

CP12/1^{**}

Financial Services Authority

Large Exposures Regime

Groups of Connected Clients
and Connected Counterparties

Contents

	Abbreviations used in this paper	3
1	Overview	5
2	Policy proposals	10
3	Guidance for the treatment of structured finance vehicles	14
Annex 1:	Guidance for the treatment of exposures to structured finance vehicles	
Annex 2:	Cost benefit analysis	
Annex 3:	Compatibility statement	
Annex 4:	List of questions	
Appendix 1:	Draft Handbook text	

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 26 April 2012.

Comments may be sent by electronic submission using the form on the FSA's website at: www.fsa.gov.uk/Pages/Library/Policy/CP/2012/cp12_01_response.shtml.

Alternatively, please send comments in writing to:

Lynnette Withfield
Cross Sectoral Prudential Policy
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Email: cp12_01@fsa.gov.uk

It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an email message will not be regarded as a request for non-disclosure.

A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

Copies of this Consultation Paper 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
CB	Covered Bond
CC	Connected client
CEBS	Committee of European Banking Supervisors (now the European Banking Authority)
CRD	Capital Requirements Directive
GCC	Group of Connected Clients
LE	Large exposures
MT	Master Trusts
SPE	Special Purpose Entity
SPV	Special Purpose Vehicle

1

Overview

Introduction

1.1 This Consultation Paper has three aims:

- To propose rule changes to:
 - the FSA Handbook definition of Connected Counterparties; and
 - the basis for aggregating exposures to Connected Counterparties when applying large exposure (LE) limits.
- To propose new guidance on the treatment of LE to structured finance vehicles. This guidance builds on the Committee of European Banking Supervisors (CEBS) guidelines on the implementation of the revised LE regime published in December 2009.¹ We aim to provide additional clarity on how exposures to structured finance vehicles, such as asset backed commercial paper (ABCP) conduits, credit card and mortgage master trusts (MT), covered bonds (CB), commercial mortgage backed securities (CMBS), collateralised loan obligations (CLO) and certain other standalone securitisation vehicles should be aggregated under the LE regime.
- To propose a change to the Handbook guidance in BIPRU 10.6.33G on the institutional exemption.

Background

- 1.2 The current LE regime applies a non-risk-sensitive regulatory backstop to a firm's exposures to counterparties, a group of connected clients and its connected counterparties.
- 1.3 Applying a non-risk-sensitive limit should address the impact of an unforeseen event risk which leads to the default of an exposure. This backstop limit seeks to reduce the likelihood of a debtor defaulting, leading to the failure of the regulated firm. Since firms do not bear

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

the full cost of their default, they do not have the optimal incentives to reduce this likelihood, which is the market failure the LE regime aims to address. Also, if a debtor's default leads to the regulated firm failing, the LE limit increases the likelihood of recoveries for UK consumers in insolvency.

- 1.4** A LE of a firm is its total exposure to a counterparty, connected counterparties or groups of connected clients, which in aggregate equals or exceeds 10% of the firm's capital resources. A firm must ensure that the total amount of its exposures to a counterparty, or a group of connected clients or its connected counterparties does not exceed 25% of its capital resources.
- 1.5** In accordance with Article 4(45) of the Banking Consolidation Directive (Definitions), a group of connected clients is:
- a) 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
 - b) two or more persons between whom there is no relationship of control 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.
- 1.6** In January 2007, in addition to implementing the concept of group of connected clients in the Handbook, the Directive definition of a 'group of connected clients' was implemented in a wider sense in BIPRU 10.3.8R (Connected Counterparties) to include counterparties connected to the firm. The definition goes beyond a narrow interpretation of the Directive definition and has the unintended consequence of connecting entities without a single risk between them being established. Furthermore, the aggregation applied to these connected counterparties is stricter than is required under the Directive. We propose to address this super-equivalence in this paper.
- 1.7** The CEBS guidelines consider two aspects of the LE regime: a) the Directive definition of group of connected clients (in particular, what constitutes control and economic interconnection for the purposes of that definition) and b) treatment of investments in schemes with exposures to underlying assets. This Consultation Paper only references the first aspect of the CEBS guidelines.
- 1.8** In this Consultation Paper, we consult on our approach to the CEBS guidelines in terms of identifying groups of connected clients, specifically in relation to a firm's exposure to structured finance vehicles.

Summary of proposals

- 1.9** We propose to delete BIPRU 10.3.8R (Connected Counterparties) and instead introduce Handbook guidance that firms should, when assessing groups of connected clients, consider both third-party clients and counterparties that are connected to the firm itself.
- 1.10** The additional guidance on identifying relationships that might constitute single risk for the purposes of the definition of ‘group of connected clients’ would include the following as examples of such relationships:
- i) where the same persons significantly influence the governing body of each of the undertakings;
 - ii) 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 is not on an ‘arm’s length’ basis;
 - iii) where it is likely that the financial problems of one counterparty would cause difficulties for the other(s) in terms of the full and timely repayment of liabilities;
 - iv) 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);
 - v) where counterparties rely on the firm for their main funding source, for example through explicit or implicit liquidity support or credit support; and
 - vi) where the insolvency or default of one of them is likely to be associated with the insolvency or default of the other(s).
- 1.11** We also propose to change the basis of the aggregation of counterparties connected to the firm, so that firms apply the 25% LE limit to groups of entities where there is the presence of single risk between them and, as such, remove the automatic aggregation of exposures to all counterparties connected to the firm.
- 1.12** We propose to introduce decision trees and a guidance paper that sets out how firms should determine if their structured finance vehicles form groups of connected clients due to their economic interconnection(s) with the reporting firm. This guidance is based on the typical features and the most prevalent forms of structured finance vehicles for which firms act as originator or sponsor.
- 1.13** By applying the vehicle specific decision trees, we determine that firm sponsored **ABCP conduits**, for both own-asset originated and third-party asset vehicles, are typically connected to each other due to their single risk with the reporting firm. This is because these vehicles all rely on the firm’s explicit and implicit credit and liquidity support for their own financial stability. Funding problems of one vehicle are therefore likely to spread to the other(s) due to this shared economic dependence on the firm.

- 1.14** Structures such as Residential Mortgage Backed Securities (RMBS) Master Trusts, Covered Bond Limited Liability Partnership (LLP) vehicles, stand-alone (discrete, non-revolving) RMBS issuing vehicles, Commercial Mortgage Backed Securities (CMBS) issuing vehicles, Credit Card Master Trusts and Collateralised Loan Obligation (CLO) issuers (in their typical format and in the typical context of the vehicle's relationship to the firm) are not considered to be automatically connected to the firm. However, in the case of both stand-alone RMBS and RMBS Master Trusts, there is a higher probability that the vehicle could be considered connected to the firm than with the other types of vehicle, so firms should carefully evaluate the considerations raised in the diagrams in Annex 1 before making a determination. For a full description of guidance and details on the treatment of these structures, please refer to the guidance section in Annex 1.
- 1.15** These conclusions on whether vehicles are connected or not are based on *typical* structures and the *typical* context of the vehicle's relationship to the firm. So, where atypical features are noted, firms will still need to consider on a case-by-case basis whether or not their vehicles are connected to the firm and should form a GCC. Regardless of whether such vehicles are connected to the firm, the firm will still need to determine if they are part of a GCC with other third-party vehicles to ensure that the total amount of exposures to such entities, whether as a third party or part of a group of connected clients with other third parties, does not exceed the LE limits.
- 1.16** The 'Institutional Exemption' (BIPRU 10.6.32R) allows exposures above the standard 25% LE limit, up to 100% of a firm's capital resources, subject to the total exposure remaining below EUR150m. In addition, there is an 'Institutional Waiver' that allows exposures greater than 100% of a firm's capital resources where the criteria in section 148 of the Financial Services and Markets Act 2000 (Modification or waiver of rules) are satisfied.
- 1.17** BIPRU 10.6.33G states that Article 111(4) of the Banking Consolidation Directive allows the FSA to grant such a waiver on a case-by-case basis in exceptional circumstances. As the Banking Consolidation Directive does not require that such waivers be granted in exceptional circumstances only, we propose to amend the Handbook guidance to reflect this.
- 1.18** We recently processed applications for renewal of the temporary Institutional Waivers that we granted at the end of 2010. We completed this process on the basis that the directive does not require that such waivers are granted in exceptional circumstances only. We now seek to clarify this by deleting the reference to exceptional circumstances from the Handbook guidance.

