~P is an associate of the firm; or~~
 - (c) ~~the same persons significantly influence the governing body of P and of the firm; or~~
 - (d) ~~the firm has an exposure to P that was not incurred for the clear commercial advantage of the firm or the firm's group and which is not on an arm's length basis.~~
- (2) ~~Where P is Business Growth Fund plc or another financial institution which makes venture capital investments and the firm is entitled to ignore that financial institution in accordance with GENPRU 2.2.209R(2) for the purposes of determining whether there is a material holding, (1) applies with the following modifications to the definition of associate:~~
- (a) ~~paragraph (3)(c) (community of interest) of that definition does not apply; and~~
 - (b) ~~in applying paragraph (3)(a) (affiliated company) of that definition, paragraph (1)(e) (participating interests) of the definition of group does not apply. [deleted]~~
- 10.3.8A G (1) The Committee of European Banking Supervisors (CEBS) has issued guidelines in relation to the definition of a *group of connected clients*, in particular with reference to the concepts of "control" and

“economic interconnection”. These guidelines can be found at <http://www.c-eps.org/Publications/Standards-Guidelines/CEBS-Guidelines-on-the-revised-large-exposures-reg.aspx- Part I>.

- (2) In applying the CEBS guidelines in relation to counterparties that are connected to the firm itself, the FSA has issued guidance in respect of structured finance vehicles. This guidance can be found at <http://www.fsa.gov.uk/library/policy/policy/2012/12-21.shtml>

Exposures to counterparties, and groups of connected clients ~~and connected counterparties~~

...

- 10.3.11 R ~~A firm’s total exposure to connected counterparties must be calculated by summing its exposures to all the firm’s connected counterparties, including both trading book exposures and non trading book exposures. [deleted]~~

...

Exposures to trustees

...

- 10.3.13 G When considering whether the treatment described in *BIPRU* 10.3.12G is misleading, factors a firm should consider include:

...

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

- 10.3.14 G In deciding whether a transaction is at arm’s length for the purposes of ~~*BIPRU* 10.3.8R(4)~~ *BIPRU* 10.3.6G(2)(f), ~~and *BIPRU* 10.3.13G(4)~~ and *BIPRU* 10.10A.1R(1)(d), the following factors should be taken into account:

...

...

10.5 Limits on exposures

Definition of large exposure

- 10.5.1 R A large exposure of a firm means its total exposure to a counterparty, ~~connected counterparties~~ or a group of connected clients, whether in the firm’s non-trading book or trading book or both, which in aggregate equals or exceeds 10% of the firm’s capital resources.

[Note: BCD Article 108]

...

Large exposure limits

10.5.6 R A *firm* must ensure that the total amount of its *exposures* to the following does not exceed 25% of its *capital resources* (as determined under *BIPRU* 10.5.2R, *BIPRU* 10.5.3R and *BIPRU* 10.5.5R):

- (1) a *counterparty*; or
- (2) a *group of connected clients*; ~~or,~~
- (3) ~~its *connected counterparties*.~~

[Note: BCD Article 111(1) first paragraph]

10.5.7 G ~~If a *connected counterparty* is also a member of a *group of connected clients* the limit in *BIPRU* 10.5.6R covers the aggregate of the total amount of the *firm's exposures* to its *connected counterparties* and of the total amount of its *exposures* to that *group of connected clients*. [deleted]~~

...

10.6 Exemptions

General exemptions

10.6.1 ~~R This section only applies to *exposures*, ~~whether~~ in the *trading book* ~~or~~ and ~~the~~ *non-trading book*, ~~to~~ *counterparties* which are not *connected counterparties*.~~
 G the *non-trading book*, ~~to~~ *counterparties* which are not *connected counterparties*.

...

Institutional exemption

...

10.6.33 G Article 111(4) of the *Banking Consolidation Directive* allows the *FSA* to waive the 100% limit on a case-by-case basis ~~in exceptional circumstances~~. The *FSA* will consider an application for such a *waiver* in the light of the criteria in section 148 of the *Act* (Modification or waiver of rules).

...

10.9A Intra-group exposures: non-core large exposures group

Application

...

- 10.9A.2 G ~~A firm must treat the exposures to its connected counterparties that are not members of its non-core large exposures group as exposures to a single undertaking and must ensure that the total amount of its exposures to such connected counterparties does not exceed the 25% limit in BIPRU 10.5.6R (Large exposure limit) and, if applicable, the trading book limits in BIPRU 10.10A (Connected counterparties: trading book limits). [deleted]~~

...

