# BANKING SUPERVISION (LARGE EXPOSURE) RULES AND GUIDANCE, 2021

The Large Exposure Rules, made in accordance with the Banking Supervision (Bailiwick of Guernsey) Law, 2020 ("the Law"), are set out in this document. Guidance, provided by the Guernsey Financial Services Commission ("the Commission") can be found in blue boxes.

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# PART 1 – INTRODUCTION

## 1.1. Application

(1) These Rules replace –

(a) The Large Exposure Policy, 2014;

(2) The Commission may in its absolute discretion, by written notice to a licensee, exclude or modify the application of any provision of these Rules.

(3) The provisions of these Rules do not affect any conditions that may be imposed, in respect to a banking licence, under the Law.

# PART 2 – ADMINISTRATION

## 2.1 Application

(1) This rule applies to licensed entities incorporated within the Bailiwick.

## 2.2 Definition of a large exposure

(1) A large exposure is defined as an exposure to an individual counterparty or a group of connected counterparties that is greater than or equal to 10% of the reporting licensee's net capital base.

> Net capital base, in this context, is the Tier 1 capital figure reported in the quarterly BSL/2 prudential return.

## 2.3 Inclusion in concentration risk policies and procedures

### 2.3.1 General

(1) All licensed entities must have policies and procedures in place which provide a comprehensive view of significant sources of concentration risk. This includes, but is not limited to, credit concentration through exposure to –

(a) single counterparties and groups of connected counterparties, both direct and indirect;

(b) counterparties in the same industry, economic sector or geographic region;

(c) counterparties in the same group or ownership structure;

(d) counterparties whose financial performance is dependent on the same activity or commodity;

(e) off-balance sheet exposures, including guarantees and other commitments; and

(f) market risk and other risk concentrations where a bank is overly exposed to particular asset classes, products, collateral, or currencies.

(2) Risk policies and procedures must –

(a) establish thresholds for acceptable concentrations of risk;

(b) properly reflect risk appetite, profile and capital strength; and

(c) be regularly communicated to, and understood by, relevant staff.

(3) Material concentrations must be regularly reviewed and reported to the Board.

> Exposure via an indirect counterparty would include exposure to collateral or to credit protection provided by a single counterparty.
>
> The Commission expects licensees to particularly closely monitor exposures to collateral or credit protection provided by group entities.
>
> Licensees' information systems should be able to identify and aggregate on a timely basis and facilitate active management of exposures creating risk concentrations and large exposures to single counterparties, or groups of connected counterparties.

### 2.3.2 Large exposure policy

(1) Within the concentration risk policies there must be specific reference to large exposures.

(2) The large exposure policy must –

(a) specify the control systems which give effect to the policy;

(b) detail the method used to monitor the size of the net capital base used to calculate the limits set within the policy; and

(c) detail how the policy is monitored by the Board.

(3) The large exposure policy must be formally accepted by the Board.

(4) Material changes to the large exposure policy must not be implemented without prior discussion with the Commission.

Each licensee may be required to justify to the Commission its policy on exposures to individual counterparties, including the maximum size of an exposure contemplated. Relevant factors which the Commission will expect a licensee to have taken into account when setting its policy and considering the acceptability of particular exposures include, but are not limited to -

- the standing of the counterparty;
- the nature and extent of security taken against the exposure;
- the maturity of the exposure; and
- the licensee's expertise in the particular type of transaction.

### 2.3.3 Related parties

(1) Exposures to companies or persons related to a lending licensee, its managers, directors or controllers are exposures to related parties. Related parties include, but are not limited to –

(a) entities within the same group as the licensee, where 'group' is defined in section 66(1) of the Law;

(b) associated companies as recognised within the accounting standards approved for use by licensees in the Bailiwick;

(c) any other party including subsidiaries, affiliates, or special purpose entities that the licensee exerts control over or that exerts control over the licensee;

(d) holders of supervised roles, within the licensee's structure, their associates and close family members. This does not apply to auditors;

(e) the holders of supervised roles at those companies identified in (a), (b) and (c), their associates and close family members. This does not apply to auditors;

(f) companies with which the persons identified in (d) and (e) are associated;

(g) an employee of the lending licensee who is not a director but who is appointed by the lending licensee to be a director of another company.

(2) Policies and procedures must be in place to –

(a) identify related party exposures;

(b) monitor related party exposures;

(c) report on related party exposures, through an independent credit review or audit process; and

(d) ensure reporting, of exceptions to the policies and procedures either to senior management or to the Board, as appropriate.

(3) Exposures to related parties –

(a) must be approved by the Board;

(b) must be entered into on an arms' length basis; and

(c) must not be undertaken on more favourable terms than corresponding exposures to non-related counterparties.

> If the Commission becomes aware of exposures to companies or persons related to a lending licensee that are of a nature of a capital investment or are made on particularly concessionary terms, it may consider deducting them from the licensee's capital base.

# PART 3 – MEASUREMENT

**3.1 Inclusions**

(1) The gross value of all exposures to a counterparty or groups of connected counterparties must be aggregated for the measurement of a large exposure.

(2) The gross exposure value, prior to the application of any credit risk mitigation or other netting, must be used for the initial identification of a large exposure.

(3) The value of balance sheet exposures must be the accounting value of the exposure.