Who should read this Consultation Paper?

- 1.19** The LE regime applies to banks, building societies and full scope BIPRU firms, and will be of particular interest to such firms and their advisers.

CONSUMERS

This paper focuses on meeting our financial stability objective by reducing the risks that banks and other financial market firms face, and improving confidence and stability in the financial sector in general. This improved stability is expected, in turn, to enhance consumer protection.

Next steps

- 1.20** This consultation will close on 26 April 2012. We will then finalise any changes to the Handbook in light of responses to this Consultation Paper. Subsequent to this, we intend to publish a Policy Statement providing feedback and setting out the finalised rules and guidance.
- 1.21** On publication of the Policy Statement, we expect the final rule changes to come into immediate effect without the use of any transitional arrangements. If firms consider that they may have problems complying with our new rules, they will need to ensure early engagement with their supervisory relationship managers.

2

Policy proposals

Interaction between groups of connected clients and Connected Counterparties

2.1 The FSA definition of connected counterparties is a much broader concept than group of connected clients (GCC) under the CRD, in terms of the circumstances in which it is applied. This is because it refers to counterparties that should be connected to each other directly due to their connection to the reporting firm. In the context of aggregating exposures, the current connected counterparties approach has a wider application than required by the CRD definition of GCC. This is because it covers a wider range of counterparties than those that may constitute a single risk with the firm. Also, exposures to all connected counterparties in aggregation are subject to a 25% limit. While there may appear to be some overlap between the two concepts, it is clear that there are a number of key areas where the definitions differ, which include:

- The requirement to automatically aggregate exposures across all connected counterparties without having to consider the economic interconnectedness and control between the counterparties themselves, and subject them to a 25% LE limit of the firm's capital resources.
- The assumption that, by virtue of having a participating interest or a community of interest or other similar relationships arising out of a share interest that the firm may have, there is a presumption of control and single risk.
- While the definition of connected counterparties includes both aspects of the GCC definition relating to control and economic interconnectedness, there is no explicit requirement to assess whether the existence of either of these result in single risk.

Q1: Do you agree with the areas above where the concepts of groups of connected clients and connected counterparties differ? Are there any additional areas that you think we should give consideration to?

Proposed policy

- 2.2** To address the issues with the definition of connected counterparties and the subsequent application of LE limits, we propose to change the rules in the following way:
- i) Delete BIPRU 10.3.8R (Connected Counterparties) and introduce Handbook guidance that, when considering GCCs, a firm should consider both third-party clients and counterparties that are connected to the firm itself.
 - ii) Include additional guidance on identifying relationships which might be considered to constitute single risk for the purposes of the definition of group of connected clients. Such relationships include:
 - i) where the same persons significantly influence the governing body of each of the undertakings;
 - ii) 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;
 - iii) where it is likely that the financial problems of one counterparty would cause difficulties for the other(s) in terms of full and timely repayment of liabilities;
 - iv) where the funding problems of one counterparty are likely to spread to another due to one way or two way dependence on the same main funding source which may be the firm itself;
 - v) where counterparties rely on the firm for their main funding source, for example through explicit or implicit liquidity support or credit support; and
 - vi) where the insolvency or default of one of them is likely to be associated with the insolvency or default of the other(s).
 - iii) We also propose to change the basis of aggregation of counterparties connected to the firm, so that firms apply the 25% LE limit to groups of entities where there is the presence of single risk between them and, as such, remove the automatic aggregation of exposures to all counterparties connected to the firm.
- 2.3** This clarification will not change the Handbook definition of GCC but the LE requirements will no longer explicitly differentiate between third party entities which are a single risk with each other and entities that are connected to the reporting firm and, as such, should be considered as a single risk to each other and should therefore constitute a GCC.
- 2.4** The guidance on the definition of GCC will make specific reference to counterparties connected to the firm. Unlike the current definition of connected counterparties, the guidance on the definition of GCC will clarify that relationships arising from share interests alone will be included only to the extent that they result in single risk. Where there is a

relationship of control (e.g. where there is ownership of more than 50% of shares/voting power), there will be a strong presumption of single risk unless otherwise shown.

- 2.5 In respect of the economic interconnection limb of the GCC definition, there will be a requirement to determine whether entities are economically interconnected with each other due to their interconnection with the firm. As is set out in the CEBS guidelines, this will include consideration of reliance on the same funding sources.
- 2.6 The LE limit of 25% of capital resources for non-trading book exposures to a firm's connected counterparties, as required in BIPRU 10.5.6R (3), will be removed. Instead the LE limits for exposures to GCC will apply to those entities that are connected to each other by virtue of being connected to the reporting firm (via two-way causalities). This will mean that the 25% LE limit will now apply to a client or a GCC, where GCC will now also include entities deemed as 'connected' to the reporting firm.

Q2: What are your views on the proposed changes? Do you agree with the approach to delete the definition of connected counterparties in BIPRU 10.3.8R and the corresponding LE limit currently applied to it in BIPRU 10.5.6R?

Q3: Do you agree with the approach to provide guidance under the group of connected clients definition in BIPRU 10.3.5R which would clarify that this should also include counterparties that should be deemed as single risk due to their connections with the reporting firm?

Treatment of exposures to entities in which the firm has a share interest

- 2.7 Participating interests and other similar equity stakes do not necessarily result in control. As set out in the rule changes, we propose to clarify that within the definition of GCC, unlike in the current definition of Connected Counterparties, there will no longer be an automatic connection as a result of the reporting firm holding a participating interest in the entities concerned or there being a community of interest relationship. Instead, relationships arising from share interests alone will be included only to the extent that they result in single risk. Where there is a relationship of control (e.g. where there is ownership of more than 50% of shares/voting power), there will be a strong presumption of single risk unless otherwise shown.
- 2.8 Therefore we propose that firms should be required to consider whether single risk exists as a result of control or economic interconnectedness between the reporting firm and the counterparty (i.e. the entity in which the firm has a equity stake) or as a result of control/ economic interconnectedness between the counterparties themselves.

- 2.9** This policy change will mean that equity stakes such as participating interests will no longer automatically be considered as constituting single risk and connected to the firm by virtue of being part of a GCC. Therefore they will not be subject to an automatic aggregation of all exposures but they may be regarded as constituting different groups of connected clients where appropriate.
- 2.10** Also, once the firm has considered whether there is a relationship of control in respect of counterparties in which the firm has a share interest, the firm will need to continue to assess whether there is economic interconnectedness between the counterparties. In determining whether these counterparties should be seen as a single risk due to economic interconnectedness, a broadly similar approach can be taken as that being proposed for structured finance vehicles. Specifically, the firm will need to consider whether there is a one way or two way causality of financial distress, whereby if the firm (or counterparty in which the firm has a share interest) faces financial difficulty, then the counterparty (or firm) is likely to also face financial difficulties.

Q4: Do you agree with the proposed treatment of participating interests and other equity stakes?