10.10A ~~Connected counterparties: trading~~ Trading book limits

Application

- 10.10A.1 R This section only applies to *exposures* in a firm's trading book to ~~its connected counterparties~~ counterparties which fulfil the following conditions:
- (1) subject to (2), and in relation to a firm, a counterparty ('P') to whom the firm has an exposure and who fulfils at least one of the following conditions:
 - (a) P is closely related to the firm; or
 - (b) P is an associate of the firm; or
 - (c) the same persons significantly influence the governing body of P and of the firm; or
 - (d) the firm has an exposure to P that was not incurred for the clear commercial advantage of the firm or the firm's group and which is not on an arm's length basis;
 - (2) where P is Business Growth Fund plc or another financial institution which makes venture capital investments and the firm is entitled to ignore that financial institution in accordance with GENPRU 2.2.209R(2) for the purposes of determining whether there is a material holding, (1) applies with the following modifications to the definition of associate:
 - (a) paragraph (3)(c) (community of interest) of that definition does not apply; and
 - (b) in applying paragraph (3)(a) (affiliated company) of that definition, paragraph (1)(e) (participating interests) of the definition of group does not apply.

10.10A.1A G In deciding whether a transaction is at arm's length for the purposes of BIPRU 10.10A.1R(1)(d), the factors set out in BIPRU 10.3.14G should be taken into account.

Trading book limits

10.10.A.2 R *Exposures in a firm's trading book to ~~its connected counterparties~~ counterparties falling within BIPRU 10.10A.1R are exempt from the 25% limit in BIPRU 10.5.6R (large exposures limit) if:*

- (1) the total amount of the *exposures* on the *firm's non-trading book* to ~~its connected counterparties~~ counterparties falling within BIPRU 10.10A.1R does not exceed the limit laid down in that *rule*, calculated with reference to the definition of *capital resources* calculated at stage (N) of the calculation in the *capital resources* table (Total tier one capital plus tier two capital after deductions) as set out in BIPRU 10.5.2R, BIPRU 10.5.3R and BIPRU 10.5.5R, so that the excess arises entirely on the *trading book*; and

...

10.10A.2A G The applicable limit for the purposes of BIPRU 10.10A.2R(1) is the total amount of the *exposures* on the *firm's non-trading book* to *counterparties* falling within BIPRU 10.10A.1R, even though there is no explicit limit to such *counterparties* in BIPRU 10.5.6R (large exposures limit).

10.10A.3 R A *firm* must ensure that the total amount of its *trading book exposures* to its ~~connected counterparties~~ counterparties falling within BIPRU 10.10A.1R does not exceed 500% of the *firm's capital resources* calculated at stage (T) of the *capital resources table* (Total capital after deductions).

...

How to calculate the concentration risk capital component

...

10.10A.6 R An *individual counterparty CNCOM* is the amount a *firm* must calculate in accordance with BIPRU 10.10A.8R with respect to its *exposures* to its ~~connected counterparties~~ counterparties falling within BIPRU 10.10A.1R.

...

10.10A. 8 R A *firm* must calculate its *individual counterparty CNCOM* for its *exposures* to its ~~connected counterparties~~ counterparties falling within BIPRU 10.10A.1R as follows:

...

- (4) a *firm* must allocate (in the order set out in (6)) *trading book exposures* to its ~~*connected counterparties*~~ *counterparties falling within BIPRU 10.10A.1R* to the unutilised portion of the 25% limit of the *firm's capital resources* calculated at stage (T) of the *capital resources table* (Total capital after deductions) remaining after deducting the *non-trading book exposures* in accordance with (3);
- (5) no further *trading book exposures* can be allocated once the 25% limit in (4) has been reached; the remaining *trading book exposures* constitute the *trading book concentration risk excess* with respect to its ~~*connected counterparties*~~ *counterparties falling within BIPRU 10.10A.1R*;

...

...

Transitional provisions and schedules

...

TP 33 Intra-group exposures: Transitional provisions for core UK group and large exposures

...

Effect of this section on intra-group exemptions in BIPRU 10

...

- 33.8 G The effect of *BIPRU* TP 33.7 is that a *firm* should not apply *BIPRU* 10.8A (Intra-group exposures: core UK group) to *BIPRU* 10.9A (Intra-group exposures: exposures outside the core UK group) to some *exposures to core concentration risk group counterparties*, or *non-core concentration risk group counterparties* ~~or *connected counterparties*~~ and this section to others. The purpose of *BIPRU* TP 33.7R is that a *firm* should choose between treating intra-group *exposures* under *BIPRU* 10.8A (Intra-group exposures: core UK group) to *BIPRU* 10.9A (Intra-group exposures: exposures outside the core UK group) and treating them under this section but that it should not mix the approaches.

Appendix 2

Designation of Handbook Provisions

FSA Handbook provisions will be ‘designated’ to create a FCA Handbook and a PRA Handbook on the date that the regulators exercise their legal powers to do so. Please visit our website for further details about this process.

We plan to designate the Handbook Provisions which we are proposing to create and/or amend within this Policy Statement as follows:

Handbook Provision	Designation
BIPRU 10.3.5A R	FCA and PRA
BIPRU 10.3.5B G	FCA and PRA
BIPRU 10.10A.1A G	FCA and PRA
BIPRU 10.10A.2A G	FCA and PRA

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