(4) For the purpose of these Rules, the accounting value of the exposure must include the full value of an advised facility, both drawn and undrawn, whether conditional or unconditional, revocable or irrevocable.

(5) The value of off balance sheet exposures must be the credit equivalent amount calculated as set out in the standardised approach to credit risk[1] as set out in rules or guidance issued by the Commission .

(6) The value of –

(a) interest rate contracts including, but not limited to –

(i) cross currency swaps;

(ii) forward rate agreements; and

(iii) interest rate options purchased;

(b) foreign exchange rate contracts including, but not limited to –

[1] See the BSL/2 Guidance Module 1 Standardised Approach to Credit Risk on the Commission's website.

(i) cross currency swaps;

(ii) forward foreign exchange rate contracts; and

(iii) foreign exchange options purchased; and

(c) other derivative contracts including, but not limited to, commodity and equity derivatives

must be the credit equivalent amount, calculated as set out in the standardised approach to credit risk, as set out in rules and guidance issued by the Commission.

(7) The value of covered bond exposures must be 20% of the nominal value of the bond subject to the following –

(a) the pool of underlying assets assigned to the bond must consist of claims-

(i) on, or guaranteed by, sovereigns, their central banks, public sector entities or multilateral banks;

(ii) secured by mortgages on residential real estate that have a loan-to-value ratio of 80% or lower; and

(iii) secured by commercial real estate with a loan-to-value ratio of 60% or lower;

(b) the nominal value of the pool of assets assigned to the covered bond instrument by its issuer must exceed its nominal outstanding value by at least 10%. The portion above 100% of the bond's nominal outstanding value may include –

(i) cash;

(ii) short term liquid assets; and

(iii) derivatives entered into for the purpose of hedging the risks arising in the covered bond,

in addition to those conditions set out at (a); and

(c) where the above conditions are not met, the value of the covered bond must be the nominal value of the bond.

(8) The measure of exposure, in relation to security underwriting activities –

(a) must not be the nominal amount; and

(b) must be measured and controlled using an approach agreed by the Commission prior to entering into the exposure.

> An exposure is the amount at risk arising from all of a reporting licensee's assets and off-balance sheet items.
>
> Covered bonds are bonds issued by a bank or mortgage institution and are subject to specific legal protection and public supervision designed to protect bond holders. Proceeds deriving from the issue of these bonds must be invested in conformity with the law in assets which, during the whole period of the validity of the bonds, are capable of covering claims attached to the bonds and which, in the event of the failure of the issuer, would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest.
>
> The standardised approach to credit risk defines how banks are required to calculate the amount of capital they need to maintain to back loans they've made and other assets they hold. This is done by weighing each of the bank's assets based on how risky the asset is. The level of risk is based on the likelihood that the counterparty to the loan or asset will default and not be able to pay the bank back. These weightings are defined by the Commission. Capital requirements are then based on the weighted asset values.
>
> In most circumstances, the Commission would expect licensees to measure securities underwriting exposures in line with the capital requirements for market risk in the Basel Framework. However, as stated in this rule, this would be agreed on a case by case basis.

### 3.2 Exclusions

(1) Measurement of exposure must not include –

(a) items deducted from capital base, unless the exposure is 1250% risk weighted;

(b) in the case of foreign exchange transactions, exposures incurred in the ordinary course of settlement during the two working days following payment;

(c) in the case of transactions for the purchase or sale of securities –

(i) exposures incurred in the ordinary course of settlement, during five working days following payment or delivery of the securities, whichever is earlier; or

(ii) where neither counterparty has settled there will be no reportable exposure until 21 days after the due settlement date, after which the replacement cost of the transaction will be considered to be an exposure;

(d) in the case of the provision of money transmission –

(i) the execution of payment services;

(ii) clearing and settlement in any currency;

(iii) correspondent banking and financial instruments clearing;

(iv) settlement and custody services to clients;

(v) delayed receipts in funding and other exposures arising from client activity which do not last longer than the following business day;

(e) segregated margin posted with a Central Counterparty; or

(f) exposures to Qualifying Central Counterparties related to clearing activities, including –

(i) trade exposures; and

(ii) both segregated and non-segregated margin.

For example, an exposure relating to a foreign exchange transaction might occur in the following way: the reporting entity has paid its side of the transaction but has

not received the counter value. Following the two working days such claims would constitute an exposure.

An exposure relating to transactions for the purchase or sale of securities might occur in the following way: payment has been made or securities delivered but the counter value has not yet been received.

Note that a licensee's exposure arising from securities trading operations should be calculated as its net long position in a particular security; a short position in another security should not be used to offset this long position.

Central Counterparties, sometimes referred to as central clearing counterparties, are institutions that provide clearing and settlement services for trades in derivatives, foreign exchange, options and securities. They take on the counterparty credit risk between the two parties to a transaction.

An examples of a central counterparty is LCH.Clearnet.

A qualifying central counterparty is an entity that is licenced and regulated to operate as a central counterparty. The jurisdiction in which it is licenced must regulate it in line with the Committee on Payment and Financial Infrastructure and International Organisation of Securities Commissions' Principles for Financial Market Infrastructures. The Commission must agree, in writing, that the central counterparty meets the above criteria.