Institutional waivers

- 2.11** The ‘Institutional Exemption’ (BIPRU 10.6.32R) allows exposures above the standard 25% LE limit, up to 100% of a firm’s capital resources, subject to the total exposure remaining below EUR150m. In addition, there is an ‘institutional waiver’ that allows exposures greater than 100% of a firm’s capital resources where the criteria in section 148 of the Financial Services and Markets Act 2000 (Modification or waiver of rules) are satisfied.
- 2.12** BIPRU 10.6.33G states that Article 111(4) of the Banking Consolidation Directive allows the FSA to grant such a waiver on a case-by-case basis in exceptional circumstances. As the directive does not require that such waivers be granted only in exceptional circumstances, we propose to amend the Handbook guidance to reflect this.
- 2.13** We recently processed applications for renewal of the temporary institutional waivers that were granted at the end of 2010. We completed this process on the basis that the directive does not require that such waivers are granted in exceptional circumstances only. We now seek to clarify this by deleting the reference to exceptional circumstances from our Handbook guidance.

Q5: Do you agree with the proposed Handbook amendment to clarify that the Banking Consolidation Directive does not require the FSA to grant ‘institutional waivers’ only in exceptional circumstances?

3

Guidance for the treatment of structured finance vehicles

CEBS guidelines

- 3.1 The CEBS guidelines were drafted to ensure harmonised implementation of the revised LE regime that came into place on 31 December 2010.
- 3.2 The guidelines are intended to clarify the CRD definition of ‘group of connected clients’ (GCC). Under the CRD, the grouping together of clients is based on the existence of single risk between the clients, which can be evidenced through either a control relationship or an economic dependence relationship. The CEBS guidelines clarify the identification of connections between clients for the purposes of applying the LE limit.
- 3.3 CEBS usefully provides a non-exhaustive list of indicators of control that will help firms identify control relationships. If there is a relationship of control there is a strong presumption of single risk. When considering economic interconnectedness, even without control of one client over another, a reporting firm is required to determine whether a relationship of economic dependence exists between clients. If it is likely that the financial problems of one client would cause funding and repayment difficulties for the other(s), there exists a single risk that needs to be addressed. An economic dependency between clients may be mutual or only one way. CEBS provides examples that illustrate possible dependencies between clients, which should cause firms to carry out further investigations regarding the need to group the clients in a GCC.
- 3.4 One of the key considerations when assessing for single risk between clients, is whether the clients are connected through a common main source of funding and, as such, CEBS provides guidance on cases where the clients should (or should not) be considered as connected because of funding relationships.
- 3.5 It follows from the control limb of the GCC definition that exposures to entities within the same group as the reporting institution are to be regarded as a single risk. Although all entities within the same group are connected clients, exposures to some or all of them may

be exempted from the LE regime in accordance with the Member State's implementation of discretions relating to intra-group exposure exemptions.²

- 3.6** The CEBS guidelines should be considered by firms when assessing counterparties that are connected to the firm itself. This applies to structured finance vehicles such as ABCP conduits, mortgage and credit card master trusts, covered bonds, commercial mortgage backed securities, collateralised loan obligations, and certain other standalone securitisation vehicles. These are entities where the firm may have originated the assets and/or the firm sponsors these vehicles and is providing ongoing support.

Q6: Do you agree with our approach to apply the CEBS guidelines to entities which are connected to the firm?

Guidance for the treatment of structured finance vehicles

- 3.7** We propose to introduce a guidance paper, including decision trees, which sets out how firms should determine if their structured finance vehicles form groups of connected clients due to their interconnections with the reporting firm. This guidance is based on the typical features and prevalent forms of structured finance vehicles for which firms that are regulated by the FSA act as originator or sponsor.
- 3.8** Based on the application of the proposed Handbook rule changes, a firm will need to assess whether the structured finance vehicles that it sponsors, or those that hold assets originated by the firm, should be considered as connected to the reporting firm. Firms will need to assess whether this counterparty should form a GCC with other counterparties to which the firm is also connected. In this assessment, firms will need to consider:
- potential control relationships between the firm and these structured finance vehicles, which result in the relationship between the counterparties constituting a single risk, i.e. in all scenarios where financial distress is experienced; or
 - potential relationships of economic interconnection between the firm and these structured finance vehicles, which may result in coincidental financial distress of those counterparties, in the majority of scenarios where financial distress may be experienced.
- 3.9** As is also set out in the CEBS guidelines, the firm will need to consider the different directions or pathways of causality. This is specifically the determination of the causality of financial distress from:
- 'vehicle to firm';

² See www.esa.europa.eu/documents/Publications/Standards---Guidelines/2009/Large-exposures_all/Guidelines-on-Large-exposures_connected-clients-an.aspx, Paragraph 35.

- ‘vehicle to vehicle’, which is useful in assessing whether there is a transmission of financial distress from vehicle to vehicle via the firm itself; and
 - ‘firm to vehicle’.
- 3.10** Upon determining which exposures should be regarded as exposures to entities connected to the firm, the firm will need to assess if and how exposures to these ‘connected’ entities will be aggregated together to form a GCC and subject to a 25% LE limit.
- 3.11** Annex 1 provides a detailed version of the proposed guidance paper. This includes specific considerations and guidance on the following structured finance vehicles:
- i) ABCP Conduits;
 - ii) Master Trusts;
 - iii) Covered Bond LLPs;
 - iv) Residential Mortgaged Backed Securities (RMBS);
 - v) Commercial Mortgaged Backed Securities (CMBS); and
 - vi) Collateralised Loan Obligations (CLO).
- 3.12** The Guidance Paper is not intended to be exhaustive and as such we require firms to continue to assess on a case-by-case basis if and how their structured finance vehicles should be regarded as connected to the firm and therefore whether they should form groups of connected clients.
- 3.13** The following questions relates to the guidance paper in Annex 1:
- Q7:** What are your views on the considerations made as to whether the named structured finance vehicles in 3.11 should be regarded as connected to the firm or not?
 - Q8:** Do you agree with the determination made about whether the structured finance vehicles are connected to the reporting firm or not? If not, then please provide explanations.
 - Q9:** Are there any areas which are unclear and require further clarification?
 - Q10:** What are your views on the decisions trees provided?

Consequential changes

3.14 There are a number of consequential amends that we will need to consider as flowing from the deletion of connected counterparties in BIPRU 10.3.8R. This includes:

- trading book limits – the ability to increase trading book limit to 500%, a commitment to revisit in due course and changes to CNCOM charge calculation; and
- regulatory reporting – changes to the data item guidance.

Annex 1

Guidance for the treatment of exposures to structured finance vehicles

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 guidelines¹ 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.

¹ See www.esa.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

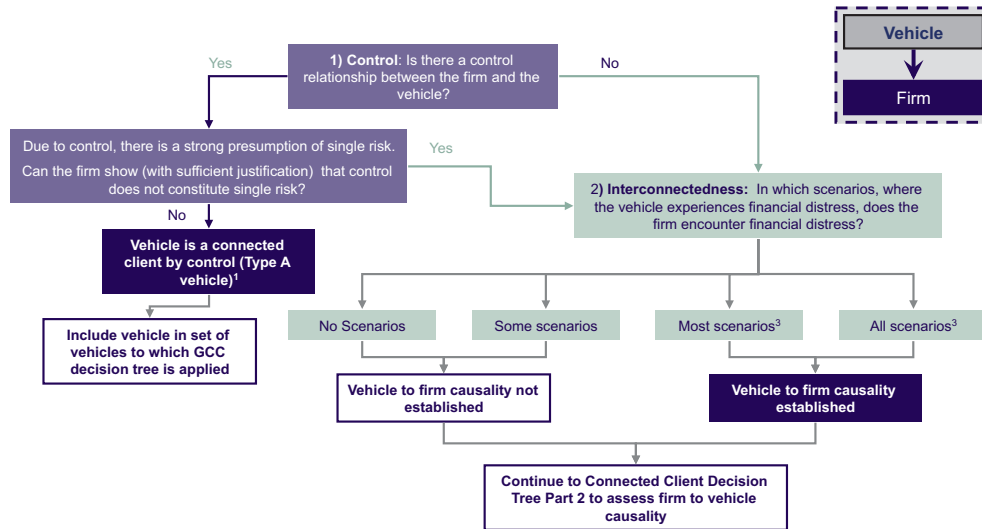
13. In the context of economic interconnection, the CEBS guidelines highlight that the GCC definition is appropriate for use with entities that may be connected:
- i) between themselves but not to the reporting firm; and
 - ii) to the reporting firm itself.
14. The CEBS guidelines highlight that an economic 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 firm. 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. We consider that decision trees are the most appropriate way to capture the approach set out in the CEBS guidelines on the key aspects of control, economic interconnectedness and assessment of the different directions of contagion transmission.
17. The following decision trees ask firms to address the questions arising from the GCC definition by using the following approach:
- i) First, assess whether there is scope for vehicle to firm contagion.
 - ii) Second, assess whether there is scope for vehicle to vehicle contagion. As part of this assessment it is relevant that the transmission of contagion originating in one vehicle to other vehicle(s) may be because the firm itself acts as a mechanism for the transmission of that contagion.

Connected client decision tree: Part 1

Determination of vehicle to firm causality of financial distress

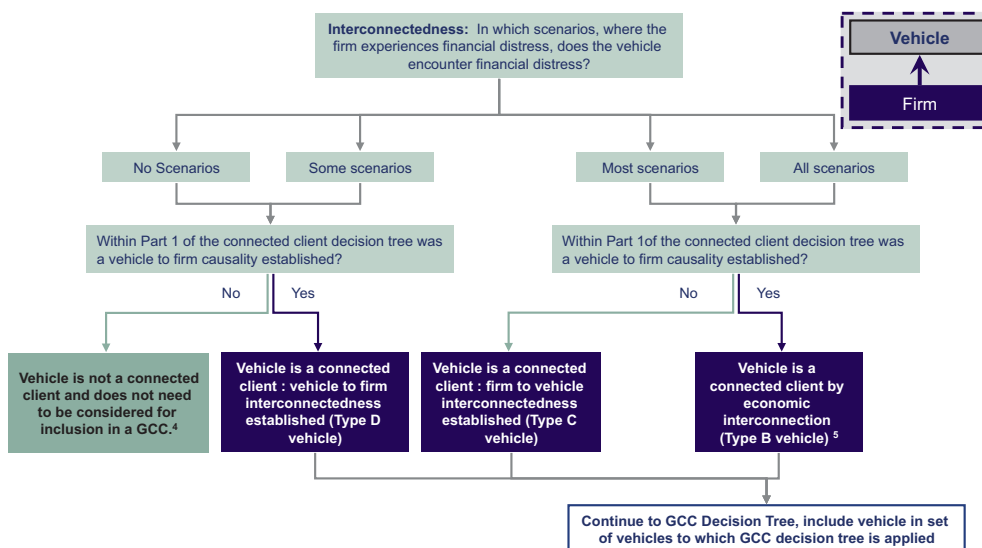


1: Aggregated exposures² to all connected clients falling in the same GCC are subject to the 25% limit in BIPRU 10.5.6 R (large exposure limit)
 2: Computed in accordance with any permitted adjustments per CRD Exclusions (Article 113 (4))
 3: Will require consideration of some probability weighting reflecting likelihood and magnitude of financial impact in such scenarios

18. Therefore, in connected client decision tree: part 1, both limbs of the GCC definition are appraised and, depending on the responses provided, the type of connection established. In order to determine if there is vehicle to vehicle contagion (via the firm), the decision trees incorporate an assessment of firm to vehicle contagion, as captured in the connected client decision tree: part 2.

Connected client decision tree: Part 2

Determination of firm to vehicle causality of financial distress

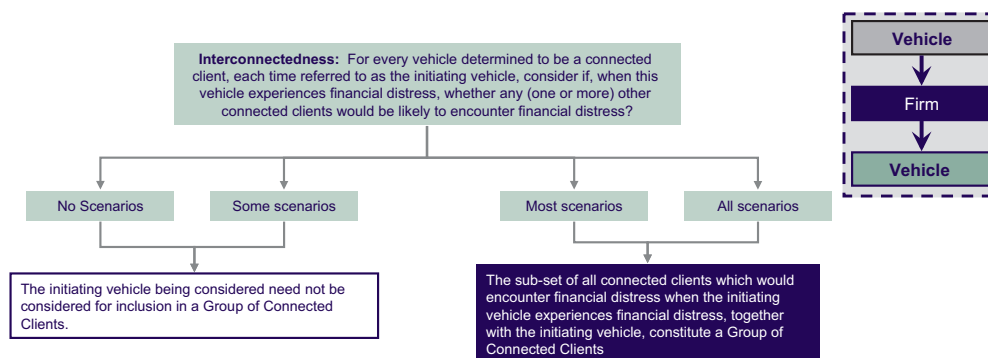


4: Assuming there is a no control relationship between vehicle (e.g. one vehicle having control over another vehicle), where such a control relationship may exist (e.g. through one vehicle holding the liabilities issued by another vehicle) control and/or interconnectedness should be considered.
 5: If vehicle is regulatory consolidated, further consideration can be given to whether the exposure qualifies for the intra-group waiver.

19. Both parts of the connected client decision tree identify the need to assess the extent of coincidence between the scenarios that result in financial distress being experienced and likely to be encountered, under the economic interconnection test.

Group of connected clients (GCC) decision tree

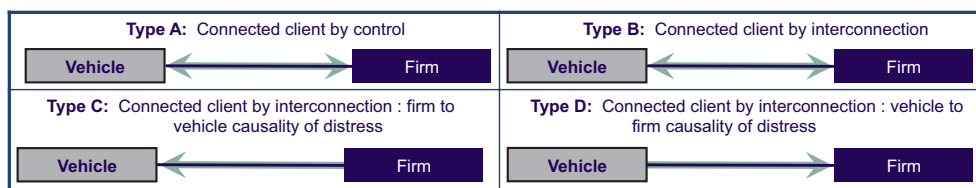
Determination of vehicle to vehicle interconnection via transmission by the firm



20. The notion of different types of connection between the firm and vehicles is established in the connected client and GCC trees above. The type of connection established is essentially dependent on the overlap between the set of scenarios that would see the firm encounter financial distress and the set of scenarios that would see the vehicle encounter financial distress.

Directional links dependent on degree of overlap in common scenarios

Vehicle types



21. 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 approvals² process to identify scenarios in which individual vehicles face funding difficulties and to what degree these overlap with scenarios where:
- the firm itself would face financial difficulties (in determining a connected client relationship); and
 - any other vehicles would also face financial difficulties (in determining a GCC relationship).

² Including among other things credit approval submissions, new business approval processes, franchise and reputational risk process.

Scenarios of financial distress

22. In addition to other considerations, we would anticipate that firms would consider scenarios for vehicles that include:
- i) the credit performance of the assets and asset-liability mismatch/liquidity³ considerations in the underlying portfolio of a vehicle;
 - ii) the tenor of outstanding debt and related frequency of debt refinancing needs;
 - iii) 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);
 - iv) 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;
 - v) the structural features of the vehicle's constitution which may exacerbate deterioration in investor appetite for replacement debt; and
 - vi) operational failures, e.g. servicer failure, collections fraud, etc.
23. 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.