Segregated margin are funds or other assets posted as collateral with a central counterparty as part of a derivatives trade or other transaction. It is separated from the central counterparty's own accounts in such way that makes it bankruptcy remote from the central counterparty. This means that it cannot be lost by the bank if the central counterparty were to default. This might include margin that is held by a third-party custodian.

## 3.3 Eligible credit risk mitigation techniques

(1) The gross value of a large exposure may be reduced, resulting in a net exposure, through the use of the credit risk mitigation techniques set out in this rule.

(2) Eligible credit risk mitigation techniques implemented, being –

(a) collateral;

(b) on balance sheet netting;

(c) guarantees; and

(d) credit derivatives,

must meet all criteria, under the standardised approach to credit risk, as set out in rules and guidance issued by the Commission in addition to those set out in these Rules.

(3) Where a licensed entity uses a credit risk mitigation technique when applying the standardised approach to credit risk to an exposure, it must apply the same technique to that exposure for large exposure purposes.

(4) When using the simple approach to credit risk mitigation[2], the amount by which the gross value of a large exposure is reduced by must be the value of credit protection as defined under the standardised approach to credit risk.

(5) When using the comprehensive approach to credit risk mitigation[3], the amount by which the gross value of a large exposure is reduced by must be the value of the collateral after the application of the standard statutory haircuts required under the standardised approach to credit risk.

(6) Only collateral that has been assigned a standard supervisory haircut under the comprehensive approach to credit risk mitigation may be used for large exposure purposes, regardless of whether the licensed entity uses the simple or comprehensive approach.

(7) If an exposure, or portion of an exposure, is mitigated by an eligible credit risk mitigation technique, the licensee must recognize an exposure to the provider of that credit risk mitigation which should be aggregated with other exposures to that counterparty as normal for large exposure purposes and the value of the exposure to the credit risk mitigation provider must be the amount by which the value of the initial exposure is reduced.

Banks can use credit risk mitigation techniques to reduce the value of an exposure for capital purposes, as discussed earlier. Under the standardised approach to credit risk, banks can use either the simple approach to credit risk mitigation or the comprehensive approach.

Banks must use the same technique when reducing the value of a large exposure.

[2] See the BSL/2 Guidance Module 1 Standardised Approach to Credit Risk on the Commission's website.
[3] See the BSL/2 Guidance Module 1 Standardised Approach to Credit Risk on the Commission's website.

The simple approach to credit risk mitigation operates on the basis of the substitution of risk weights. For example, if a bank made a loan to a counterparty, they would use the risk weight appropriate to that counterparty. If that counterparty provided the bank with a guarantee from a third party or some cooperate bonds as collateral, the bank could then use the risk weighting of that third party or corporate instead.

Under the comprehensive approach to credit risk mitigation, before the weighting is applied the value of the exposure is reduced by the value of the collateral. However, the value of the collateral is first reduced by the application of various haircuts. The haircuts banks must use are defined by the Commission.

Rule 3.3(3) means that if a licensed entity uses government bonds to reduce the risk weighted value of an exposure under the standardised approach to credit risk, it must also apply the same bonds when reducing the value of the exposure under the large exposure rules.

Guarantees include unfunded participation agreements.

### 3.3.1 Eligible credit risk mitigation techniques - Funded sub-participation agreements

(1) For a funded sub-participation agreement to be eligible, as a method for the reduction of the net value of the exposure, there must be no possibility of the participated portion of the exposure returning to the balance sheet.

Other methods of reducing the value of an exposure are permitted for exposures to specific types of counterparty. These methods are set out in the relevant sections.

# PART 4 – IDENTIFICATION OF A COUNTERPARTY

**4.1 Transactions relating to persons**

(1) For the purposes of this rule, a transaction relates to a person if it is a transaction under which –

(a) that person incurs an obligation to the licensee or, as a result of which, may incur such an obligation;

(b) the licensee will incur, or as a result of which it may incur, an obligation in the event of that person defaulting on an obligation to a third party; or

(c) the licensee acquires, or incurs an obligation to acquire, an asset the value of which depends wholly or mainly on that person performing their obligations, or otherwise on their financial soundness;

and where the risk of loss attributable to the transaction is the risk of the person concerned defaulting on the obligation.

> The identity of a counterparty will normally be the borrower, the person on whose behalf a guarantee has been issued by the licensee, the issuer of a security in the case of a security held, or the party with whom a contract was made in the case of a derivatives contract.

**4.2 Exposures to groups of connected counterparties**

(1) Exposures to groups of connected counterparties must be aggregated for large exposure purposes.

(2) A single exposure limit will apply to the aggregated exposure to a group of connected counterparties.

Groups of connected counterparties are those counterparties that are connected in such a way that the financial soundness of any of them affects the financial soundness of the other, or the same factors may affect the financial soundness of them all.

For example, if a bank has an exposure to Client A, and a separate exposure to Client B, where Client A and B are connected counterparties, the relevant exposure limit will apply to the sum of the exposures.

For the purposes of the Large Exposure Rules, the Commission considers that the following types of connection would lead to the financial soundness of one counterparty affecting the financial soundness of another –

- Control relationship – one of the counterparties, directly or indirectly, is able to exercise control over the others;
- Economic interdependence – if one of the counterparties were to experience financial difficulties then the other counterparties, as a result, would be likely to experience financial difficulties.

Schedule 3 sets out further guidance on how licensees should assess control and economic interdependence.