Establishing single risk

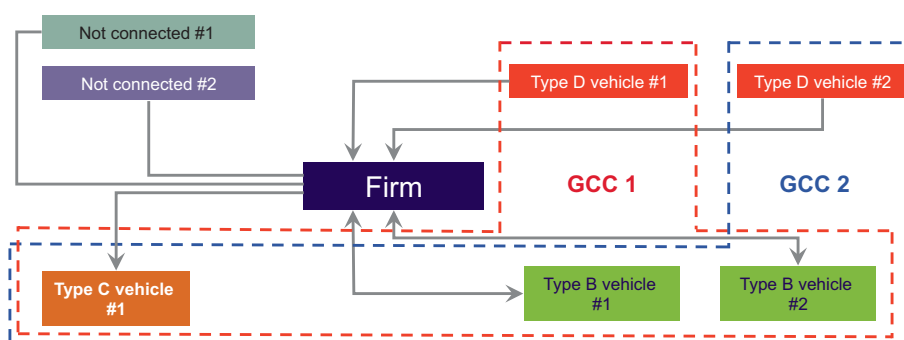
24. Firms should seek to ensure that commonality of other factors is considered. These should include the:
- i) commonality of borrowers and/or sellers (i.e. exposures to a particular borrower or seller of assets, in a vehicle where the firm also has exposures to the same or related borrower/seller on its own balance sheet); and
 - ii) 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.

³ 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.

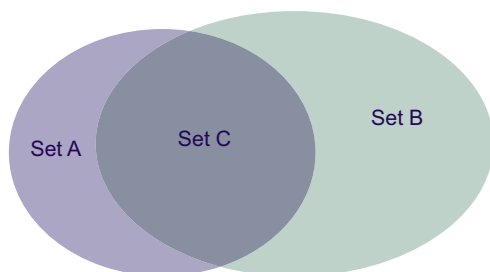
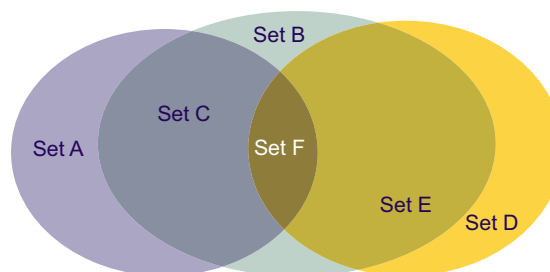
C. Process for aggregation of exposures to Connected Client that are structured finance vehicles

25. Having determined which vehicles are connected clients with the firm, along with the associated direction of contagion transmission, it may be feasible for firms to assume that all connected clients which only have a vehicle to firm causality of financial distress contagion should not fall in to the same GCC as they do not have a common set of scenarios in which they encounter financial distress.

Illustrative application of decision trees



26. Those connected clients that have a firm to vehicle causality of financial distress contagion should be grouped with other vehicles which have any connection with the firm. This approach assumes that the establishment of single risk with the firm naturally results in a single risk with other entities that also have a single risk with the firm. This is not necessarily so, but may be a position that firms are willing to take to avoid having to undertake deeper analysis to demonstrate the differences in scenarios that may cause different vehicles to encounter financial distress.
27. For illustrative purposes, the diagram below looks at the commonality of different scenario sets in order to ascertain connections between two vehicles which would result in the firm regarding exposures to vehicles 1 and 2 as connected client exposures.
28. Diagram 1 illustrates where vehicle one is connected with the reporting firm. Diagram 2 illustrates where vehicle one and vehicle two are both individually connected with the reporting firm.
29. Both vehicles have a one way dependency on the firm, but there is no direct connection between the two vehicles, except in the sample of events illustrated by set C, which shows that the vehicles are connected with each other by virtue of being connected to the firm itself.

Diagram of scenario analysis for CC and GCC determination**Diagram 1****Diagram 2**

30. Key for the diagram above:
- Set A = population of events where vehicle one encounters financial difficulties.
 - Set B = population of events where the firm encounters difficulties.
 - Set C = set of common events where both the firm and vehicle one encounter difficulties (this overlap area represents both exogenous shocks which adversely impact the vehicle and the firm and endogenous shock where the shock affects the vehicle (firm) which in turn precipitates a shock in the firm (vehicle)).
 - Set D = population of events where vehicle two encounters financial difficulties.
 - Set E = set of common events where both the firm and vehicle two encounter financial difficulties.
 - Set F = set of events where the firm and both vehicles encounter financial difficulties.
31. The conclusions in paragraphs 32 and 33 are arrived at by assessing the graphical representation of the different sets of scenarios:
- i) In Diagram 1, Set C (the intersection between Sets A and B) represents more than half (i.e. most) of the scenarios in which vehicle one would encounter financial distress, but less than half (i.e. only some) of the scenarios in which the firm would encounter financial distress. Therefore in accordance with the connected client decision tree: part 1, a vehicle to firm causality is not established, while from connected client decision tree: part 2, a firm to vehicle causality is established (i.e. type C connection).
 - ii) A similar rationale applies to vehicle two (in Diagram 2, for the intersection between Set B and Set D), also resulting in a type C connection.
32. In assessing whether the two vehicles should form a GCC with the firm, there needs to be consideration of the direction of the causality of financial distress.
- i) If vehicle one was to experience financial distress and, consequently, the firm also encountered financial distress (i.e. the overlapping region as represented by Set C), consideration should be given to the proportion of scenarios in which vehicle two also

encounter financial distress (i.e. as represented by scenarios in Set F). The assessment would therefore need to consider what proportion of Set C is represented by Set F. If this overlap set (Set F) captures most of the scenarios that would see the vehicle one and the firm encountering financial distress (i.e. Set C), then exposures to vehicle one and vehicle two should be aggregated in a GCC.

- ii) If a GCC determination has not been established, firms should repeat the analysis, beginning with the situation where vehicle two experiences financial distress, along with the firm encountering financial distress, and assess what proportion of Set E (rather than Set C in the previous consideration) is represented by Set F.
33. In the diagram above, Set F does not represent most of the scenarios that would see either of the two vehicles and the firm encountering financial distress together. This diagram demonstrates that the two vehicles do not constitute a single risk; therefore a GCC will not need to be created.
34. 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

35. Decision trees help to illustrate the process that firms should go through when assessing connectedness. They are, however, not intended to be a list of exhaustive or prescriptive considerations, but should help firms develop an understanding of the types of structural features and behavioural interactions that should be used to determine the existence of connected clients.

D1. ABCP Conduits

Structural features

36. There are a number of primary features of an ABCP conduit that lead us to conclude that they are connected:
- i) A variety of liquidity support mechanisms including, but not exhaustively:
 - i) liquidity facilities;
 - ii) Liquidity Asset Purchase Agreement (LAPA);
 - iii) asset repurchase agreements;
 - iv) total return swaps;

- v) letters of credit; and
- vi) desk commitments to purchase ABCP issued.
- ii) Credit support mechanisms:
 - i) program wide credit enhancements; and
 - iii) 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

37. During the recent crisis period in 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.
38. 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.
39. 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

40. 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. RMBS Master Trusts

Structural features

41. The key structural features of RMBS master trusts that indicate the vehicles could be considered connected clients include:
- i) 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.
 - ii) 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
 - iii) ‘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.
42. 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:
- i) principal deficiency ledgers;
 - ii) 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
 - iii) the self-administering and self-liquidating nature of the assets as reflected in
 - i) the legal maturity of the bonds being set at approximately two years after the longest dated mortgages; and
 - ii) priority of payment directions allowing allocation of asset cash flows to repay the bond liabilities through time.
43. At the legal maturity of the liabilities 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):
- i) 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
 - ii) the comparatively small proportion of assets expected to be outstanding at or about the legal maturity date of the longest dated liability.