### 4.3 Exposures to collective investment schemes, securitisation vehicles and other structures

(1) Where the exposure is to structures such as collective investment schemes and securitisation vehicles, the licensed entity must look through the structure and recognise exposures to the underlying assets. This does not apply where the licensed entity can demonstrate that exposure to each underlying asset is less than 0.25% of net capital base.

# PART 5 – EXPOSURE LIMITS

## 5.1 Exposures to group entities

(1) A licensee must not incur net exposures to group entities which, in aggregate, exceed 100% of net capital base.

(2) A licensee may enter into exposures with group entities without further notification to the Commission provided that the aggregate exposure is within the exposure limit.

(3) All on balance sheet exposures to group entities that are not subject to eligible credit risk mitigation techniques must have a maximum maturity of no more than six months.

(4) The exposure limit includes all types of exposure, both off and on balance sheet, to another entity within the licensee's group.

(5) A licensee may use eligible credit risk mitigation techniques, in accordance with rule 3.3, to reduce the net value of an exposure for the purposes of the exposure limit.

(6) Where a bank within the same group as the licensee provides a guarantee, funded sub-participation agreement or unfunded risk participation agreement, in support of a client loan, the value of the guarantee or participation agreement should not be included in the exposure limit.

(7) A licensee may treat a security interest in another group entity's mortgage book as acceptable financial collateral, in accordance with rule 3.3.1, provided they meet the 'Requirements for recognition of collateral' at Schedule 1.

> The Commission has set an exposure limit in respect of the aggregate exposures to the parent bank and other entities within the parental group ('the upstreaming limit').
>
> The Commission would expect licensees to closely monitor their exposures to group entities created by guarantees provided to support client lending under subsection

(5). Should the concentration risk created by these exposures exceed a prudent level, the Commission may consider taking measures to reduce or prevent further increases in risk.

The Commission may consider exceptions to the upstreaming limit but approval for this needs to be requested, in advance, from the Commission and is only likely to be granted in unusual circumstances .

For example, the Commission may consider excluding a particular exposure, a particular type of exposure or exposures to a particular counterparty from the upstreaming limit if the counterparty's asset base is sufficiently high quality.

Rule 5.1(7) is intended to enable licensees to fund another group entity's mortgage lending, provided it has a direct claim on the underlying security.

The Commission would not expect licensees to take as security mortgages that would not meet their own internal credit quality requirements.

The Commission reserves the right to reduce the upstreaming limit at any point if it appears that this would be desirable for the protection of the reporting licensee's net capital base and for the protection of depositors.

**5.2 Exposures to third parties**

(1) A licensee must not incur net exposures to a third party client or groups of connected third party clients which, in aggregate, exceed 25% of net capital base.

(2) A licensee must not incur net exposures to a third party bank or groups of connected third party banks which, in aggregate, exceed 50% of net capital base.

(3) A licensee must not incur exposures which exceed 10% of net capital base to clients or groups of connected clients which in aggregate exceed 800% of the net capital base without the prior agreement of the Commission.

(4) The large exposure limit, in relation to exposures to third parties, includes all types of exposure both on and off balance sheet.

(5) A licensee may use eligible credit risk mitigation techniques, under rule 3.3, to reduce the net value of an exposure to a third party.

(6) The gross value of all exposures to a non-bank third party, client or group of connected third party clients must not exceed 100% of net capital base, regardless of the use of eligible credit risk mitigation techniques.

Third parties includes banks, individual clients and groups of connected counterparties. It excludes sovereigns and entities within the same group as the licensee.

In rule 5.2(1), (3) and (6), client refers to a third party that is not a bank.

The Commission may consider exceptions to the large exposure limit but approval for this needs to be requested, in advance, from the Commission and is only likely to be granted in unusual circumstances.

**5.3 Exposures to sovereigns**

(1) Exposures to the following will not be subject to any limit –

(a) the States of Guernsey;

(b) the Governments of Jersey and the Isle of Man;

(c) multilateral development banks as listed in the Commission's Guidance Notes for completion of the BSL/2 return; and

(d) all other sovereigns.

'Sovereign' includes sovereign governments, central banks, rated supranational authorities (e.g. the European Bank for Reconstruction and Development) and those government agencies that have an unconditional guarantee from a sovereign government (e.g. GNMA or 'Ginnie Mae').

The Commission may also be willing to consider, as sovereign exposures, some exposures to sovereign government sponsored enterprises. These enterprises do not have the 'full faith and credit' of the underlying government however and they will not be subject to the exposure limits set out in this rule. Instead the Commission will discuss exposures to government sponsored entities on a case by case basis and in advance of any exposure being entered into. Such enterprises include FHLMC ('Freddie Mac'), FNMA ('Fannie Mae') and SLMC ('Sallie Mae').

# PART 6 – LARGE EXPOSURE REPORTING REGIME

### 6.1 Prior notification

(1) Prior notification of large exposures must be made to the Commission in cases where, either alone or together with other existing exposures to the same counterparty or group of connected counterparties, an exposure exceeds 25% of net capital base before the application of eligible credit risk management techniques.

(2) Increases in an exposure, which are beyond that which the Commission already has notice of, must be notified to the Commission, in writing, prior to entering into the increase.

(3) The Commission must be notified when an exposure, which has been previously notified to the Commission, is repaid in full.

(4) This rule does not apply to large exposures made to –

(a) group entities;

(b) third party banks; or

(c) sovereigns.

Where a proposed transaction with one of the excluded counterparties (group entities, third party banks or sovereigns) will result in an exposure which represents a significant departure from the licensee's statement of policy on its large exposures, as submitted to the Commission, the Commission will expect the proposed transaction to be discussed with it in advance of the licensee entering into the exposure.

All notifications to the Commission, under this rule, should be made by letter and submitted on the Commission's Online Submissions Portal. Guidance on the detail to be included can be found at Schedule 2.

For some exposures the Commission may request further information. This may include, but is not limited to –

- signed extracts from Group Credit and/or Risk Committee minutes;
- copies of agreements supporting credit risk mitigation techniques; and
- evidence that any credit risk mitigation techniques used are legally enforceable.

The Commission will acknowledge the exposure and provide a unique 'large exposure number' which must be used to report the exposure on the subsequent BSL/2 returns.

Please note that this is a notification regime and not an approval regime. The decision to enter into any exposure, large or small, is a matter for the commercial judgment of the management of the licensee.

Acknowledgement of notification, from the Commission, should not be regarded as permission or approval.

### 6.2 Quarterly notification of exposures – licensed entities incorporated in the Bailiwick

(1) Entities incorporated in the Bailiwick must report on large exposures on a quarterly basis.

(2) In the case of parent and group entities all exposures, regardless of size, must be reported. In all other cases all exposures of 10% of net capital base and over must be reported.

(3) Where an exposure is excluded from an exposure limit it must still be included in the quarterly report.

Separate spreadsheets within the BSL/2 are available for the reporting of –

- exposures to group entities;
- exposures to third party banks;
- exposures to sovereigns; and
- exposures to clients or groups of connected clients.

### 6.3 Quarterly notification of exposures – licensed entities incorporated outside the Bailiwick

(1) Branches must report on the –

(a) ten largest market loans; and

(b) ten largest credit exposures

on a quarterly basis.

> Market Loans – may be to a parent or group entity or to a third party bank.
>
> Returns will be made using BSL/2.

### 6.4 Breaches of limits

(1) Any breach in large exposure limits must be reported, in writing, to the Commission immediately after the entity becomes aware of the breach.

(2) Where a licensee exceeds a bank large exposure limit, it shall not be regarded as a breach of these Rules, subject to the following conditions –

(a) any excess above the large exposure limit is cleared within three working days;

(b) the licensee notifies the Commission of all such excesses on a quarterly basis; and

(c) such excesses only occur occasionally.

> A breach will be deemed to have occurred if there was a –
>
> - breach of an exposure limit;
> - breach of an exposure limit caused by the change in value of the collateral used for credit risk mitigation purposes;

- failure to conform to the credit risk mitigation requirements for exposures in excess of 25% of net capital base.

In rule 6.4(2) “bank” refers to both third party banks and group banks.

The quarterly notification of excesses required by rule 6.4(2)(b) should be completed via the BSL/2 return.

Licensees are asked to pay particular attention to the effect of any proposed reduction in net capital base, such as the proposed payment of a dividend, in order to ensure that exposure limits are not inadvertently breached by such a reduction.

**Further guidance on the Commission’s powers**

The Commission may require any relevant subsidiary to make such arrangements that may appear to be desirable for the protection of the licensee’s net capital base. This power flows from section 26(6) of the Law and would normally be used in cases where the Commission considers a licensee to be exposed to particular concentration of risk.

The arrangements will differ depending on the circumstances.

For example, the Commission –

- may require a locally incorporated entity to maintain higher capital ratios than would otherwise be the case;
- may impose a lower upstreaming limit;
- and would have regard to –
    - the acceptability of the exposures, when considered in the context of the licensee’s large exposures policy;
    - the particular characteristics of the individual licensee, including the nature of the business and the experience of its management; and
    - the number of such exposures, their individual size, and nature.

# PART 7 – GENERAL PROVISION

## 7.1 Interpretation

(1) In these Rules terms have their ordinary meaning unless specifically defined in the Law or in these Rules.

(2) In these Rules the following definitions should be followed -

**"central counterparties"** are financial institutions that provide clearing and settlement services for trades in financial instruments;

**"control relationship"** indicates the counterparty who, directly or indirectly, is able to exercise control over the others;

**"economic interdependence"** means the situation where, if one of the counterparties were to experience financial difficulties then the other counterparties would be likely to suffer consequential financial difficulties;

**"groups of connected counterparties"** are those counterparties connected through control relationships and/or economic interdependence;

**"net capital"** means the Tier 1 capital figure reported in the quarterly BSL/2 prudential return;

**"qualifying central counterparties"** are central counterparties that the Commission has agreed, in writing, meet the following criteria –

(a) they are licensed and regulated to act as a central counterparty; and

(b) they are regulated in line with the Committee on Payment and Financial Infrastructure and International Organisation of Securities Commissions' Principles for Financial Market Infrastructures;

**"segregated margin"** refers to funds or other assets posted as collateral with a central counterparty as part of a derivatives trade or other transaction. It is separated from the central counterparty's own accounts in such a way that it cannot be lost by the licensed entity if the central counterparty defaults.

(3) The Interpretation and Standard Provisions (Bailiwick of Guernsey) Law, 2016[4] applies to the interpretation of these rules.