Behavioural interactions

44. 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:
- i) the unavailability of replacement funding from the RMBS investor base;
 - ii) 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
 - iii) 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.
45. 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.
46. In the case of RMBS master trusts, which are structured with a step-up and call option available to the issuing vehicles, although the bonds may have a longer 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.
47. 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.
48. 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.

49. Given the above, to arrive at conclusions on whether the RMBS master trusts are connected clients, firm should consider:
- i) statements made by the sponsor to RMBS investors about their intentions to call the bonds on their call option date;
 - ii) 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;
 - iii) 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
 - iv) 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

50. 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.
51. In addition to the softer considerations around call-date versus legal maturity date repayment expectations, sponsors should also ensure their analysis incorporates consideration of:
- i) liquidity facilities (if provided);
 - ii) actions taken by the firms to provide non-contractual top up of reserves (or other forms of credit enhancement) in the master trust; and
 - iii) contractual requirements on the firm to top up reserves (or other forms of credit enhancement) within the RMBS Master Trust.

Conclusion

52. This paragraph summarises circumstances in which RMBS master trust vehicles are likely not to be considered connected clients.
- i) 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:
 - i) the self-liquidating nature of the asset portfolio, which enables it to repay its liabilities by the legal maturity date;
 - ii) 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

- iii) outstanding bonds being repaid in accordance with priorities of payment as outlined at the outset of the transaction.
 - ii) 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.
 - iii) 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).
 - iv) The assets and liabilities of the master trust vehicle are reported on the regulatory balance sheet.
53. 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 LE group.

D3. Credit card Master Trusts

Structural features

- 54. 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.
- 55. Any reserves required in the master trust are typically replenished through the trapping of the excess spread flowing from the assets.
- 56. 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

- 57. 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.

58. Recently, subordinated note tranches have (on a non-contractual basis) been inserted into trusts following deterioration of the underlying assets, and have been subscribed to by the sponsor for such purposes. 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.

Connected Client determination

59. Interaction of sponsor firms in providing credit support to credit card master trusts through mechanisms was not envisaged at the outset of the structures, suggesting that firms are likely to be willing to provide similar support again as needs arise in the future. In considering whether it is appropriate to determine a credit card master trust to be a connected client of the sponsor firm, the decision tree should seek to identify examples of the forms of support provided and how these might result in the likelihood of the credit card master being considered a connected client.

Conclusion

60. 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.
61. 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 this activity has limited (but such activity could lead to a determination that the vehicle is a connected client).

D4. Covered Bond LLPs

Structural Features

62. Covered Bond LLPs (CB LLP) have several features and characteristics that support the conclusion that the LLPs are not connected:
- a) 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.

- b) 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.
- c) The (frequently long) legal maturity date of the bonds, and provisions for the sale of assets to meet upcoming liabilities, 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

63. 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

64. 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

65. 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.
- i) 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.
 - ii) 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.
66. 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

67. 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

68. Sponsor firms are asked to ensure that appropriate consideration is given to historical behaviour for supporting investors in the vehicle and any anticipated future support.
69. In addition to the softer considerations around call-date versus legal maturity date repayment expectations, sponsors should also ensure their analysis incorporates consideration of:
- i) liquidity facilities (if provided);
 - ii) actions taken by the firms to provide non-contractual top up of reserves (or other forms of credit enhancement); and
 - iii) contractual requirements on the firm to top-up reserves (or other forms of credit enhancement) within the RMBS vehicle.

Conclusion

70. This paragraph summarises circumstances in which stand-alone RMBS vehicles are likely to not be considered connected clients.
- i) 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:
 - i) the self-liquidating nature of the asset portfolio to repay rated liabilities by the legal maturity date;
 - ii) 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
 - iii) outstanding bonds are repaid in accordance with priorities of payment as outlined at the outset of the transaction.
 - ii) 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.
 - iii) The assets and liabilities of the vehicle are reported on the regulatory balance sheet.

D6. CMBS issuing vehicles

Structural features

71. 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

72. 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 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

73. The behavioural and structural features discussed should be incorporated in to firm considerations as to the appropriate level of aggregation required between on-balance sheet and securitised commercial mortgages.

Conclusion

74. Typical CMBS issuing vehicles are not likely to be considered connected clients of the sponsor firm, however firms should ensure connected client considerations are addressed in any new structures in the CMBS market. Consequently, unless the sponsor has historically provided non-contractual support to their sponsored CMBSs, it is unlikely that vehicles would be considered a connected client of the sponsor firm.

D7. CLO issuing vehicles

Structural features

75. 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

76. 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 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

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

Conclusion

78. Typical CLO issuing vehicles are not likely to be considered connected clients of the sponsor firm, however firms should ensure connected client considerations are addressed in any new structures in the CLO market. Consequently, unless the sponsor has historically provided non-contractual support to their sponsored CLOs, it is unlikely that vehicles would be considered a connected client of the sponsor firm.

Annex 2

Cost benefit analysis

1. Before proposing new rules, we are obliged under section 155 of FSMA to publish a cost benefit analysis (CBA), unless we consider that the proposed rules will give rise to no costs or to an increase in costs of minimal significance. As a matter of policy, we also provide a CBA for significant proposed guidance relating to rules.

Market/regulatory failure analysis

2. This paper addresses two existing regulatory failures regarding the LE regimes:
 - Some of our current rules regarding LE create an undue burden on firms. Specifically, firms are currently required by our rules and guidance to aggregate some type of exposures regardless of whether these exposures constitute a single risk.¹ As a result, a bank can be unnecessarily constrained to limit its exposures and loses some associated economic benefits (like economies of scale for instance), without any benefit from a reduction in LE risk. The proposed rule and guidance changes on what constitutes a connected counterparty seek to address this regulatory failure.
 - There is also a regulatory failure related to the application of the current LE regime to sponsored structured finance vehicles. The CEBS has developed guidelines on the definition of groups of connected clients (Article 4(45) of the CRD), which provides clarity on what should constitute a single risk, and provides information as to what should be considered to be economically interconnected. As was set out in CP10/17, we introduced a direct reference to the CEBS guidelines as per BIPRU 10.3.8A.G. We have considered that these guidelines should be applicable to both groups of connected clients and connected counterparties. In our discussions with firms, we found inconsistencies in the implementation of the current LE regime regarding exposures to structured finance vehicles and the consideration about whether these should be considered to be connected

¹ E.g. participations and community of interests are defined as connected counterparties and because of this, are aggregated by default with all other exposures defined as connected counterparties. Not all these exposures are likely to represent a 'single risk', i.e. to be interconnected to such a degree with the likelihood that if one of them experiences financial problems, all of them are likely to encounter repayment difficulties.

to the firm by way of ‘connected counterparties’ or whether they should form groups of connected clients. These inconsistencies have prevented some of the benefits of the LE regime to occur. Therefore, we propose guidance to provide some clarification in that field, which would apply in addition to the CEBS guidelines.

3. A summary of proposals is provided in the Overview to this paper.
4. This consultation also seeks to introduce guidance to set out the proposed treatment of a number of different structured finance vehicles within the LE regime.

Scope and markets affected

5. These proposals will apply to all banks, building societies and investment firms to whom the LE requirements apply (see ‘scope of application’ in Chapter 2 of CP09/29, in which we first introduced a reference to the CEBS guideline in the Handbook). Large banking groups are likely to be the most affected by the changes because they tend to have a significant proportion of LE and often have structured finance vehicles in place which they sponsor.