(4) A reference in these rules to an enactment should be taken to include any amendments, re-enactments (with or without modification), extensions and applications.

[4] Order in Council No. V of 2018, as amended.

# PART 8 – TRANSITIONAL ARRANGEMENTS, CITATION AND COMMENCEMENT

## 8.1. Transitional arrangements

(1) Entities required to follow these Rules must ensure that they are fully compliant with these Rules within twelve months of the date on which they come into force.

## 8.2. Citation and commencement

(1) These rules made shall come into operation on 1st November 2021 and may be cited as the Large Exposure Rules 2021.

# SCHEDULE 1

## REQUIREMENTS FOR RECOGNITION OF COLLATERAL

### General requirements of legal certainty

(1) In order for banks to obtain the benefit from any use of Credit Risk Mitigation techniques the following, minimum, standard for legal documentation must be met –

(a) all documentation used in collateral transactions, and for documenting balance sheet netting, guarantees and credit derivatives, must be binding on all parties and legally enforceable in all relevant jurisdictions; and

(b) banks must have conducted sufficient legal review to verify this, have a well-founded legal basis to reach this conclusion and undertake such further review as necessary to ensure continuing enforceability.

(2) In addition to the general requirement for legal certainty set out above, the legal mechanism by which collateral is pledged or transferred must ensure that the bank has the right to liquidate or take legal possession of it, in a timely manner, in the event of –

(a) the default;

(b) insolvency;

(c) bankruptcy; or

(d) one or more otherwise defined credit events set out in the transaction documentation, of the counterparty and, where applicable, of the custodian holding the collateral.

Furthermore, banks must take all steps necessary to fulfil those requirements under the law applicable to the bank's interest in the collateral to obtain and maintain an enforceable security interest.

| Steps taken could include registering the interest with a registrar, or exercising a right to net or set-off. |
| --- |

(3) In order for collateral to provide protection, the credit quality of the counterparty and the value of the collateral must not have a material positive correlation.

> For example, securities issued by the counterparty – or by any related group entity – would provide little protection and so would be ineligible.

(4) Banks must have clear and robust procedures for the timely liquidation of collateral to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed, and that collateral can be liquidated promptly.

(5) Where the collateral is held by a custodian, banks must take reasonable steps to ensure that the custodian segregates the collateral from its own assets.

# SCHEDULE 2

## NEW CLIENT LARGE EXPOSURE NOTIFICATION

When a bank proposes to enter into an exposure which, either alone or together with other existing exposures to the same client or group of connected clients, exceeds 25% of net capital base, details must be notified to the Commission before the bank becomes committed to the exposure.

A notification letter from the bank to the Commission must contain as much of the following details as applicable.

**Basic details**

| | |
|---|---|
| **Client name** | The name of the client counterparty. |
| **Amount of new facility** | The maximum amount that may be drawn under the new facility and the currency of the facility.<br><br>If the loan is to be made available in tranches, provide details.<br><br>If the loan is to be subject to a sub-participation agreement, please report the gross amount of the facility to the client (i.e. ignoring the effect of any sub-participation). |
| **Type of facility** | For example, mortgage, overdraft, temporary loan, etc. |
| **Term of facility** | State the term of the facility and the maturity date for the exposure.<br><br>If the facility is a rolling facility or a revolving credit facility, provide details. |
| **Date of anticipated drawdown** | The earliest date on which the client is expected to draw down some or all of the facility. |
| **Purpose of facility** | Provide as much detail as possible on the purpose of the facility. |
| **Valuation (property only)** | Where the exposure involves property give the date and the amount of the most recent professional valuation of the property. |
| **Loan to Value** | Give the loan to value of the asset, where applicable. |
| **Credit Risk Mitigation** | Give the type and value of the credit risk mitigation, its currency and its location.<br><br>If the collateral is encumbered in any way, provide details. |
| **Details of any sub-participation agreement** | If the loan is subject to a sub-participation agreement provide details of the participating entities, the nature of the agreement, the amount that will be sub-participated, and the exposure |

| | |
|---|---|
| | remaining on the balance sheet of the bank net of a sub-participated amount.<br><br>Provide an explanation of how the Board has satisfied itself that there is no possibility of the credit risk covered, by the sub-participation agreement, returning to the balance sheet of the bank. |
| **Net capital base in GBP** | Unless the capital has changed, give the net capital base of the bank as reported in the most recent BSL/2 quarterly prudential report. |
| **% of net capital base this new facility represents** | State the % of net capital base that this new facility represents. |

Examples of collateral entries include –

- Cash to the value of GBP 1,500,000 held in custody by the bank;
- US Treasury Bills to the value of USD 500,000 pledged to the bank under a security interest agreement, and cash to the value of USD 250,000 held in custody at the bank;
- Parental guarantee to the value of GBP 5,000,000.

**Other exposures to the client/group of clients**

If there are multiple exposures that are already held in a separate spreadsheet, supply a copy of this sheet. The information must include the following –

| | |
|---|---|
| **Details of existing exposure to this client** | Provide details of all other exposures to this client, including –<br>• Large Exposure number (where applicable);<br>• Amount of facility;<br>• Term of facility;<br>• Collateral held;<br>• Purpose of facility. |
| **Aggregate value of all exposures to this client** | Provide the aggregate value of all exposures to this client, to include all existing exposures, however small, and the new facility which is the subject of this notification. |
| **% of net capital base this aggregate exposure represents** | Please state the % of net capital base that this aggregate exposure, including the new facility, represents. |
| **Connected party details** | If this client is connected to other parties to which the bank already has an exposure, provide details of –<br>• The parties;<br>• The nature of the connection; and |

| | |
|---|---|
| | • The exposure to those clients, including the amount, term, and type of the exposure and the associated collateral. |

**Risk Assessment**

Identify the highest level at which the exposure has been sanctioned.

| Examples include - individual lending officer, Guernsey Credit Committee, Group Credit Committee, Group Risk Committee, Group Chief Risk Officer, etc. |
|---|

# SCHEDULE 3

## GROUPS OF CONNECTED COUNTERPARTIES

**“Control”**

(1) Interpretation of “control” in the definition of a group of connected counterparties -

(a) Control refers to the relationship between a parent undertaking and a subsidiary, or a similar relationship between any natural or legal person and an undertaking.

(b) Control will be presumed to exist when the counterparty owns directly, or indirectly through subsidiaries, more than half of the capital or voting power of an entity, unless in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control.

(c) A counterparty owning 50% of the shares/voting power of another counterparty may be able to exercise one or more of the powers mentioned below. This can also occur where two equal partners/owners share the power and govern the entity jointly.

(d) Control can also exist when the counterparty owns less than half of the voting power or does not hold any participating interest in the entity at all. In those cases the institution should refer to indicators of control that can be seen when the counterparty is able to exercise one or more of these powers.

(e) In respect of control, the Commission would expect that, where any of the examples at (2) exist, in order NOT to consider the counterparties to be connected counterparties, the bank should be able to document that what seems to be a control relationship truly is not. It is not relevant whether the counterparty does or does not exercise control; it is the ability to do so that is the key. Voluntary self-imposed limitations by a counterparty, on the exercise of control, such as legal ring-fencing or statements of a similar nature, would not suffice as valid documentation.

(2) Powers which are indicators of control

The power to -

(a) direct the activities of the undertaking so as to obtain benefits from its activities;

(b) decide on crucial transactions;

(c) govern the financial or operating policies of the undertaking;

(d) appoint or remove the majority of directors, the supervisory board, members of the board of directors or equivalent governing body of the undertaking, where control is exercised by that board or body;

(e) cast the majority of votes at meetings of boards of directors, general assembly or other governing body of the undertaking, where control is exercised by that board or body; and

(f) co-ordinate the management of an undertaking with that of other undertakings in pursuit of a common objective, i.e. where the same natural persons are involved in the management or board of two or more undertakings.

**Economic "interconnectedness"**

(3) Interpretation of economic "interconnectedness" in a group of connected counterparties -

(a) Two or more natural or legal persons between whom there is no relationship of control 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.

(b) If a bank can evidence that one counterparty would be able to experience funding or repayment difficulties without the other counterparty also facing funding or repayment difficulties, then there is no requirement to consider such counterparties to be interconnected.

Sharing the same trustee or investment manager does not automatically connect two counterparties.

Examples of economic dependencies that a counterparty may not be able to overcome without experiencing repayment difficulties can include –

- 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 (e.g., the owner of a residential/commercial property and the tenant who pays a significant part of the rent);

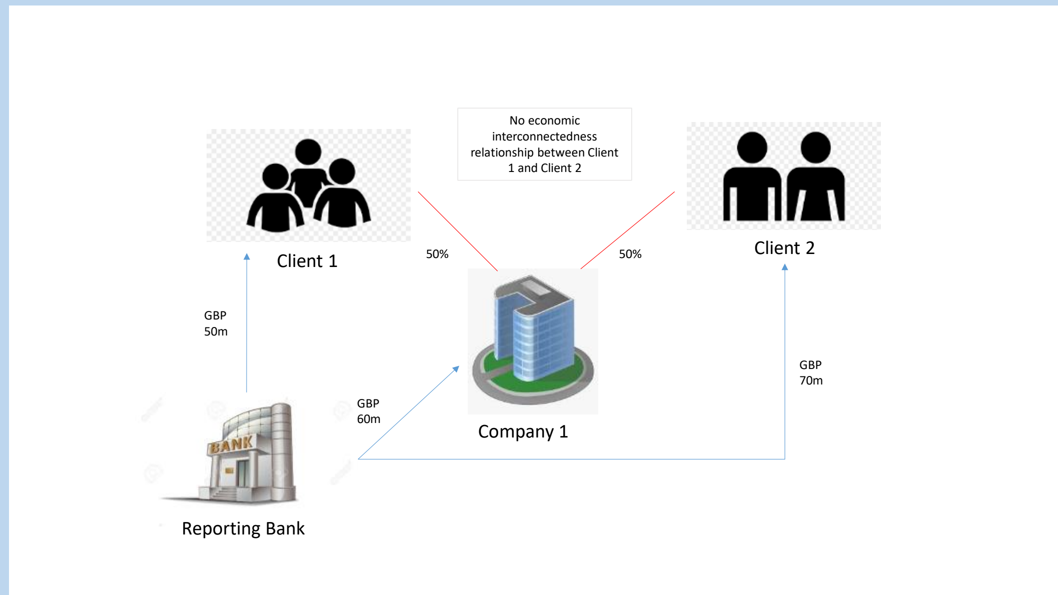
- Where one counterparty has fully or partly guaranteed the exposure of the other counterparty, or is liable by other means;
- Where a significant part of one counterparty's production/output is sold to another counterparty, which cannot easily be replaced by other customers;
- When the expected source of funds to repay the loans of both counterparties is the same and neither counterparty has another independent source of income from which the loan may be serviced and 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 others;
- 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.