Cost benefit analysis

6. The rules and guidance proposed in this paper will affect the management of LE by restricting or expanding some of the limits of a firm’s lending to its counterparties. We will discuss separately in this section the costs and benefits arising from the policy proposals to embed connected counterparties within the groups of connected clients definition and those from the guidance on structured finance vehicles that should be considered to be connected to the reporting firm and should therefore form different groups of connected clients.
7. In some cases, it has not been possible to estimate the exact costs of the proposals because of the very large variety of firms’ type of exposures and the difficulty on our side to identify the nature of the link between these exposures. In these cases, we have tried as much as possible to establish the relative magnitude of the net benefits or the qualitative trade-offs involved.

Rule changes: deleting the Connected Clients (CC) definition and embedding the concept into group of connected clients (GCC)

Benefits

8. LE are currently limited to 25% of the capital base of the firm. Exposures defined as connected counterparties are aggregated together and their total amount is subject to the 25% capital base limit. With the changes in the handbook, firms will only have to aggregate exposures that form a ‘single risk’, i.e. that are legally or economically

interrelated. This means that the limit of some exposures will increase as a result (potentially up to the 25% LE limit if this exposure is not part of a GCC).

Costs

9. As firms are already required by our current rules to assess the size of their LE and to aggregate them, we believe that these changes will not create any additional costs for firms.
10. The proposed changes are intended to remove regulatory failure around constraining exposures to entities that are not considered to pose a single risk to the reporting entity. We believe for this reason that they will not reduce the benefits of the LE regime disproportionately.

Q11: Do you agree with the above considerations in the cost benefit analysis for the impact of the proposed rule changes?

Guidance on groups of connected clients and the process for aggregating exposures to structured finance vehicles

11. This applies to:
 - i) The treatment of ABCP conduits, which are currently not treated as connected to the firm, but should be due to a clear connection between the failure of the firm and a failure of the ABCP conduit, and as such should form a group of connected clients and be subject to the 25% LE limit.
 - ii) The treatment of all other exposures not currently treated as connected to the firm, but which should be examined as to whether they fall within a group of CCs with other third party exposures because they constitute a 'single risk'.

Benefits

12. This guidance will ensure that the benefits of the LE regime (and of the CEBS guidelines in particular) will be achieved. A better definition of the LE should help firms to reduce the likelihood of the default of a structured finance vehicle, leading to the failure of the firm exposed to it. It will also increase the likelihood of recoveries for UK consumers in the event of such a default occurring.

Compliance costs for assessing CCs and GCCs of structured finance vehicles

13. As the CEBS guidelines have been implemented in 2010², firms should already have some of the necessary processes in place to identify and monitor LE in conformity with the rules and

² Handbook Notice 105, www.fsa.gov.uk/pubs/cp/cp10_17.pdf

guidance we are consulting on.³ However, requiring firms to reevaluate their LE according to the criteria proposed in the paper may lead to incremental compliance costs. These costs may be incurred initially, when the new systems are set up, as well as on an ongoing basis.

14. We estimate that firms will spend approximately 14 man-hours per vehicle to consider whether there is single risk between the firm and each of its vehicles and therefore whether they should be regarded as connected to the firm. Furthermore, we estimate that in terms of the process of aggregating entities together to form groups of CCs and further consideration of single risk between entities, this would involve a further 15 hours per firm. These man-hours are for all functions within the firm, e.g. compliance, legal, front office and back office administration, who would all be involved in this process. Depending on the number of structured finance vehicles each firm sponsors or originates, and depending on where its originated assets are held (across each of ABCP conduits, master trusts, covered bonds, stand-alone securitisations, CMBS, CLOs, etc, or only a subset of these), we estimate a potential additional compliance cost of £95,000 across the industry as a whole.

Costs regarding the guidance for ABCP conduits

15. A firm sponsoring several ABCP conduits will now have to aggregate all its ABCP conduits together to form a group of connected clients. The aggregate amount of exposure to ABCP conduits will be subject to the 25% LE limit of the capital base of the firm. This change will have three effects:
- A direct effect on the ABCP market: the firms sponsoring several ABCP conduits may have to reduce the size of some of their ABCP programs in order to remain compliant with the LE limits.
 - This reduction of the ABCP market may affect:
 - the funding of the markets financed by ABCP conduits: the firms that are using ABCP programs as a funding instrument may have to reduce their activities or find alternative source of funding; and
 - the liquidity of the market for ABCP conduit paper itself.

We have tried to estimate the potential size of these impacts and we discuss our findings in the following sections.

³ We stated in CP10/17 (www.fsa.gov.uk/pubs/cp/cp10_17.pdf) when we first consulted on the implementation of the CEBS guidelines for large exposures that 'firms should in the meantime have due regard to the CEBS guidelines when considering if counterparties form a group of connected clients, in particular with reference to the concepts of control and economic interconnection'. and that they 'should also have due regard to the CEBS guidelines when considering the appropriate counterparty for exposures to schemes with underlying assets'.

Direct impact of the guidance on the firms sponsoring ABCP programs

16. Based on supervisory information, we are aware that some UK banks may need to reduce their exposures to ABCP conduits to be compliant with the 25% limit of their group capital base, and their solo level capital base. This means that these banks may have to make changes to their current short-term funding structure.

Indirect impact of the guidance on the funding of the markets financed by ABCP conduits

17. We have tried to identify the markets financed by these types of conduits. We have used public available data for our analysis.
18. We have applied in our analysis the same proportions that we found in the Standard & Poors' data⁴ regarding the securitised/non-securitised collateral split and to the type of assets funded. Following this hypothesis, we find that approximately £60bn of ABCP commercial paper fund non-securitised assets⁵ and £73bn fund securitised assets, out of the total exposure of £133bn to ABCP conduit that we have identified previously.
19. We have estimated that the £60bn of non-securitised assets financed by ABCB conduits funds mainly two categories of lending:
- UK corporate, CRE and SME lending constitutes around £34bn, i.e. around 6% of the total lending in this segment⁶;
 - All categories of personal lending excluding mortgages in the UK constitute around £22bn, i.e. nearly 25% of the total lending in this segment.⁷ This category includes auto loans, credit cards, student and consumer loans and other smaller categories. In this segment, ABCP conduits also buy a small part of already securitised assets, which mainly include credit card ABS (around GBP3bn).
20. Firms using ABCP for their financing in these two markets will adjust to the reduction of the exposure from banks to ABCP conduits by reducing their lending or by compensating the reduction in funding from ABCP by the use of alternative forms of securitization or funding, or by responding with a mixture of both.
21. Because of the many alternative types of funding, and parameters influencing this type of decision, we have not been able to estimate the consequential changes in behaviours by firms in terms of their funding methods. However, we have tried to consider how firms may fund assets using other types of structured finance vehicles, and how could this affect their funding costs.

4 S&P have rated a large part of CP issued by UK ABCP conduits (GBP62 billion),

5 These are likely to consist of multi-seller conduit ABCP; i.e. conduits that fund lending in the "real economy", as opposed to ABCP used specifically for arbitrage.

6 Source: BoE, AFME, JP Morgan, FSA banking specialists' calculation.

7 Source: BoE, AFME, JP Morgan, FSA banking specialists' calculation.

22. For instance, instead of funding credit card loans via ABCP, firms could use master trust vehicles. The European ABCP funding cost is at the time of writing (mid 2011) circa 5-15 bps over Libor. Auto ABS currently fund at 65bps over Libor (for three-year AAA), while credit card ABS currently fund at 120bps over Libor (for five-year AAA). Consequently, using only a point-in-time comparison, the funding cost increase for auto lending that must move from conduits to the public securitisation market is approximately 50-60 bps, while for credit cards it is approximately 105-115 bps.

Indirect impact of the guidance on liquidity of the market for ABCP conduit paper

23. We have also tried to estimate if the requirement for firms to reduce their exposures to within the 25% LE limit could also have an impact on the liquidity of this market itself, as opposed to the impact on the underlying assets that are typically funded by this market.
24. By way of analogy, i.e. when seeking to assess the impact of market size on market liquidity in the securitisation sector, a read-across from the UK credit card ABS sector to the ABCP sector, could be made. The size of the UK credit card ABS market, after the crisis, reduced significantly, down to £7.7bn in December 2010. This was probably its lowest point in terms of total bonds outstanding, after which it subsequently increased in size due to renewed issuance. Nonetheless, the UK credit card ABS market has continued to be one of the most liquid segments of the securitisation market (together with RMBS and Auto ABS). This is due to the short-dated, floating-rate, fast-amortising nature of the bonds issued.
25. Consequently, we believe that a further reduction of the size of the ABCP market as a result of this guidance may not necessarily have a negative impact on the liquidity of the ABCP market. This is because commercial paper issued by ABCP conduits is an extremely short-dated paper (essentially a 30-90 day discount paper, and so even shorter than UK Credit Card ABS), and is generally held to maturity, rather than held for secondary liquidity and trading. This cannot be definitively stated, however, as the true outcome would depend on the reaction of the market participants, which cannot be predicted in advance.

Q12: Do you agree with our assessment of the various impacts of the guidance for ABCP conduits? Are there any other considerations to make in terms of the impact of the proposed guidance?

Costs regarding the guidance for all other exposures to structured finance vehicles

26. Some firms might have to consider how this guidance might impact on future funding arrangements if they find that some exposures (for instance to master trusts) should have been included in a GCC and exceed 25% of the capital base.

Q13: Do you agree with our assessment of the impacts of the guidance for all other exposures to structured finance vehicles? Are there any other considerations to make in terms of the impact of the proposed guidance?

Annex 3

Compatibility statement

1. This section sets out our assessment of the compatibility of the proposals outlined in this Consultation Paper (CP) with our general duties under Section 2 of FSMA and our regulatory objectives.

Compatibility with our regulatory objectives of market confidence and financial stability

2. The LE rules aim to take account of our regulatory objectives of market confidence and financial stability. The modifications to the prudential sourcebook for banks, building societies and investments firms (BIPRU) as well as the guidance on which we are consulting aim to clarify the existing LE rules and enhance our achievement of these regulatory objectives.
3. Our draft handbook changes and guidance seek to reduce the risk of market disruption arising from the financial failure of structured finance vehicles that could affect the financial stability of regulated firms or could exacerbate existing financial difficulties of such firms.

Compatibility with our other regulatory objectives

4. The guidance is not directly related to the objectives of securing the appropriate degree of protection for consumers (even if our proposal could contribute to it indirectly, by increasing reducing the probability of failure of a BIPRU firm), or reduction of financial crime. We do not believe that the proposals are incompatible with those objectives.

Principles of good regulation

5. Section 2(3) of the Financial Services and Markets Act 2000 (FSMA) requires that, in carrying out our general functions, we should have regard to the principles of good regulation. The most relevant principles in the context of this CP are set out below.

Efficiency and economy

6. Firms are currently required to report all large exposures and connected counterparties. The proposed rule changes and guidance should reduce ambiguity when firms identify groups of connected clients and therefore make compliance with the rules easier and reduce our level of oversight required to ensure compliance with the LE requirements.

Proportionality

7. The cost and benefits associated with the rule changes are outlined in Annex 2 of this CP. We believe that the benefits to the wider economy and the potential impact on financial stability is proportionate to the burden or restriction that will be imposed on some firms as a result of the implementation of the proposals in the CP.

Competition

8. In our discussions with firms, we found inconsistencies in the implementation of the current LE regime regarding exposures to structured finance vehicles and the consideration about whether these should be considered to be connected to the firm by way of ‘connected counterparties’ or whether they should form groups of connected clients. The proposed changes and guidance should ensure consistent application of the LE requirements across the industry, removing any potential unfair advantages that are currently occurring in the industry.

Equality and diversity

9. We have assessed the equality and diversity impacts on our proposals. We believe that there are no equality and diversity implications. However, we would welcome any comments that respondents to the consultation may have.

Annex 4

List of questions

- Q1:** Do you agree with the areas above where the concepts of groups of connected clients and connected counterparties differ? Are there any additional areas that you think we should give consideration to?
- Q2:** What are your views on the proposed changes? Do you agree with the approach to delete the definition of connected counterparties in BIPRU 10.3.8R and the corresponding LE limit currently applied to it in BIPRU 10.5.6R?
- Q3:** Do you agree with the approach to provide guidance under the group of connected clients definition in BIPRU 10.3.5R which would clarify that this should also include counterparties that should be deemed as single risk due to their connections with the reporting firm?
- Q4:** Do you agree with the proposed treatment of participating interests and other equity stakes?
- Q5:** Do you agree with the proposed Handbook amendment to clarify that the Banking Consolidation Directive does not require the FSA to grant 'institutional waivers' only in exceptional circumstances?
- Q6:** Do you agree with our approach to apply the CEBS guidelines to entities which are connected to the firm?

- Q7:** What are your views on the considerations made as to whether the named structured finance vehicles in 3.11 should be regarded as connected to the firm or not?
- Q8:** Do you agree with the determination made about whether the structured finance vehicles are connected to the reporting firm or not? If not, then please provide explanations.
- Q9:** Are there any areas which are unclear and require further clarification?
- Q10:** What are your views on the decisions trees provided?
- Q11:** Do you agree with the above considerations in the cost benefit analysis for the impact of the proposed rule changes?
- Q12:** Do you agree with our assessment of the various impacts of the guidance for ABCP conduits? Are there any other considerations to make in terms of the impact of the proposed guidance?
- Q13:** Do you agree with our assessment of the impacts of the guidance for all other exposures to structured finance vehicles? Are there any other considerations to make in terms of the impact of the proposed guidance?

Appendix 1

Draft Handbook text

**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 [*date*].

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.

Citation

- F. 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
[*date*]

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 counterparties</i> 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 counterparties</i> 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 connected counterparties counterparties</i> <u>falling within <i>BIPRU 10.10A.1R</i></u> , 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:

(1) ...

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(ies) 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-ebis.org/Publications/Standards-Guidelines/CEBS-Guidelines-on-the-revised-large-exposures-reg.aspx- Part I](http://www.c-ebis.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 [insert link on FSA website]. Counterparties that are connected to the firm itself may also be identified in accordance with the decision trees in BIPRU 10 Annex 3 (Decision trees for identifying structured finance vehicles as connected counterparties).

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

...

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
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: t~~Trading book limits

Application

10.10A. R This section only applies to *exposures* in a *firm's trading book* to ~~its~~
1 ~~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. G In deciding whether a transaction is at arm's length for the purposes of
1A *BIPRU* 10.10A.1R(1)(d), the factors set out in *BIPRU* 10.3.14G should be taken into account.

Trading book limits

10.10A. R *Exposures* in a *firm's trading book* to ~~its connected counterparties~~
2 *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*;

...

10 **Identification of groups of connected clients: decision trees for structured**
Annex 3 **finance vehicles**

[To be added] [Please refer to the decision trees in Annex 1 Guidance on the treatment of exposures to structured finance vehicles]

Transitional provisions and schedules (BIPRU transchedule)

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.

PUB REF: 002834

The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: www.fsa.gov.uk

Registered as a Limited Company in England and Wales No. 1920623. Registered Office as above.