**Reporting exposures with connected counterparties**

(5) In respect of reporting an exposure to an entity that has multiple beneficial owners, the reporting depends of whether the exposure is to the entity alone, in which case it is a single exposure to that company, or whether there are other exposures to the beneficial owners of that company.

These two examples deal with exposures to a company and to one or more of its beneficial owners.

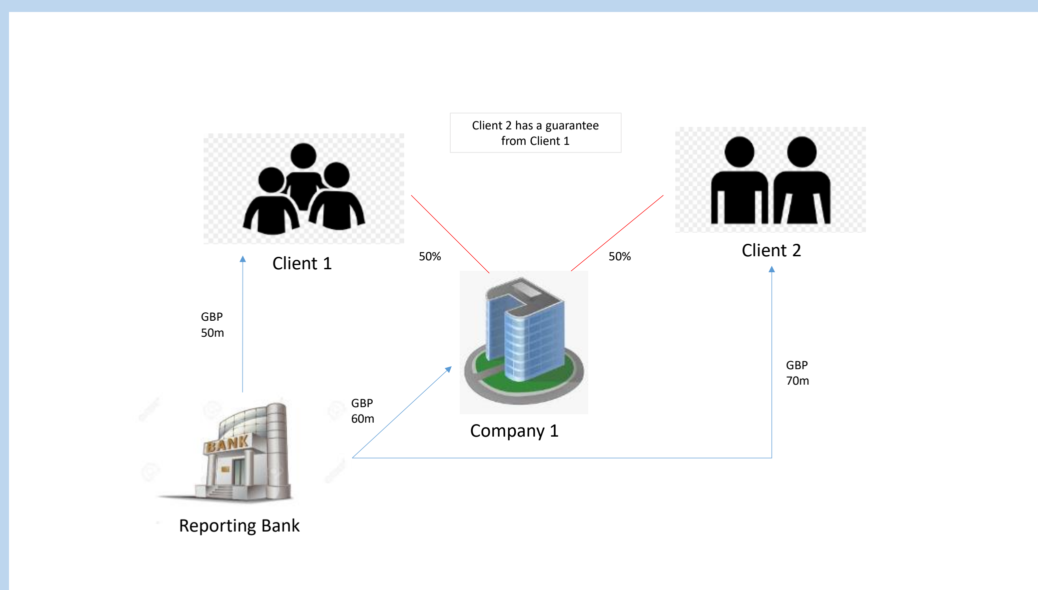
*Figure 1*




Using the figure above, consider the following example –

- The bank is asked to loan £60m to Company 1. This is Loan 01.
- Two months later one of the shareholders, Client 1 who has a 50% shareholding in Company 1, asks for a loan for £50m for personal use. Since there is a control relationship between Client 1 and Company 1, these clients are connected. Loan 01 increases to £110m. Note that although Client 1 owns only half of Company 1, prudence dictates that the whole amount of the loan to Company 1 should be included in Loan 01.
- Six months later, the other shareholder, Client 2 asks the bank for a loan of £70m, also for personal use. He is unconnected to Client 1, other than through ownership of Company 1, and there is no economic dependence between them.
- The control relationship between Client 2 and Company 1 makes them connected clients, but the lack of any other link to Client 1 means that this connection can be treated separately. This is Loan 02 with a value of £130m.
- This logic can be applied to multiple shareholders, provided that there is no economic dependence between them (i.e. the only link between the individuals is that they have shares in the same company).

*Figure 2*




In this example, there is economic interconnectedness between the shareholders. The reporting would be as follows –

- The bank is asked to loan £60m to Company 1. This is Loan 01.
- Two months later one of the shareholders, Client 1 asks for a loan for £50m for personal use. Since there is a control relationship between Client 1 and Company 1, these clients are connected. Loan 01 increases to £110m. Note that although Client 1 owns only half of Company 1, prudence dictates that the whole amount of the loan to Company 1 should be included in Loan 01.
- Six months later, the other shareholder, Client 2 asks the bank for a loan of £70m, also for personal use. As collateral for the loan, he presents a guarantee from Client 1.
- The guarantee establishes an economic dependence; Client 1 and Client 2 are connected not only indirectly from their ownership of Company 1, but also directly by the guarantee. It is now prudent to consider the loan to Company 1 and the two exposures to Client 1 and Client 2 to be connected. Hiving off Client 2 and his ownership of Company 1 into a separate exposure is no longer appropriate.
- Loan 01 becomes £180m.

Assume that there is third shareholder who now comes along and asks for a loan of £25m for personal use. If this person has an economic dependency with either Client 1 or Client 2, then the amount of his exposure will also need to be included in Loan 01, which would now make it £205m. If, however, his only connection to Client 1 and Client 2 is through ownership of Company 1, then he can be hived off into a separate exposure, which would have a value of £85m.